Entering A Higher Grade—Proposals to Reform Russia's Education System
by Stephen P. Heyneman

Reform of Russia's education system affects 33.6 million young people, from preschoolers to Ph.D. candidates. It also affects some 54 million parents and 5.7 million teachers. Those 93.3 million citizens represent roughly 63 percent of the population in the Russian Federation.

Russia's school system presents many contradictions: On the one hand, basic education is available to all children; the labor force is literate; females constitute an equal proportion of higher education students; and international comparisons of academic achievement, when aggregated, continue to demonstrate higher average skill levels in science and math in Russia than in many OECD (Organization for Economic Cooperation and Development) countries.

On the other hand, educational successes of the past were linked to the skill requirements of a centrally planned economy, not to the demands of an unplanned labor market and an open society. Capital investments in education have been declining for two decades. Buildings have deteriorated, libraries are antiquated, and laboratory equipment is becoming unusable. Applications to postcompulsory education have declined by an average of 11 percent in the past two years, the dropout rate is increasing, and young people are leaving school earlier. The quality of the human capital base in Russia is declining.

Challenges to reform

• Less money is assigned for education as the economic decline continues (real GDP has dropped by about 40 percent between 1991 and the first quarter of 1994). The proportion of GDP Russia allocates to education has declined from 7 percent in 1970 to 3.4 percent in 1992. Comparative international figures include the United States, which allocates 5.5 percent; France, 5.4 percent; and the United Kingdom, 5.3 percent. Between 1991 and 1992, spending (in real terms) on compulsory education (involving el-
Kindergartens and nurseries, traditionally financed by both local authorities and state-owned enterprises, experienced a 35 percent drop in (per capita) expenditures between 1991 and 1992. The facilities have been hard hit by the decline in public education spending and the shift of financing from state-owned enterprises to municipalities and rayons. Parents are increasingly asked to provide some of the funding. Their contributions in fees now represent up to 20 percent of average recurrent expenditures per child, but are still not enough to offset the decline in enterprise contributions.

The mandatory primary and secondary education system (see page 5) is trying to cope with simultaneous expenditure declines and price increases. Investment, especially for physical infrastructure, has become scarce, while costs have shot up, especially for utilities and food services. The school system has tried to maintain expenditures for the bare essentials: wages and benefits, stipends, food, and utilities. (While teachers' wages have increased, they have not kept pace with other sectors in the economy. As a result, the best-qualified teachers are leaving the profession.) Textbooks, pedagogical equipment, official travel, educational activities, medicine, clothing, and capital investment and repairs (on buildings, equipment, and libraries) have received lower priority. Further reductions in these nonsalary items will weaken educational effectiveness.

Vocational schools and polytechnics frequently have been set up and sponsored by local state enterprises, and occasionally have been located on enterprise property. This support is waning. New, private sources of financing are growing, but are nowhere near the level necessary. Labor markets are shifting according to local demand but policy for professional education is, by and large, still determined in Moscow. Many professional institutions are still linked to state enterprises that are either stagnating or restructuring and can longer use their graduates.

Universities and colleges have been under the financial control of the State Committee for Higher Education, the Ministry of Education, Health, Culture, and Agriculture, and 16 other sectoral ministries. Currently, 15 to 20 percent of students are paying tuition fees, but this represents only 2 to 3 percent of total expenditures. (Regional authorities are beginning to finance local universities and colleges, and are demanding institutional accountability for resource use and relevance to local labor markets. Universities are establishing private businesses, renting spaces, engaging in consulting work, and selling services or products.)

**Fiscal responsibilities have been transferred to 89 regions**, but fiscal relations between the federation and the regions remain ambiguous, responsibilities overlap, and financing is inefficient. The 1992 Education Law delegated managerial responsibility to schools involved in compulsory education. School finance has been entrusted to regional- and rayon-level authorities. Nonetheless, the federal government still designs and distributes reading materials, licenses teachers, establishes norms for classroom space and equipment, and sets the requirements for instruction in Russian language, sciences, and math, trying to maintain standards by imposing curriculum authority vertically. Yet federal authorities have little or no responsibility in humanities, history, civics, and the social sciences, areas of curriculum critical for citizenship in a democracy. Neither the schools nor the local authorities can perform their assigned functions effectively as long as these discrepancies remain.

**The market economy requires new skills.** The school system should shift its emphasis to meet the new demand for creativity and innovation in teaching and learning, to orient engineering and technical skills away from defense and heavy industry and toward civilian and commercial sectors, and to upgrade and expand the humanities and social sciences curricula.

Russia's curricular traditions are ill-suited for an economy where a premium is placed on problem solving and occupational flexibility. Soviet curriculum tended to emphasize the acquisition of factual material and to underemphasize the skills necessary for applying this material to unfamiliar circumstances—in other words, problem-solving skills. This is illustrated in national samples of the science and mathematics performance of thirteen-year-olds in 19 countries.

Russian studies demonstrate that, although performance in general in the former Soviet Union (FSU) is well above the average, it declines relative to the performance of children in OECD countries the more the students are asked to apply their knowledge to circumstances not in the standard curriculum or textbook. Conversely, in a number of high-performing OECD countries students perform least well on memorization of
factual material and best on application to unforeseen circumstances.

- **Decentralization requires timely, accurate, accessible, and relevant statistical information.** But the current statistical system is hierarchical, access to information is difficult, and information coverage is inadequate. There are no regular statistics on learning achievements, employment trends, or the relationship of costs to outputs.

- **Educational inequality increases.** According to the Education Law of 1992, education is available, free of cost, to all Russian citizens regardless of gender, race, ethnicity, social background, or party affiliation. In the past, this was enforced through input norms for curricula, educational materials, teacher salaries, and qualifications, and pedagogy that were standardized across the country. The parameters of citizenship—what made the "Soviet person"—were defined by the communist party through the Academy of Pedagogical Sciences.

  The new legislation sanctions diverse types of schools, instructional methods, and educational materials. It has placed the teacher, the school director, and parents in charge of choosing curricular emphases and appropriate pedagogy. Decentralization of school finance and school administration further differentiates available resources across and within regions. Sixteen of the country's 89 regions now spend more than one-third more per student in compulsory education than do the 18 regions at the bottom of spending on schools.

  **Suggested adjustments**

  1. **Coherence between federal and regional responsibilities**
     - **Curricular authority.** Federal authorities should be responsible for overall performance standards of school leavers. Regional authorities should decide what to emphasize in the curriculum according to local standards and requirements. Schools should be responsible for choosing subject specializations and pedagogical styles appropriate for particular students.
     - **Preparation for professions.** Professional training should be financed based on the ability of graduates to locate employment. Institutions that cannot restructure or eliminate unproductive programs should be closed.

  2. **Fiscal adequacy and stability**
     - **Curricular authority.** Schools should be financed according to identical nonsalary per capita expenditure norms, leaving the schools considerable discretion on how to allocate that money year by year. Local management of education should involve ownership shift of educational property and facilities to rayons, municipalities, and regional authorities. This would facilitate raising extra capital from the market and encourage further liberalization of the system.

  Redistribution of the financial burden among federal and local authorities would require the federal government to finance, at a minimum, about 50% of Russia's most specialized Ph.D.-granting universities, as well as educational research and quality control systems. The equalization mechanism for interregional expenditures needs to be strengthened. Federal matching-grant programs could be used to encourage the adoption of federally mandated reforms. Private expenditures (households, private nonprofit institutions, and business corporations) could add as much as 20% percent to existing public rayon and district expenditures.

  3. **Efficiency in management**
     - The budgeting process needs to shift toward economic efficiency criteria, and

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**Russian University Programs—Closer to Market Place**

If Russia's regional authorities are to both finance and manage some parts of higher education, the tax base should be stabilized and the necessary local infrastructure developed. However, federal authorities must continue to be involved in some higher education finance and management. Federal assistance for higher education education would go to efficient institutions, and to students who otherwise could not afford higher education.

This assistance would match the financial assistance provided by regional authorities in support of interinstitutional programs and facilities (integrated libraries, laboratories, upgraded dormitories and classrooms).

National programs should link regional university libraries and facilities to the electronic superhighway for better communication, with facilities in Moscow and outside Russia.

Federal money should also support efforts in health, education, and agriculture to develop new professional programs in collaboration with independent institutions such as the National Training Foundation.

The World Bank last December approved a $40 million loan to Russia to shore up market-oriented training programs in management, accounting, auditing, banking, and public finance. The programs will be implemented through the National Training Foundation. The money will serve to acquire and develop curricula and teaching materials, organize and deliver media programs for distance education (including communications equipment), and train instructors.
away from planning according to fixed inputs, such as space standards, numbers of desks, and books per student. Ways of increasing efficiency include diversifying sources of finance (such as donations, fund raising, revenue generation through sale of services and rental of facilities, user charges, and cost sharing), reducing staff, eliminating functions and closing down institutions and programs, and monitoring the absorption of graduates, in order to make budget allocations based on the ability of a program to place graduates.

Different regions need different efficiency answers. Options will need to be tested and decided locally. Managers will need considerable autonomy to make use of discretionary (untied) resources in making and implementing the necessary choices. To measure, monitor, and interpret progress, managers, technical specialists, and decisionmakers will require new training programs, as well as new university programs and in-service training.

4. Equal educational opportunities

The public sector has to ensure that schools are geographically accessible, affordable to the poor, and equipped with educational resources that meet a minimum standard, and that they deliver a curriculum that does not handicap a child's access to higher education. This process could be promoted by a fair, affordable, and enforceable mechanism of compensatory finance both between and within regions (utilizing the interregional equalization mechanism introduced in the 1994 budget), and an objective and efficient mechanism to administer selection to higher education. For example, admissions should be based on tests that can be administered anywhere in Russia.

The author is head of the World Bank's Human Resources and Social Development team.

**EDI Disseminates Transition Know-How**

The traditional Soviet education system offered little, if any, exposure to modern economics and public policy, and neglected applied research entirely. To help policymakers and teachers obtain more broadly based knowledge and skills, including exposure to the principles of modern economics, the World Bank's Economic Development Institute (EDI) initiated a program, "The Economics of the Market," in 1992. Since then, EDI has built a strong network of local trainers who go on to train government officials.

The training of trainers (TOT) program conducts four regional preparatory courses. The best 40 participants are then invited to attend the main course in Washington. This cycle runs twice annually. By the end of 1994, the total number of participants had reached almost 5,000. (See "EDI Training Program in the FSU," *Transition*, January 1994, p. 18.)

The Washington curriculum covers macro- and microeconomics, the economics of transition, and statistics/econometrics. Specific topics include public and welfare economics, general equilibrium models, international trade theory, cost-benefit analysis, fiscal federalism, and fiscal decentralization; economic decline during transition; reform of the financial and banking systems; and privatization, property rights, and enterprise adjustment. During a five-day workshop, conducted by the IMF, the participants design a stabilization program, outline a case study, and make policy decisions in an assumed transitional economy. In the final stage they test their newly acquired skills by designing a training program for government officials tailored to the specific needs of their respective countries.

The "Autumn School '94—Economics of the Market" (already the fifth in the series on the training of trainers) offered a demanding eight-week course in Washington, D.C., to 37 teachers and trainers, who represented universities and training institutions from nine countries (Azerbaijan, Belarus, Kazakhstan, Kyrgyzstan, Russia, Tadjikistan, Turkmenistan, Ukraine, and Uzbekistan). Two trainers from China, who attended as observers, will assist the EDI in implementing courses for government officials in the Central Asian republics and other Asian economies in transition.

During 1995-96, EDI will offer additional training courses, including:

- Accounting and Financial Management (one week)
- Basic Accounting and Corporate Finance for Practitioners (one week)
- Agricultural Project Analysis—Training of Trainers for Central Asia (nine weeks)
- Business Planning and Restructuring for Practitioners (two weeks)
- Banking and Investment Financing for Practitioners (two weeks)
- Enterprise Management for Restructuring and Privatization Training of Trainers (seven modules, each from one week to one month)
- Macroeconomic Training for Government Officials (four weeks)
- Project Management Follow-on Training for Trainers, Russia (six weeks)
- Project Management Training for Trainers, Ukraine (11 weeks)
- Procurement Training for Trainers, Russia (three weeks)
- Social Sector Project Analysis
- Social Sectors in the FSU
- Real Estate Appraisal (two to three weeks)
- Transport Management Training
- Urban Land Use Planning and Development in CIS Countries (two weeks)
- Joint Vienna Institute Introductory Course in Market Economics and Financial Analysis (9-13 weeks)

For more information: Economic Development Institute, Moscow, Ogareva 5, Building 3, 3rd floor; Moscow, Russia, tel. (7095) 956-2167/7, fax (7095) 956-2162/3; or EDI, World Bank, 1818 H Street, N.W., Washington, D.C. 20433, USA, Ms. Nubia Lopez, Room M-3025, tel. (202) 473-6463, fax (202) 676-0838.
Russia's School System

Adult Education (40% of the population)

Older than 17
- 20%
- 5%
- 15%

5% Do not continue studies after secondary school

Higher Institutions (35%)

Secondary Vocational Schools (30%)

Vocational Schools (60%)

10% Do not continue studies after secondary school

Age

15-17
- 5%
- 10%
- 30%

10% 15% 20% 10%

55% complete studies in the same school

45% continue studies in other schools

Basic Secondary School (100% participation)

Elementary School (100% participation)

65% enter school at age 7 and take a 10-year course

35% enter school at age 6 and take an 11-year course

10% take grade one in preschool at age 6

20% enter elementary school at age 6 after preschool

45% enter elementary school at age 7 after preschool

10% take grade one in preschool at age 6

20% enter elementary school at age 6 after preschool

Preschool Educational Institutions (70% of children of preschool age)

25% enter school at age 7

30% enter preschool at age 3

40% enter preschool after age 3

5% enter school at age 6

Annually, 2.0-2.5 million children are born in Russia

Source: Author

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Breeding a New Generation of Economists in the FSU
Eurasia Foundation President William Bader on How to Beat Red Tape

How effectively can a relatively small foundation, distributing U.S. government money, contribute to the advancement of business and economic education in the countries of the former Soviet Union? Dr. William B. Bader, President of the Eurasia Foundation, explains in an interview with Transition editor Richard Hirschler that even small grants can make a difference—if distribution is to a wide variety of carefully selected projects (especially "on the ground") and if commitment long-term institution building is maintained.

Q. How strongly is the Eurasia Foundation involved in supporting education and training in the states of the former Soviet Union?

A. Our foundation was established in 1993 as a privately managed, nonprofit, grant-making organization, with funding from the U.S. Agency for International Development (USAID). Besides the Washington, D.C. headquarters, we have field offices in Russia (Moscow, Saratov, Vladivostok), Ukraine (Kiev), and Uzbekistan (Tashkent). The foundation has spent almost $5 million so far to promote business and economic education, as well as management training, in countries of the former Soviet Union. This sum is about a third of the $15 million that we have given away in grants since May 1993. We support training of trainers and educators, fund independent media to educate the public on economic matters, provide grants to business schools and universities to develop new curriculum, purchase computers and textbooks, and establish electronic communication links. We try to reach as many regions as possible, in as far away places in the territory of the FSU as possible. To be able to process the hundreds of proposals we receive each year, we rely on our field offices, which often directly deliver resources, training, education, skills, and know-how to our grantees.

Q. Could you specify some of Eurasia's education-related projects?

A. The countries of the FSU need a new generation of Western-oriented economists in the government, at universities, and in research institutions. Our two largest grants thus far, totaling $350,000, have been awarded to the New Economic School in Moscow. To compare, our average grant size is less than $50,000. The Soros Foundation, initiator of this project, contributed similar grants to the school, which—during its two years of existence—has become the best economic training institute in the FSU. "Russia's Harvard" as the Financial Times recently put it teaches advanced market economics to some 30-40 students each year.

We also foster the training of a new genre of business people. With our support of about $330,000 a new high-quality business school has been set up at St. Petersburg University, assisted by the University of California-Berkeley. In Ukraine the Kiev-Mohyla Academy, with our funding, has trained economics teachers throughout Ukraine. It will soon join the Internet and create a campus-wide computer network. The Kyrgyz-American Business School at the Kyrgyz State University in Bishek was established in 1993, as a private, tuition-based business and law program—the first of its kind in Central Asia. With our grant, the faculty of the University of Nebraska-Lincoln trains the Kyrgyz faculty in business computing and marketing, and assists with curriculum development. Computers and printers have been purchased to set up a business library and student learning lab. And $100,000 has been provided to support a management training program in Tbilisi, Georgia, to train Georgian managers, entrepreneurs, and small business people. We have also helped set up small business development centers in Kyrgyzstan, Moldova, Russia, and Ukraine to provide information, training, and counseling to small entrepreneurs.

Q. What are your selection criteria when providing grants?

A. Before deciding on a grant, the Washington office (or the field offices directly) looks at the cost-effectiveness of the project, scrutinizes its budget, determines the experience and expertise of individuals and institutions involved, and examines whether the project has ample support in and participation from the region or locality. (The Foundation may also make recoverable grants or loans, called program-related investments.) To help potential candidates successfully compete for a grant, we send staff to conduct brief seminars on how to apply for funding, and, if the grant is won, seminars are offered on how to ensure the long-term sustainability of the project. What we do not support...
ar shorter-term, ad hoc training programs that lack significant follow-up activities, and proposals that lack a long-term funding strategy.

Q. But many of your beneficiaries are U.S. institutions...

A. That is right to date, but all of them have close ties in the target countries, and strong local partners who will eventually take over all responsibilities. At present about 45 percent of our project support is going directly to local organizations, but that share is increasing as our field office network becomes more active.

Q. How far will you go to increase local participation?

A. The more grants we award to local groups, the faster we can reach our ultimate goal: the development of cooperating binational foundations. We are presently developing a strategy to achieve this goal. Eventually we intent to have foundations "on the ground"—being run by locals. In short, we are in the process of empowering the FSU countries to do this kind of work themselves.

Q. You claim that every dollar you offer in grant money in these countries is cofinanced by two dollars from other funders.

A. This is what we call the catalytic role: to attract other funds and other organizations into partnerships. Our great advantage is that we are able to do things quickly and with great flexibility. The Eurasia Foundation often can initiate unconventional, ground-breaking projects with small grants, and convince others to join. Moreover, we also cofinance projects with the U.S. private sector and with other U.S. government agencies.

Q. Some activities of the World Bank, such as the training programs of its Economic Development Institute, seem similar to yours. Do you coordinate training activity and financing with them?

A. Not yet, although we are aware of preliminary outline of the Partnership Program, a consortium of funders and leading Western universities, in collaboration with Russian and Ukrainian graduate schools of economics and research institutes, would provide research grants to economists and train future teachers and researchers. (We appreciate the contributions of Kathryn Wittneben and Olga Arkhangel'skaya.)
With the collapse of central planning and the opening of the economies of Central and Eastern Europe and the former Soviet Union, many state-owned enterprises turned to state-owned commercial banks for credit to allow them to defer restructuring or liquidation. The banks' loan portfolios, already burdened by the inheritance of risky and nonperforming loans from the earlier monobank era, deteriorated further, crowding out economically viable investments by the emerging private sector. The liabilities of the state mounted, while implicit government guarantees of deposits deterred governments from allowing banks to fail. There is now general agreement that the problem has to be addressed in an integrated manner—including banks, enterprises, and government—and that postponing the problem risks a crisis of confidence by the emerging private sector. But the consensus stops there.

We have reviewed twenty-three countries that have introduced varying degrees of change in their banking systems. Some imposed hard budget constraints making a public commitment to rapid privatization, segregating nonperforming bank assets from loan portfolios, and following prudent macroeconomic policies. Other countries have opted for gradual transformation to minimize shocks, but at great fiscal cost that threatens to undermine competitive advantages. Most countries have adopted a mix of reforms that falls between these extremes. Some lessons from these early experiences may prove instructive in guiding future efforts.

Private ownership is more likely to transform banks into competitive financial institutions than are state-led restructuring efforts. If private capital is not available to provide the needed investment, any interim recapitalization of state-owned banks should occur only in association with a performance-based restructuring plan that alters incentives and is tied to a formal timetable for privatization. Adequate supervision of management performance to protect shareholder value needs to be demonstrated (this includes effective credit policy, protection of deposits, prudent asset-liability management, and retention of earnings to achieve capital adequacy). Absent these conditions, state-owned banks should not be recapitalized unless government assumes full liability for the banks' nonviable assets. If government is unwilling or unable to assume these liabilities, it should move to liquidate the bank.

Work-out units can help banks recover problem loans and develop needed banking expertise and credit risk evaluation skills. However, work-outs may be ineffective in the absence of enough skilled staff, appropriate legal and regulatory frameworks for loan recovery, and market mechanisms for enterprise liquidation. It might make more sense for governments to write off these loans up front. Poland has used a combination of work-out units, out-of-court conciliation, and privatization in its bank recapitalization program. The program has resulted in the successful restructuring of 75 percent of targeted nonperforming loans. Slovenia, too, has successfully used work-out units, supervised by the Bank Rehabilitation Agency and explicitly tagged as a preprivatization rehabilitation program for the banks. Estonia is using work-out units to develop skills and accelerate bank privatization.

Debt-equity swaps can strengthen bank balance sheets and generate large profits once markets are stronger, but excess exposure to risky investments may
jeopardize the safety of deposits and bank capital. The risk can be reduced by observing two rules of prudent swap behavior: swap nonperforming loans for equity only after the loans are written down, and set up separately capitalized subsidiaries to take the equity risk of the loan swaps. However, even after write-downs, investment in loss-making enterprises raises the risk of future liquidity being drained to prop up these enterprises in the hope that they will eventually become profitable. Banks are generally advised to focus on generating maximum profitability from their core businesses, rather than assuming equity risk in weak companies under volatile economic conditions in which market reforms have not yet fully taken hold.

Loan sales and asset swaps are still rare in transition economies. Their expanded use awaits the development of secondary markets for sales and swaps, interbank markets, and nonbank institutions specializing in discounted loan purchases and sales. There is currently little market demand for such swaps, and no market tradition. Improved loan recovery mechanisms and legislation encouraging nonbank financial institutions should stimulate the development of secondary markets.

Bank rehabilitation agencies are useful for restructuring inefficient banking systems, expediting the cleanup of loan portfolios, and helping to prepare the way for private banking. However, skills have not yet caught up with need, holding back such efforts.

Are Czech Banks Ready to Present Reality Checks?

Czech banks are under pressure from bad debts and mounting competition from abroad. Bad loans granted in the early 1990s are now appearing on Czech banks' balance sheets. The problem is exacerbated by the banks' reluctance to file bankruptcy claims, a problem not helped by the ill-prepared courts.

According to Spencer Nash, a banking analyst at Prague stockbrokers Wood & Co., processing a bankruptcy can take up to three years to complete. Komercni Banka, the country's largest commercial bank and the one with the largest number of loans, has taken out bankruptcy proceedings against 46 customers, which together employ some 30,000 workers. To date, only two bankruptcies have been finalized, liquidating two companies with only 80 employees between them. Ceska Sporitelna, the largest savings bank, has an even worse record. It has filed bankruptcy claims against 15 companies, only one of which has yet been made bankrupt.

The cumbersome nature of the bankruptcy process may just provide a convenient excuse for the banks to carry on lending to their worst clients. As Nash points out, investment funds managed by the banks now own up to 20 percent stakes in virtually all the companies privatized in the first and second wave. "We think the banks may not have been able to effectively define the Chinese walls between lending, asset management, and securities operations within their organizations," he says.

Another problem is that some banks manage companies in their portfolios. Investicni a Postovni Banka, the Republic's largest investment bank, is a good example. Last November it led a consortium to buy 34 percent of Svit, a heavily indebted shoe maker and also one of its clients. Nash says: "Given the lack of personnel in the Czech Republic with real business experience, it is hard to see what added value such fund representatives can have."

There may also be political pressure on the big banks not to push through too many bankruptcies before the general election in 1996. This is because the major shareholder in the privatized commercial banks is still the National Property Fund, a government body that operates within the framework of the Ministry of Finance and the national bank. The dominant position of Komercni and Sporitelna has created a structural imbalance in the banking sector.

It took three bank failures in the first half of 1994 to force the national bank to take action. [Kreditni a Prumyslova Banka was closed in February 1994; Banka Bohemia, the fifteenth largest bank, collapsed in April; and AB Banka, the eighth-largest bank had its license withdrawn in May, after being weighted down by bad debts.] The activities of another six banks are being watched closely by the national bank. Although the three banks to collapse accounted for only 2 percent of total banking assets, the impact of their failure on the banking system has been significant.

The national bank's response has been to suspend the granting of new bank licenses, tighten supervision, increase its powers of intervention, and encourage consolidation.

Among the most important measures, it has raised the minimum capital requirement for banks after loss provisioning, to Kc500 million ($18 million), a move that could cause many smaller banks to fold or merge.

In September, Sporitelna took over the troubled AB Banka with a view to possibly turning it into a mortgage bank or building a society. The savings bank has since concluded another deal, buying 16 percent of Ceska Banka. It is talking to five other banks about buying equity stakes of about 10 percent.

At the end of April 1994, the four largest commercial banks were responsible for nearly 70 percent of the total assets, and Komercni and Sporitelna together accounted for nearly half the assets. In February 1995, new antimonopoly legislation will come into force prohibiting Sporitelna and Komercni from having more than 30 percent of the total deposit and lending market, respectively. In the meantime the larger banks have to make a bigger contribution not only to the reform of the banking system, but to the economy as a whole. Consolidation will inevitably be part of the process, but speeding up the bankruptcy process has to be the priority.

(Excerpts from Peter Weston's article in the December 1994 January 1995 issue of the Central European, a London-based magazine of Euromoney)
Stimulating Environment

The legal and regulatory environment needs to be made more responsive to banking system needs.

- Countries need an orderly bank liquidation process that allows banks to fail without undermining depositor confidence. The Czech Republic, Hungary, Poland, and the Slovak Republic have strengthened laws protecting property rights, collateral pledges, and transfers of ownership, but stronger laws are still needed elsewhere.

- Better laws are also needed to protect depositors (and bank capital and state fiscal resources) from bank investment exposure and stock market transactions in countries where stock markets lack breadth and depth, a common characteristic in emerging markets worldwide. Transition countries should consider raising capital adequacy ratios above the 8 percent. (This is the rate most of them have targeted to offset the higher risks found when compared with more mature economies and banking systems.) Deposit insurance needs to be rationalized, and coverage levels and cost-recovery mechanisms need to be specified more clearly to remove distortions that impede the development of competitive markets, and to limit governments' potential liability under implicit deposit guarantee schemes.

- Tax laws should be revised to permit banks to expense provisions for loan losses before profit taxes are assessed, thereby creating incentives for banks to report more accurately profitability, capital, and reserve figures.

- Basic frameworks are still lacking to guide leasing, insurance, real estate, mutual funds, venture capital, brokerage, loan collection, and other specialized and nonbank financial intermediation activities.

Bank supervision requires more trained supervisors, better information systems, and adequate enforcement powers.

Bank supervisors must have the authority to enforce prudential regulations and the institutional capacity to monitor risk, particularly as banks adapt to new accounting principles. Early detection of bank solvency and liquidity problems reduces the need for costly recapitalization later.

Corporate governance of banks has been strengthened in many countries in advance of privatization by limiting insider lending, borrower concentration, and public enterprise ownership of state banks. The role of supervisory boards has been upgraded to scrutinize management performance and enforce stricter credit standards. These improvements should provide "internal" supervision in the banking sector, helping to promote stability and confidence.

Privatization of large state banks is still politically sensitive in many countries. Governments are on record as committed to private banking systems, but only the Czech Republic and countries of the former Soviet Union have privatized most of their state banks. Hungary and Romania have succeeded in attracting foreign investment in their banking sectors with relatively open banking regimes. Poland resisted for years foreign investment in the banking sector unless the investment was in an existing bank, sending an imprudent market signal and perpetuating a major structural weakness. Only recently have there been signs that this policy may be changing.

Private commercial banks are beginning to capture increasing market share in Croatia, Estonia, Poland, Romania, and Russia; joint ventures and direct foreign investment are occurring in the Czech Republic, Hungary, Poland, and Romania; and state banks are being consolidated in Bulgaria and Slovenia in advance of privatization. It is expected that fiscal costs will encourage governments to accelerate bank privatization, and that this will add momentum to general enterprise privatization. Governments that attempt to retain excess control of banks and enterprise operations are expected to become less competitive, slowing economic growth and ultimately making privatization a more compelling argument at a future date.

Entry Requirements Help

Key challenges facing state banks are illiquidity, insolvency, and the necessary restructuring of the banking systems. The banks' dominance continues to distort the banking system, deter competition, and slow the development of a market economy. Their financial weakness relate to poor management, weak governance, and distorted incentive structures. Continued government interference often results in a new accumulation of bad loans, further weakening earnings and reducing liquidity. Some governments, in the belief that state banks will be able to recapitalize from operating cash flows once the economy begins to grow, are delaying privatization in the hope that it will be less politically and economically costly down the road. Delays tempt governments to revert to bank subsidies to stimulate lending and economic activity. However, any short-term production and employment gains would likely come at a high cost in lost discipline at the enterprise and bank level.

Not all private banks are prudently managed or capable of generating positive returns. In Estonia and Poland, poorly capitalized and mismanaged private banks have jeopardized deposits and capital. Easy entry requirements may be a problem, particularly where bank supervision and enforcement capacity are weak. In most countries of the former Soviet Union, rapid privatization of the monobank system through mass privatization schemes has resulted in an abundance of small, poorly capitalized
Fewer but Stronger? *Euromoney* on the Merge-Fever of Polish Banks

What will happen when more foreigners swarm into Poland after 1997, when Warsaw must throw open its doors to financial institutions from the European Union under the terms of its association agreement with Brussels?—"Our banks will lose ground rapidly then, unless they merge now," warns Krzysztof Kalicki [Poland's first deputy finance minister]. Hence his delight with recent developments suggesting that, with a firm push from the Ministry of Finance, the country's feeble and fragmented financial system—still largely state-owned but marked for privatization—is beginning to consolidate. Three separate nationwide universal banking groups of mainly regional institutions have just been formed with a view to working together and, possibly, merging. Parliament is backing a government-inspired plan to transform the ailing cooperative bank network into a powerful national force. And Narodowy Bank Polski, the central bank, has been unexpectedly successful in finding acquirers for several of the country's troubled private banks. "We're on our way to a banking system with four or five major players," Kalicki says enthusiastically.

Although a more concentrated financial system is clearly desirable in the long run, naysayers argue that now is hardly the time to be chasing mergers and partnerships; the banks' immediate priority should be honing their competitiveness rather than tackling the welter of strategic problems that inevitably accompany the fusion of two or more institutions.

The fate of Polish banking is of particular interest to Warsaw financiers. Besides boasting the biggest economy in Central and Eastern Europe, after Russia, Poland is also currently enjoying the fastest growth in all of Europe. Only half of Poland's increasingly wealthy population have retail bank accounts, and few but the largest corporate customers consume investment banking services. So there is clearly huge potential for growth—far more than in the Czech Republic, Hungary, and Slovakia.

Poland's 2.5 trillion zloty ($100 billion) economy supports at least 13 state-owned, 3 formerly state-owned and now privatized, 80 or so private, and more than 1,600 cooperative banks. Yet the 20 largest institutions (which include the state-owned banks) boast less than Z1 60 trillion in capital combined and can absorb only Zl 700 trillion of risk—no more than Landeskreditbank Baden-Württemberg, the twelfth-largest bank in Germany.

Most individual banks simply aren't big enough to satisfy their corporate customers' growing appetite for loans and services, or broad enough to provide the sprawl of sophisticated services that Polish companies increasingly demand. Only state-owned Bank Handlowy w Warszawie (BH), the nation's biggest financial institution with capital of Zl 9.5 trillion, can claim to be a truly national commercial bank and a real match for the foreigners. But even BH is poor in branches outside Poland's main cities and suffers from restricted access to medium-size corporations. On the retail front Powszechna Kasa Oszczędności BP and Bank Polska Kasa Opieki, both of which are also state-owned, have offices nationwide. But their range of services is limited. And the other state-dominated banks are mainly regional institutions with few customers, and fewer offices, outside their home territories.

Most private sector banks are more localized still, with just a handful of branches each. Besides, since only a few of the oldest private banks are covered by the state's deposit guarantee scheme, corporate and retail customers are often reluctant to deal with them. They also tend to be badly managed, often taking up to three weeks to process a domestic payment that would take a regional bank no more than three days. And in some cases their portfolios are riddled with bad debts because of ineffective internal controls and poor credit analysis techniques. A number of private banks have been liquidated or

This article is based on the author's recently published World Bank Discussion Paper [no. 279], Restructuring Banks and Enterprises—Recent Lessons from Transition Countries.

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suspended by the central bank in recent months and then sold off to other, stronger institutions.

When the bulk of the central bank's commercial banking activities were hived off as communism lay dying in 1989, the government originally intended to assign them to three to five large institutions. But powerful provincial lobbying groups demanded separate banks for each of their regions, and the authorities agreed. The upshot: nine small regional institutions plus a handful of specialist houses, most of which inherited a slew of bad debts and skewed portfolios from their socialist parent and saw the quality of their balance sheets decline further during the past five years.

To be sure, the banks have recently been recapitalized, so they now boast reasonable prudential ratios. Three—Bank Rozwoju Eksportu, Wielkopolski Bank Kredytowy, and Bank Slaski w Katowicach—have even been privatized. But generally the banks' balance sheets tend to be underdiversified and overexposed to the dominant, often troubled, industries of their regions. Bank Gdanski has more than its fair share of loans to the shipbuilding sector, for example, while the Powszechny Bank Gospodarczy (PBG) portfolio contains hundreds of billions of zlotys in credits to the ailing textile companies of the Lodz area.

While state-owned banks were proliferating, the central bank was doling out licenses for private banks by the score in the conviction that more banks meant keener competition and greater efficiency. Although spreads between loan and deposit rates have narrowed from 15 percent in the hyperinflationary days of 1990, they are still a whopping 6 percent. And there is little sign of real rivalry among the banks—private or state-owned—for business, especially in big-ticket areas such as corporate and project finance.

The authorities now maintain that consolidation would overcome many of the banks' most critical problems. If ailing private banks were acquired by their stronger peers, the competitiveness and creditworthiness of the sector as a whole would be enormously improved, they say. What's more, stitching together groups of state-owned institutions would create banks with better-balanced portfolios as well as the capital to develop a wider range of services, permitting them to lend more to large companies and to compete effectively with foreigners.

In late July Warsaw's Polski Bank Rozwoju, Krakow-headquartered Bank Przemyslowo-Handlowy, and recently privatized Wielkopolski Bank Kredytowy of Poznan submitted a letter of intent to form a joint group with a view to "expanding, diversifying, and improving our market position."

In September 1994 [the authorities] sanctioned the central bank's recommendation that Banque Nationale de Paris and Dresdner Bank be allowed to establish a joint operation in Poland. It was the first foreign banking license issued since 1991, when the central bank decided to award licenses only if applicants were willing to acquire ailing Polish banks. The central bank then followed up by announcing that it expected to respond favorably to Commerzbank's plan to acquire a 20 percent stake in Bank Rozwoju Exportu.

The four-way alliance of Pomorski Bank Kredytowy w Szczecinie, Bank Depozytowo-Kredytowy, Bank Zachodni, and Lodz-based PBG was announced in October 1994. Those banks together would have a relatively balanced portfolio plus the resources to meet the borrowing needs of all but the biggest Polish companies. Similarly, a much-vaunted—but yet to materialize—merger of Bank Handlowy, PeKaO, and Polski Bank Inwestycyjny, which specializes in large-scale project finance, would create a potent universal bank with a strong loan book, wide-ranging financial expertise, and easy access to retail deposits.

(Excerpts from David Fairlamb's article Wedlock or Gridlock published in Euromoney, December 1994, p. 62)

**Government program in Eastern Europe**

*Former finance minister of Hungary, Laszlo Bekesi, presented in this cartoon, resigned in February 1995*

From the Hungarian weekly *168 ORA*
Syndromes of Public Withdrawal in Postcommunism

by Daniel N. Nelson

In Poland’s recent (June 1994) statewide local elections, only a quarter of eligible voters turned out. Similar low turnouts have plagued electoral contests in the Czech Republic and Hungary and referenda in Lithuania. In many other transition countries the number of people who say they intend to cast ballots in upcoming elections has also dropped. This low electoral involvement—only five years after the Berlin Wall fell—is accompanied by a widespread lack of interest in politics and cynicism about the utility of participating in public affairs. When asked whether they can affect government policies, merely 20 to 25 percent of Hungarians responded positively in surveys conducted in 1992 and 1993. Only a third of the Poles interviewed for the same study agreed that voting would enable people to exert any influence.

About the same time, a survey conducted in many East European countries found that more than half of those questioned approved of the old (that is, state-owned and centralized) economic system, while only 39 percent favored the new market-oriented systems. In Belarus, Bulgaria, Slovakia, and Ukraine, the socialist economy is remembered positively by more than twice as many as those who now see the economic system in a positive light. See also "What Postsocialist People Have in Mind," Transition, July-August 1994. The editor.

In Russia only 19 percent of those surveyed in a national poll conducted in June 1994 regarded the government as "democratic," with a quarter of the sample believing that Russia did not need a democracy in any case. And in Eastern Europe, one-half or more of respondents in national samples from Bulgaria, Hungary, and Slovakia (in late 1993 to early 1994) considered the old communist regimes preferable to new political systems.

The public sentiment is reflected in recent election outcomes. Elections during 1993 and 1994 returned postcommunist socialists to power in Bulgaria, Hungary, Poland, and Slovakia, and candidates who favored accommodations with Moscow emerged as clear victors in Belarus and Moldova. Even in the eastern Länder of Germany (formerly the German Democratic Republic), erstwhile communists have made a strong comeback.

Only the Czech government, committed to free market economic principles, maintains strong public support. 81 percent of Czechs agreed in 1992-93 that the "government needs time" to deal with problems inherited from the communists, while only 63 percent of Bulgarians, 59 percent of Romanians, and 50 percent of Hungarians gave the same response. See Transition, November-December 1994. The editor.

Citizenship: Klaus versus Havel

Conservative Prime Minister Vaclav Klaus, in a memorable public debate with President Vaclav Havel hardly a year ago, rejected Havel’s belief that citizenship requires a collective conscience—a commitment to the larger society and its well-being. Klaus argues, on the contrary, that the market will be the catalyst for citizenship, and that property and profit will energize and enable people to care about and participate in the public political sphere. Individual interests, pursued for profit in the market, are the best guide for citizenship, Klaus contends. He suggests that, much as John Locke envisioned, the democracy and the free market are inseparable, and that the nonprofit, nongovernmental sector is not required to mediate between the state and its citizens.

But Havel maintains that without mediating structures such as nonprofit nongovernmental organizations, citizens will become alienated from the state and its policies and from their political leaders. Voting will become nothing more than an abstract exercise to a disaffected populace, and "representation" will wane as an adequate substitute for direct involvement. On the other hand, group and collective interests, when espoused by citizens banded together in organizations, can enhance the efficacy of citizenship and bring general, rather than narrow, interests into political life.

At issue is the relationship between market and democracy. In a city where Charter 77 epitomized civil society in opposition to authoritarian rule in the communist era, those who opposed communist repression now debate about how to create and maintain a public political sphere. Klaus and Havel agree that citizenship in a democracy requires a culture of participation—but they disagree entirely on how to obtain such a transformation. For Klaus, the market provides all that is needed for a populace to become engaged. For Havel, it will take
more than the chance to make a profit and own property to truly empower the citizenry—that is, to give a voice to all, including the powerless.

**Theses and Hypotheses**

Consequently, important questions must be raised:

- What enables a society to develop and maintain an active public political sphere in which those holding state power are held accountable to the citizenry?

- What conditions endanger such a participatory culture and cause the public to withdraw, leaving political life to extremists and demagogues?

Free markets, coupled with democratic political institutions and processes, create the conditions under which postauthoritarian countries can find peace and prosperity. However, the social and political costs of accelerating a broad range of market-oriented reforms in Eastern and post-Soviet Europe—ending centralized control of wages and prices, selling off state property, and establishing the full convertibility of the national currency—are only now being seen and assessed. [See Branko Milanovic, "A Cost of Transition: 50 Million New Poor and Growing Inequality," *Transition*, October 1994.]

The forced march toward free market economies, notwithstanding the exports it might generate, the industrial surge it might create, or the Mercedes dealerships it might spawn, fosters a milieu of socioeconomic insecurity (unemployment, inflation, crime, and political turmoil). And there are other, external, threats—ranging from mass migrations to direct attack. Such insecurity—worsened by cultural, ethnic, or other factors—may harm political participation, commitment to tolerance, pluralism, competition, and other core elements of democratic citizenship.

Studies have identified the strongly negative effect of income inequality on democratization. And such inequality is rapidly rising in postcommunist Europe. Alexander Kuranov, of the Moscow daily, *Nezavisimaja Gazeta*, pointed out that those who have gained the most wealth under transformation are the former activists in communist parties and young communist organizations who received excellent, often Western, educations as rewards for their loyalties. These "red managers" profited early in various trading and stock companies, and later went on to create their own firms and joint ventures. It is they who effectively control power at every level.

In addition to this temporary surge in income inequality, rapid, externally enforced "marketization" will further heighten public insecurity and conflict sharply with a demonstrated preference for gradual change. This is a mix that bodes ill for proto-democracies. If citizens' involvement in the public political sphere is weakened by a heightened sense of insecurity brought on by both threatening external conditions and relentless and wrenching internal changes, then the future of these nascent democracies is security-dependent, with important implications for transformation policies.

The transition economies' initial emphasis on institutions and processes characteristic of Western democracies—such as laws that facilitate private ownership, skills development for entrepreneurs, parliamentary and judicial professionalism, or the techniques of electoral politics—needs to be reassessed. Focusing on the citizenry, not on institutions or processes, implies a greater concern that the system deliver "political goods" of central importance to individuals and their families. We must give up the notion that a successful democratic transition can be transplanted wholesale from one setting to another and explore democracy's dependence on the development of a native culture of citizenship. Our goal is not necessarily rapid change—rather it is a successful transition to free markets and democratic systems. The incompatibility of these goals is now evident.

**Security Issues**

Accepting slower socioeconomic change, expanding safety nets, eliminating foreign debt accumulated by communist dictatorships, opening Western markets—these are some of the steps required to reduce the threat of transitions to citizens' security. It is also essential to retarget Western support for postauthoritarian transitions so that it enhances the indigenous public political sphere. To some degree, the United States began such a reorientation in 1994 with the "Democracy Network Program" conceived by the Agency for International Development. With a $30 million investment, this A.I.D. initiative alone will not turn the tide, but the concept is new and the emphasis appropriate. Helping East European nongovernmental organizations in their efforts to promote democracy, spur economic growth, maintain the social safety net, and protect the environment, the program, though small, may slow the deteriorations of civil society and citizenship.

Civil society began an expanded public political realm and the dawn of public legitimization in communist-ruled Europe. Now that achievement is endangered by the internal costs of transition and by external threats. People feel insecure, and this underscores their commitment to change and their patience with transition processes. The insecure recoil from the dangers and, in an effort to protect themselves and their families, withdraw from public life. Once that begins to happen, the political life of the country is left to the neo-authoritarians.
— the same people who governed earlier regimes, albeit "reborn" with different labels. Without a strong, vibrant, public political realm, in which citizens act as legitimators, democracy will soon recede, and an all-too-familiar authoritarianism will return with a vengeance.

This article is based on the paper, "Civil Society Endangered: The Perils of Post Communism," forthcoming as a working paper of the Wilson Center for International Studies. The author is Professor in the graduate program of International Studies at the Old Dominion University in Norfolk, Virginia, and president of Global Concepts, Inc., an international consulting firm. His next book, After Authoritarianism, will be published in 1995 by Greenwood Press.

Quotation of the Month: "The primary raison d'etre of privatization, to create a competitive market economy, appears to have been forgotten by many."

Latest study of the London-based Adam Smith Institute warns of reform amnesia

Although much has been achieved over the four-year period since the abandonment of communism, there must be serious concerns over the implementation of privatization in many postcommunist countries. New and innovative methods have been devised to "sell enterprises that nobody owns and nobody wants to people who cannot pay" (in the words of Poland's former privatization minister, Janusz Lewandowski, such as voucher schemes and the sale of shares to employees, with little money changing hands. But with the partial exceptions of the Czech Republic, Hungary, and Poland, overall progress has been painfully slow. This is particularly the case in southern East European states and in the southern former Soviet republics.

Experience has shown that success in implementing real privatization depends on a number of critical factors:

- Public and political awareness of and support for privatization program measures, including the legislative changes and restructuring necessary for success.

- The momentum of the program—that is, the propensities of government to get on with the process quickly rather than argue endlessly over legislative and operational details. Momentum requires the early acquisition of expertise in different methods of privatization, such as cash sale of enterprises at auction and through vouchers.

- The establishment of an appropriate legislative environment for privatization—particularly relating to the efficacy of voucher schemes, demonopolization, corporate governance laws, and so on.

- The ability of new shareholders to trade shares in an equitable way so as to create pressures for profit, reward success, and create a market for corporate control.

Furthermore, a significant share of the privatization that has been carried out is significantly flawed, burdened with problems arising from the transfer of monopolies to the private sector, including: the new owners' inability to exercise their ownership rights properly, entrenchment of the old management, restrictions on the scope of activity of the privatized company, inability to trade shares effectively, and regulatory restrictions on private sector activity as a whole. The primary raison d'etre of privatization—to create a competitive market economy—appears to have been at least partially forgotten or misunderstood by many. This may be dubbed the "amnesia of reform." Instead, "technical" privatization, without liberalization, has become the new objective.

Success in privatization is usually defined as the achievement of the transfer of a significant proportion of the economy from state hands into private hands. However, with the above reservations in mind, there are three key qualifications that need to be made to this goal if it is to be compatible with the wider aim of creating a prosperous market economy.

- Privatization must be defined as the majority of shares or controlling shares being fully in the hands of private individuals and private businesses. For example, ownership of a majority of shares by another state enterprise, state bank, or any other organization controlled by the state does not, in our view, represent privatization. Throughout the postcommunist world, there are many enter-
prises describing themselves as privatized that do not fit our definition—either because they are indirectly owned by the state, or because they operate under arrangements initiated before the 1991 Gorbachev reforms or under some other form of indirect state control.

Privatization is a necessary (but insufficient) condition for the creation of a market economy. For example, if a whole sector is privatized but existing monopolies, cartels, and cartelized networks are maintained, the benefits of privatization could be small. Furthermore, the benefits of privatization can be severely diminished if shares in privatized enterprises cannot be traded (legally or informally) or if licensing, business regulations, or terms under which enterprises are constituted have the effect of erecting insurmountable barriers to market entry. Thus, privatization must be accompanied by liberalization measures that create competitive pressures, ownership pressures, and economic freedom.

The political and economic power of directors of state enterprises is a significant barrier to liberalized privatization, and one that explains much of the difficulty experienced in implementing privatization properly. A coherent political-economic strategy much be developed to overcome this barrier.

The pressure to privatize state enterprises while leaving their monopolistic structure and operations intact should be resisted. Instead, enterprises should be broken up, if necessary, prior to sale. This actually provides the opportunity to enfranchise more managers, as owners. Thus, potentially, state enterprise managers can be made rich within the context of a liberalized privatization program. All enterprises above a minimum size should be sold as open joint-stock companies, with company constitutions (memoranda and articles of association) that entrench the rights of all shareholders.

Managers may be encouraged to take substantial stakes in the context of a mass privatization program in which the majority of shares are taken up by outsiders (whether by voucher investors alone or in combination with other investors). The widely dispersed share ownership that results from mass privatization should give managers the ability to retain their jobs, but only if their performance warrants it. The many new shareholders that result from a mass privatization program will take time to get organized and to exert their influence effectively, whether through investment funds or other means.

(Excerpts from the Adam Smith Institute report, "Amnesia of Reform: A Review of Post-Communist Privatization," by Peter Young and Paul Reynolds; information: Adam Smith Institute, 23 Great Smith Street, London, SW1P 3BL, tel. (4471) 222-4995, fax (4471) 222-7544.)

"It's so good to talk to you. At last a businessman who is not complaining."

From the Budapest magazine Hungarian Economy
Real Output Decline in Transition Economies—Forget GDP, Try Power Consumption Data!
by Istvan Dobozi and Gerhard Pohl

According to official statistics, aggregate economic output (GDP) has declined by more than 50 percent in the former Soviet Union since 1989. This is a much larger slump than the Great Depression of the 1930s, when GDP in the United States declined by about 30 percent; by the same indicators, economic activity in Central and Eastern Europe is said to have declined by about a quarter since 1989.

Many observers believe that the statistical drop in GDP, especially in the case of countries of the former Soviet Union, exaggerates the actual decline, possibly by a very large margin. Only qualitative arguments, however, have been marshaled in support of this view, claiming that:

- Enterprises are strongly interested in underreporting output to avoid high taxes or minimize residual "state supply" obligations, calculated at artificially low prices.

- Official statistics are biased toward declining products and sectors and inadequately capture the shift to new activities inside and outside the former state enterprises. (For example, the production of an automobile factory may still be measured by the number of cars produced, but production may have shifted to automotive components for exports.) Many activities have been spun off from former state enterprises into new legal entities, but statistical offices have not yet adjusted their reporting systems.

In market economies aggregate economic activity and electric power consumption usually move in lockstep (with an electricity-GDP elasticity close to one). Unlike any other specific energy source, electric power pervades all aspects of modern economic activity. In industry, for instance, electricity use and output move in tandem because two-thirds of electricity consumption is linked to power for driving pumps, fans, and compressors, and for handling and processing materials (robots, conveyors; pulverizing and mixing machines). Thus, much of this electricity would not be used up if machinery was idle or handling low loads due to the economic downswing. In Central and Eastern Europe, industry consumes a large part of electric power, while the share used by businesses and households is fairly small. Even if electricity prices had remained very low, energy consumption could not have grown much, due to limited capacities and the need for costly new investments in consumer equipment (e.g., for space heating). But prices have increased in general, which should have resulted in some modest improvement in electricity intensity over the past few years.

Thus, in Central and Eastern Europe the 22 percent average accumulated decline in electric power consumption between 1989 and 1993 is in harmony with the reported 24 percent average accumulated decline in economic activity (see figure, p. 18). A fairly large discrepancy is found in the Czech Republic where electric power consumption fell only half as much (11 percent) as GDP (22 percent). This may indicate a large unreported shift into new activities, such as services. The discrepancy is much more dramatic in countries of the former Soviet Union. Electric power consumption declined cumulatively by 15 percent during 1989-93, while official statistics report a GDP decline of 54 percent. In Georgia official GDP declined by 80 percent during 1989-93 (and close to a stunning 90 percent by 1994), while power use was down by "only" 40 percent over the same period.

The huge differences in the electric power consumption-GDP gap across countries cannot be explained rationally. Although economic reforms have moved at different speeds, all countries are restructuring their economies in the same direction. The electricity intensity of production cannot have remained unchanged in Poland while it increased by 45 percent in only four years in Russia. Moreover, one should be able to expect some modest improvement in electric power intensity by now, since highly power-intensive heavy industries have been hardest hit by the reforms (with a few exceptions, such as aluminum production in Russia). In other words, official data notwithstanding, actual GDP has probably declined by less than power consumption.

The discrepancy between power consumption and official GDP statistics is all the more perplexing, for three reasons:

- Significant improvements in power efficiency can be achieved even applying partial reforms, given the large untapped energy efficiency reservoir inherited from the past.

- Electricity prices rose substantially (although the widespread nonpayment for electricity blunted the efficiency effect of higher prices).

- Electric power-intensive activities were among the hardest hit by industrial restructuring.
Some factors, however, could have pulled down the efficiency of electricity utilization, including:

- A rise in fixed (overhead) electricity use per unit of output due to the drop in capacity utilization and lack of factory closures.

- Some technological regress due to reduced investment and lack of funding for basic maintenance and repair. The impact on power use would be small.

It is plausible to assume that the consumption-increasing effect of these factors was largely offset by the combined impact of higher electricity tariffs and shifts in the output mix away from heavy industry. Electricity intensity of (properly measured) output cannot have changed by more than a few percentage points, except in the resource-rich Central Asian countries where electrification continues to advance.

More important, the electricity intensity of economic activity cannot have gyrated as erratically—and inconsistently across countries—as implied by power consumption-GDP ratios. The only reasonable explanation is that electric power consumption is a far better indicator of true economic activity in Eastern Europe and the former Soviet Union than any of the officially reported economic statistics that are widely used by the IMF, the World Bank, and the international community at large.

Our figure presents the estimated drop in GDP based on power consumption as an output proxy, together with official GDP statistics. For Central and Eastern Europe the estimated and official GDP are fairly close. By contrast, for the former Soviet Union as a whole our analysis points to a threefold overstatement of the downturn in aggregate economic activity. Official economic statistics for Russia and Ukraine appear to suffer from a gross downward bias. The electric power consumption indicators also imply that economic activity has declined less in the former Soviet Union than in Central and Eastern Europe. The countries that have been hit particularly hard include the Baltics, Bulgaria, and Romania, all of which have suffered external trade disruption (and for some, slow reforms), and Armenia and Georgia, which have faced severe civil disturbances. (In some countries power consumption was up in 1994, indicating that these economies have returned to growth.)

One implication of our analysis is that official economic statistics of output seem highly unreliable. Until better national income data become available, a much simpler method would be to rely on power consumption data, a more reliable indicator of short-run economic activity.

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### GDP Decline in Transition Economies—Different Methods, Different Results

![GDP Decline Chart]

Source: Authors.
Milestones of Transition

The Czech Republic's monetary authorities said they were taking steps to make the koruna fully convertible under IMF guidelines, possibly by July 1. The national bank ruled out an imminent revaluation of the currency. Czech firms will be able to buy goods, take out foreign loans, or issue bonds abroad without restriction and without approval of the national bank. Czech residents will also be able to invest abroad, but the current limit on buying hard currency will remain in place for a while. Until the end of 1994, Czechs could purchase hard currency worth up to 12,000 koruny a year. This figure was raised to 100,000 koruny in January, and Prime Minister Vaclav Klaus said the limit will eventually be abolished.

The Czech Republic's annual inflation rate was 10 percent in 1994, compared with almost 21 percent the previous year. The steepest increase in costs, 14 percent, was recorded in the service sector. Food prices rose by 13.9 percent. The government estimates that the 1995 inflation rate will be 7 to 9 percent. The budget surplus last year totaled 11.2 billion koruny ($390 million). Off-budget expenditures have been financed by privatization receipts and by funds that would previously have been used for subsidies to Slovakia.

The European Bank for Reconstruction and Development's controversial $840 million funding of completion of two partially built 440 MW Soviet-designed pressurized water reactors at Slovakia's Mohovce nuclear plant, 120 km (75 miles) east of Bratislava, is wrong, says a report by the Oko-Institut, a German ecological organization. The report adds that the EBRD wrongly assumes that the plant is the cheapest way of supplying Slovakia's energy needs. On the contrary, the nuclear plant would cost about $320 million more than the gas alternative over the lifetime of the plant. Austria is considering pulling out of the EBRD if the bank proceeds with the funding. The EBRD will vote on the decision in April.

Slovak economic ministers and representatives of the National Property Fund and the Supreme Supervisory Office met in early February to discuss how to speed up the privatization process. The delegates decided that Slovakia's second wave of coupon privatization will probably start on 1 July. The second wave, planned by the previous government, was scheduled to begin on 15 December. Despite the tremendous popularity of the program (about 3.5 million adults, more than 90 percent of those eligible, registered), it was delayed by the current government, which claimed the program was ill-prepared and time was needed for an investigation of multiple registration of coupon holders. Enterprises to be sold off have not yet been designated.

Hungarian Prime Minister Gyula Horn appointed Lajos Bokros, Managing Director of Budapest Bank, as Finance Minister, and Gyorgy Suranyi, Managing Director of the Central European International Bank, as National Bank President. Analysts said the appointments should send positive signals that the central bank will hold an independent course and that fiscal reform will continue. Bokros, an economist, also currently heads the Budapest Stock Exchange Council. Suranyi was a consultant to the World Bank in 1986. Horn expects the share of private property in the economy to reach two-thirds by the end of the current Parliament's term in 1998, adding that the country's stalled privatization program would regain momentum this year once sale of stakes in the energy and banking sectors go ahead. The privatization bill is expected to go before the full legislature for a vote in March.

China had an inflation rate of 24.4 percent last year, more than double the government's target. The State Statistical Bureau has also reported that the economy grew by 11.8 percent in 1994, the third consecutive year of rapid growth. This year, China wants to cut inflation to 15 percent, cool growth to 9 percent, and make use of interest rates as an economic lever. An official of the State Planning Commission confirmed that in 1995 no new large and medium-sized fixed-asset investment projects will be approved, adding that demand in China for building materials already far outstrips supply.

China is encouraging overseas investment funds to become shareholders in state-owned enterprises, China Daily reported. At the same time, Yuan Mu, director of the State Council Research Office, China's most powerful research organization has asserted in an article in the Economic Daily (Beijing) that "privatization is not a model for us, state ownership is the basis of socialism." He ruled out following former communist countries on the road to privatization.

China plans a three-stage approach to full currency convertibility by the year 2000, the People's Bank of China's Xu Bing said. In the first stage, all foreign exchange income must be purchased by appointed banks. The second stage would relax rules in international trade payments, although restrictions would remain on capital outflow. In the final stage, free capital flows would be permitted, Xu said. (China's foreign exchange reserves approached the $50 billion mark in 1994, more than double the 1993 level.)

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A good harvest and robust trade helped Viet Nam's economy grow 5 percent in 1994, according to preliminary figures published in Hanoi. Industry grew 13.5 percent during the year, while agricultural output grew 4.5 percent despite heavy floods in the southern part of the country. Foreign investment increased 20 percent in 1994 over the previous year. Record imports forced Viet Nam's trade deficit up to $900 million in 1994 from $200 million the previous year, according to official figures published in Hanoi. Exports grew marginally from $3 billion to $3.6 billion while imports shot up from $3.2 billion to $4.5 billion. Viet Nam's monthly inflation rate increased to 3.8 percent in January following higher consumer spending.

Half of Viet Nam's 72 million people still live below the poverty line and malnutrition is widespread among children, according to a nationwide survey, that was conducted in 1992 and 1993 by the State Planning Committee and the National Department of Statistics, with advisory help from the World Bank. Only 10.5 percent, or $400 million, of the $3.82 billion pledged by foreign countries and financial institutions since 1991 has reached the country, state bank experts said in a report entitled "Viet Nam Investment Review." Foreign financial institutions, including the IMF and World Bank, have offered to train officials in financial management.

In 1995 Ukraine will introduce its new national currency, the hryvna, in its effort to reform its monetary system and ailing economy, President Leonid Kuchma told Ukrainian Television. Kuchma also signed a decree creating a presidential advisory Council on Economic Reforms, formally establishing his current team of economic advisers as a group charged with developing economic policy. The new council will be chaired by Viktor Pynzenyk, the first deputy prime minister for economic reforms. Ukraine intends to cut its 1995 budget deficit to 4 to 5 percent of GDP with the help of foreign credits and short-term state bonds. Last year, Ukraine had to struggle with huge energy debts, a 27.8 percent decline in production, a 26 percent drop in revenue, high inflation, and massive credits to the agricultural sector. This year, Ukraine plans to overhaul the financing system for the farm sector and privatize large segments of the agricultural industry.

The Ukrainian government has decided that the sixth nuclear reactor at the Zaporizhzhia atomic energy station, considered the largest of its kind in Europe, will go on line for testing purposes in the first quarter of 1995 in preparation for its planned commercial usage by the end of the year. Ukraine obtains up to 40 percent of its energy from five nuclear power stations throughout the country, including Chernobyl. Despite protests from environmental groups, Ukrainian authorities have said the energy crunch in the country is forcing them to continue to rely on and even expand their civilian nuclear program.

The Russian Ministry for Cooperation with CIS Countries disclosed that in the first three quarters of 1994 Russia supplied Belarus with 28 percent more gas than agreed to, Moldova with 15 percent more than contracted, and Ukraine with 55 percent more than agreed. These three countries are Russia's largest gas debtors. In all, Russia supplied over 28 million tons of oil, 64 billion cubic meters of gas, over 4 million tons of coal, 600 tons of gasoline, 1.5 million tons of diesel, and 1.4 million tons of fuel to CIS states in the first ten months of 1994. Russia did not meet its full obligations of oil supplies to Armenia, Georgia, and Kazakhstan.

Russian trade with non-CIS countries in 1994 increased by 7 percent compared with 1993, amounting to more than $76 billion, the Ministry of Foreign Economic Relations announced in early January. Russian exports to non-CIS countries increased 9 percent to $48 billion. Most of the positive trade was due to the increase in the export of raw materials, oil, and petroleum products. Russian machinery exports were down 16 percent and made up less than 5 percent of the country's total exports. Some 70 percent of the exports went to industrialized countries, particularly the EU. Russian imports amounted to $28 billion, an increase of 5 percent over 1993. Half of the imports were foodstuffs and consumer goods.

Russia's GDP in 1994 totaled 630 trillion rubles; the nongovernmental sector accounted for 62 percent, including 25 percent that was produced by private enterprises, the State Statistical Service reported. In constant prices the 1994 GDP amounted to 88 percent of that in 1993, while spendable incomes in real terms increased 14 percent. Services accounted for half of GDP, as compared with one-third in 1990, prior to the start of economic reforms. Banking, insurance, and real estate operations accounted for the growth in the services sector, while the volume of "traditional" services shrank by one half on 1993. The overall volume of industrial production in current prices totaled 344 trillion rubles, a decrease of 21 percent. The rates of decline were minimal in the fuel and energy complex and in nonferrous...
metallurgy. Machine building was the worst hit, with a decline of 39 percent. The slump in light industry amounted to 53 percent. Farming output is estimated at 82 trillion rubles.

Russia's GDP in the first quarter of 1995 is expected to stand at 250-260 trillion rubles, down 6 to 8 percent compared with the same period in 1994. The rates of decline are expected to be greater in the processing industries than in the mining and raw materials industries. This will be a difficult year for Russia if it pursues a consistently stringent financial policy in order to secure economic stabilization, said Economics Minister Yevgeny Yasin. January inflation is expected to be above 15 percent, after reaching 16.4 percent in December, the second-biggest monthly rise for 1994. Inflation has to be brought down to a monthly 2 to 3 percent.

During the past three years, between 1991 and 1994, wages in Russia grew only half as fast as prices, the Moscow daily, Izvestia reported. Housing construction in 1994 was 25 percent higher than in 1993, and amounted to approximately 7 million square meters of floorspace. The number of unemployed stands at 5.3 million, 7.1 percent of the workforce, but together with the partially unemployed, the unemployment rate rises to 13.5 percent. Women and young people accounted for two-thirds of Russia's unemployed in 1994. Average life expectancy of Russians has dropped from 65.1 years in 1993 to 64 years in 1994.

About 23 percent of the Russian population (34 million people) had money income below the minimum subsistence level, which amounted to 240,000 rubles ($57) a month in January. Russians with the highest incomes have 15 times as much as the lowest, Russia's State Statistics Committee reported. In 1993 the ratio was 11:1 and in 1991 it was 4.5:1. In January through November 1994, 10 percent of the population received 30 percent of the total income, while the poorest 10 percent received only 1.9 percent. About 65 percent of the population had incomes below the average level. By the end of 1994, average salaries and wages were just over the equivalent of $100 a month.

Russia's imports of grain in 1995 could reach 25-30 million tonnes, Deputy Prime Minister Aleksandr Zaveryukha predicted. Food shortages in grain, meat, butter, and vegetable oil were particularly alarming, Economy Minister Yevgeni Yasin told the Duma on 10 February, and he called for a ban on exports of certain farm goods in order to create a "favorable environment for Russian producers." Since 1990, annual agricultural output has fallen by 45 to 50 percent, compared with the 1986-90 average, and the number of cattle has declined by 20 million (24 percent), pigs by 11 million (36 percent), and sheep and goats by 17 million (40 percent). Farmers are short of fuel and equipment; fertilizer usage is 8.5 times less than in 1990 and 20 times less than in EU countries.

The Russian Duma approved the 1995 budget, which provides for revenues of 169.8 trillion rubles ($42.45 billion) and spending of 243 trillion rubles ($60.75 billion), leaving a deficit of 73 trillion rubles ($18.25 billion)—7.7 percent of Russia's GNP. The budget must still be brought before the Federation Council (the upper house of parliament). The upper house voted on 10 February to raise the minimum wage from 20,500 rubles to 54,100 rubles ($13). The minimum wage is used as a basis for calculating benefits and pay for all public employees. The president is likely to veto the increase. Finance Minister Vladimir Panskov warned that such an increase in the minimum wage would swell the budget deficit and fuel inflation.

The first draft of Bulgaria's 1995 state budget was submitted to the cabinet by Finance Minister Dimitar Kostov, on 7 February. Revenues are estimated at 321 billion leva ($4.8 billion) and expenditures at 348 billion leva ($5.2 billion). The estimated budget deficit of 27 billion leva ($400 million) equals 3 to 3.5 percent of estimated GDP. Inflation is projected to reach 40 to 50 percent in 1995 (the government estimated inflation at 35 to 40 percent in 1994, but it reached 121 percent). The draft budget is to be discussed later this month. Prime Minister Zhan Videnov has said the 1995 budget has top priority and will be passed by the end of March.

Bulgaria's government has announced price hikes for fuel, energy, and other goods, including flour, as of 1 February. The price of electricity is expected to rise by 70 to 200 percent. The Bulgarian Socialist Party is considering distributing vouchers among lower-income earners to cover higher electricity and heating costs. Unemployment in Bulgaria is expected to rise to 750,000 in 1995. More than 300,000 unemployed receive no state compensation. The state paid out some 2.7 billion leva (about $180 million) in unemployment benefits in 1994, reported Tруд the Sofia daily.

With average annual income per head of about $80, low domestic savings, and tightly restricted credit, Mozambique's growth will depend largely on continued foreign investment and support. The government is currently preparing the state budget proposals for a March meeting of the World Bank's Consultative Group in Paris. At the last meeting in December 1993, donors pledged over $1 billion, partly in support of the peace process. Mozambique is seeking at least $1.4 billion in foreign aid in 1995, Plan-
ning and Finance Minister Tomas Salomao said.

Mongolia has published a new set of laws, to take effect in April, that allow private citizens to own land and foreigners to lease it. The country posted a 2.1 percent rise in its gross domestic product in 1994, its first economic growth in five years.

Poland on 1 January introduced a new currency that lops four zeros off the bank notes currently in circulation. One U.S. dollar will now buy 2.4 new zloty, compared with 24,000 old zloty. The currency transformation will cost the Polish central bank the equivalent of $20 million.

(We appreciate the contributions of Open Media Research Institute's Daily Digest, a joint venture between the Open Society Institute and the U.S. Board for International Broadcasting.)

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World Bank/IMF Agenda

 Ahead of Sweeping Reforms?

U.S. Treasury Undersecretary for International Affairs Lawrence Summers said that the G-7—rather than simply reacting to financial crises—should focus on reforms of international financial institutions that will help avoid these problems. Summers said he expected financial reform issues to figure prominently at the G-7 summit scheduled for June 1995, in Canada. In another development, a sweeping reform of the United Nations and other global institutions is recommended in a report by a group of senior statesmen, entitled "Our Global Neighborhood." Among the group’s recommendations is the establishment of an economic security council charged with monitoring the global economy, providing a long-term strategic framework, and achieving consistency between the policy goals of large international agencies, particularly the World Bank, the IMF, and the new World Trade Organization. Former World Bank President Barber Conable is among the 28 members of the commission.

World Bank Approves $500 Million for Ukraine

A $500 million World Bank loan approved 22 December 1994 will help stabilize and restore growth to the Ukrainian economy. Ukraine’s per capita income was estimated at $1,910 in 1993, placing it among the lower-middle-income nations. Its population of 52 million is the fifth largest in Europe. Ukraine joined the World Bank in September 1992. The first World bank loan to Ukraine for $27 million, was made in June 1993 to strengthen government institutions in support of economic reforms.

IMF Agrees to Extend STF Program

The IMF Board at its December 1994 meeting decided to extend until the end of April 1995 the systemic transformation facility (STF) loan program for countries in transition. The program, which "provides special assistance to help formerly communist countries make the shift to a market economy," was due to expire at the end of December 1994. It has so far lent $4.9 billion to transition economies. A longer-term extension has been held up by a debate between industrialized and developing countries over a new special drawing right (SDR) allocation. Developing countries, led by India, want a general allocation of SDRs rather than an allocation targeted only at countries that have joined the IMF since 1981. Germany and other industrial countries have opposed a general allocation. Negotiations on the issue are expected to continue until IMF's Spring Interim Committee meeting.

IMF and World Bank Provide Loans to Moldova ...

The IMF approved $32 million in loans to help Moldova reform its economy and pay for increased imports of wheat and other cereals. About $18 million was made available from the compensatory and contingency financing facility (CCFF) to help to defray the cost of increased cereals imports, following a major crop failure in 1994/95. Cereal production fell by 49 percent, compared with the previous crop year. A further $15 million has been drawn under Moldova’s standby credit facility with the IMF. A $60 million World Bank loan was approved in early December to back Moldova’s continued structural reforms. The loan supports a program of privatization, hardened budget constraints on enterprises, creation of a competitive environment, and better targeting of social benefits.
Help To Belarus

On 31 January the IMF approved a $103 million second disbursement of an STF loan to Belarus to support the country's economic reforms. The first disbursement of about the same amount was approved in July 1993. Last year real GDP contracted by 21.5 percent in December, consumer prices increased by 31.3 percent, and external current account deficit widened to 11.6 percent of GDP. In 1995 the economy is expected to stabilize, and by year-end the monthly inflation rate should fall to 1 percent. In late January a World Bank delegation discussed how to improve oil production and the overall performance of the Belarusian energy complex; proposals included turning Belarusneft, the republic's largest oil-producing complex, into a joint-stock company, with the help of the World Bank. Liberalization of Belarusian oil prices and improvement of the tax system were also on the agenda.

and Loans Estonia

The IMF on 9 January granted Estonia a second loan worth $16.9 million under its systemic transformation facility (STF). The IMF said that Estonia's monthly inflation had been down to between 1 and 2 percent over the past two years, and that output grew by about 5 percent in 1994. Like the same-size STF loan approved on 27 October 1993, the new loan will be channeled into the economy through Estonian commercial banks. Although the IMF charges an annual interest rate of 5 percent, commercial banks will receive the money at about 7 percent, with the leeway to raise the rate to up to 18 percent. Later in January the World Bank approved an $18 million loan to be used to build a bioclinic for Estonia's Tartu University, purchase medical equipment, and organize training programs.

Camdessus's Qualified Praise for Poland

IMF Managing Director Michel Camdessus during a late December visit to Poland praised the country's drive to a market economy and the announcement that the Polish currency would become partially convertible as of 1 January 1995. Exchange restrictions for all current transactions in imports, exports, tourism, and services were to be lifted. The controls that remained would apply only to capital transactions. Camdessus congratulated the Polish authorities on what he called a "historic" decision. But Camdessus said Poland would have to cut annual inflation to 5 percent to be admitted to the European Union. (Inflation is expected to drop from 29 percent in 1994 to 17 percent in 1995.)

Algeria Borrows and Reschedules

Algeria is expected to resume talks with the IMF and seek financing of "probably over $1 billion" to rebuild its economy. An IMF spokesman said negotiations with Algeria would resume in mid-February in Geneva. An agreement with the IMF would also open the way to a new rescheduling of Algeria's Paris Club debt and to credits for free market reforms. Negotiations with commercial creditors have resumed in London to discuss rescheduling of $2.5 billion-$3 billion worth of commercial bank debt. The talks with the IMF would focus on a medium-term program spread over three years to consolidate the transition toward a market economy.

Earlier, Algeria completed a round of debt rescheduling deals with individual creditor governments in the Paris Club, covering $5.3 billion of debt. The public and private debt will be rescheduled after a new adjustment agreement (covering 1995-98) with the IMF is reached this spring. (Contrary to Fund expectations, the French daily, Algeria's economy did not recover in 1994 the French daily, LeMonde, reported.) In another development, a $130 million World Bank loan approved 31 January aims to help Algeria reduce its backlog of badly needed road and bridge rehabilitation. Earlier, a $150 million economic rehabilitation support loan was approved to shore up the private sector, help public enterprise restructuring, reform public expenditures, complete the legal and regulatory framework, and strengthen the social protection system.

IMF Approves Loan to Georgia

In mid-December the IMF approved a $40 million systemic transformation facility loan to support Georgia's macroeconomic stabilization and reform over the next twelve months. The government's program aims to achieve noninflationary growth, bring monthly inflation down to 1 percent by the end of 1995, and raise living standards following the end of the war with Abkhazia. Monetary policy will be tightened and budgetary policy will be made more restrictive, with the aim of liberalizing foreign exchange regulations and trade.

IMF Loan and IDA Credit to Armenia

The IMF in mid-December approved a $25 million systemic transformation facility credit to Armenia to support the government's economic and financial program. Armenia foresees 5 percent growth in 1995, and aims to bring monthly inflation down from 26.3 percent in 1994 to 5 percent this year. Monetary policy will be tightened, budget restrictions will be applied, prices will be liberalized, and a privatization program will be pursued. In addition, a $13.7 million IDA credit approved in early December will help restore three thermal and three hydro-power generation plants and will improve dispatch and distribution systems. A second IDA credit of $43 million aims...
to help Armenia rehabilitate its rapidly deteriorating irrigation infrastructure and improve maintenance and water resource management. Armenia depends on irrigated lands for about three-quarters of its agricultural production.

Lithuania Cleans Beaches

A $7 million World Bank loan approved in early December will help Klaipeda—Lithuania’s only port on the Baltic Sea—to repair and expand its wastewater treatment system and prepare a comprehensive coastal zone management plan. The beaches, as well as crucial fisheries and wildlife habitats in the area, are threatened by the discharge of partially untreated wastewater.

World Bank Helps Streamline Cambodia’s Government

The World Bank has signed an agreement to provide Cambodia technical assistance worth $17 million. Finance Minister Keat Chhon said the money would be used to provide training and equipment for civil service reform and "to provide a legal environment conducive to the development of the private sector." Cambodia would like to secure up to $450 million from international donors in 1995, to be able to increase economic growth to 7 percent while improving general living conditions.

Eritrea Receives $250 Million

Donor nations and agencies attending a two-day meeting at the World Bank’s Paris office in December 1994 pledged aid of up to $250 million to Eritrea to help rebuild the newly independent state after thirty years of war. Francis Colaco, IBRD Director for Eastern Africa, said the pledges were more than had been expected and would be on highly concessionary terms. The country badly needs foreign aid to develop its economy and resettle its refugee population. The IMF has granted extended structural adjustment facility (ESAF) eligibility to Eritrea, bringing to 80 the number of low-income countries able to draw ESAF credits. (ESAF credits are disbursed over three years; loans carry an interest rate of 0.5 percent repayable over ten years, with a five-and-a-half year grace period. Total ESAF disbursements to date amount to $4.2 billion.)

IMF and IDA Assist Laos

The IMF approved on 25 January a $17 million ESAF loan to Laos to support the country’s reform efforts in the next twelve months; the target is real economic growth of 7 percent and a reduction of the annual inflation rate to 5 percent. A new IDA credit of $19.2 million will help provide a broad range of improvements to the overall health system in Laos, including training, equipment, and maternal and child health programs. Several program components target malaria control and treatment, and a pilot program will provide basic health services to isolated minority groups.

Tanzania Meets Donors in Paris

Tanzania Finance Minister Jakaya Kikwete said the country borrowed $40 million from commercial banks after Finland, Sweden, and Norway imposed an aid ban. Before attending a donors’ consultative group meeting in Paris he stated that the borrowing had in turn fueled inflation and thrown the country’s economic recovery program out of gear. The three countries cited concern over official reports that tax evasion cost the country $125 million in 1994. Other Western donors followed suit and withheld undisclosed amounts of aid. Kikwete said he was investigating the tax evasion racket and said his top priority would be efficient tax collection. He was ready to review the country’s fiscal policies. The World Bank has scheduled an appraisal mission to arrive in late March or early April to assess the country’s progress in its economic liberalization program.

IFC Invests in Balkan Fund

The International Finance Corporation (IFC) has announced a $5 million investment in the Euro-Merchant Balkan Fund, a venture capital fund capitalized at $27.3 million. The fund will invest in small and medium-size companies in Bulgaria and possibly other countries in the region.

IMF Approves Uzbekistan STF Credit

The IMF has approved a $74 million STF credit for Uzbekistan and said it hopes to agree on a new economic program that could produce additional financing. The IMF said the loan disbursement supports a comprehensive economic program for this year designed to cut inflation (which hit 425 percent in 1994) while seeking to limit economic decline. The IMF noted that with a large share of production concentrated in commodities such as energy, cotton, and gold, Uzbekistan appears to have been able to escape some of the impact of trade disruptions in the region.

IFC Helps Eel-raising in China

The IFC will help finance eel-raising in China. A $19 million loan signed on 24 January will give the IFC a 21 percent share in the Nantong Wanfu project in China, a joint Sino-Japanese venture producing about 3,000 tons of eels a year, mainly for export to Japan.

Developing Countries to Gain from Uruguay Round

Developing countries will gain between $60 billion and $100 billion annually from the liberalization of world trade resulting from the Uruguay Round of trade nego-
Cuts in protection on merchandise trade will produce those increases, which represent between 1.3 and 2 percent of real income. World Bank Vice President and Chief Economist Michael Bruno said during a two-day conference discussing the impact of the Round on developing countries. "The agreement on agriculture achieved a great deal by defining rules for agricultural trade, but much less than was hoped in terms of immediate market opening. This process of integration is important. By the end of the next decade, we expect developing countries to take over a third of industrial country exports, up from around a fifth today," Bruno said.

MIGA Mid-Year Results

The Multilateral Investment Guarantee Agency (MIGA), the World Bank affiliate that promotes private investment in developing countries through guarantees against noncommercial risk, announced that in the six-month period from 1 July to 31 December 1994, it issued 28 investment insurance contracts with a combined maximum coverage of $312.1 million, and three commitment letters totaling $123 million of potential coverage. (This included coverage for copper products and machine tool manufacturing facilities in China.) During the same period, MIGA membership increased to 128 countries. Mozambique, Ukraine, and Viet Nam were among countries completing membership requirements.

Albania’s Power Pirates: Unplugged

A World Bank project—funded by an IDA credit of $5 million—will reduce electricity thefts in Albania; inspections will be enforced, and revenues increased. Since 1990, household electricity consumption in Albania has increased more than fivefold. But about half of the consumption is illegal. In the Shkoder region in the north, for example, only half the consumers have meters, and the majority of them are broken. And meter tampering has been common. Besides this Power Loss Reduction Project, another project is being prepared that will finance the rehabilitation and upgrading of power transmission and distribution of systems.

Conference Diary

Poland and European Union
March 2-3, 1995, Brussels

Conference organized by the Club de Bruxelles. Topics include: the Polish economy; the association agreement, commercial exchange, and interregional cooperation; investment and international aid in Poland.

Information: Club de Bruxelles, 10, rue du College Saint-Michel, B-1150 Brussels, Belgium, tel. (322) 771-9890, fax (322) 770-6671.

Has the Time Come to Invest in Russia?
March 17-19, 1995, New York

19th Arden House Conference, organized by Harvard University, Russian Research Center and Columbia University, Harriman Institute.

Information: Harvard University, Russian Research Center, Archibald Cary Coolidge Hall, 1737 Cambridge Street, Cambridge, Massachusetts 02138, USA, tel. (617) 495-8900, fax (617) 495-8319.
E-mail: chess@husc7.harvard.edu

China’s Foreign Trade and Investment Law
March 24-25, 1995, San Francisco

International conference organized by The 1990 Institute, a California-based research institution studying China’s basic social and economic policy issues. Leading experts on Chinese business law from North America, China, and Hong Kong will explore foreign trade regulation and administrative structure, foreign investment, technology transfer and intellectual property protection, and dispute resolution mechanisms, and will address the issue of the compatibility of China’s foreign trade law with the requirements of the World Trade Organization.

Information: Mr. Hang-Sheng Cheng, President, The 1990 Institute, 651 Gateway Boulevard, Suite 880, South San Francisco, CA 94080, USA, tel. (415) 872-0787, fax (415) 742-0828.

Hungary in Change: Provisional Results of the Transformation Processes in Hungary and Aspects of Hungarian-German Relations
April 6-8, 1995, Kassel, Germany

Organized by Ost-West-Wissenschaftszentrum, Universität Gesamthochschule Kassel/Hessische Landeszentrale für Politische Bildung. Information: Mrs. Gabriela Gorzka, Ost-West-Wissenschaftszentrum, tel. (561) 804-3609, fax (561) 804-3793, E-mail: gorzka@hrz.uni-kassel.de.

Western Aid to Central and Eastern Europe
April 18-20, 1995, Washington, D.C.

Organized by the Woodrow Wilson International Center for Scholars and the Friedrich Ebert Foundation, with the theme, "What we are doing right, what we are doing wrong, how we can do it better." Participants include policymakers, donor and recipient offi-
cials, and scholars and researchers. Topics include: Privatization of Industry and Services, Private Sector and Agricultural Development, U.S. Policy toward Central and Eastern Europe: A Congressional Perspective, and Applications to the FSU.


Evaluation of Research, Development and Technology (RDT) Programs
April 26-28, 1995, Thessaloniki

First International Conference of the European Commission. Conference will evaluate research, development, and technology (RDT) programs, and joint programs of the EU member states with Central and Eastern Europe and the CIS.


Seventh Annual Bank Conference on Development Economics (ABCDE)
May 1-2, 1995, Washington, D.C.

Organized by the World Bank, sponsored by Vice President (Development Economics) and Chief Economist Michael Bruno, with a keynote address by Domingo F. Cavallo, Argentina's Finance Minister. Conference will have a roundtable discussion on second-generation issues of transition, including: From Stabilization to Growth (Stanley Fischer), Limiting Corruption (Susan Rose-Ackerman), and Does Mass Privatization Really Spur Restructuring? (Jana Matesova). Other topics of the conference: Revisiting Redistribution with Growth (Albert Fishlow and Pranab Bardhan), Demographic Change and Development (Peter Diamond and Nancy Folbre), Aid and Development (Dani Rodrik, Elinor Ostrom, and Richard Cooper), Fiscal Decentralization (Vito Tanzi and Rudolf Hommes). Bank-IMF staff members are welcome; others by invitation.

Information: Boris Pleskovic or Gregory Ingram, the World Bank, Research Advisory Staff, Room N9-037, 1818 H Street, N.W., Washington, DC. 20433, USA, tel. (202) 473-1062, fax (202) 477-0955.

Fifth World Conference on Democracy
May 1-2, 1995, Washington, D.C.

International conference organized by the National Endowment for Democracy to focus on challenges in achieving and maintaining democracy. Regional panel discussions will address recent developments in Asia, Eastern Europe, and the former Soviet Union.

Information: National Endowment for Democracy, Fifth World Conference on Democracy, 1101 Fifteenth Street, N.W., Suite 700, Washington, D.C. 20005, USA.

Economic Relations with Russia
May 6, 1995, Dusseldorf, Germany

Conference organized by Deutsche Anwalt Akademie/Max Planck Institut fur Auslandisches und Internationales Privatrecht. Legal aspects of economic relations with Russia will be discussed.
ship; Foreign Capital and Joint Business Ventures; Social Protection and Social Care; the European Union's Expansion into Eastern Europe; Empowerment, Participation, and Social Inclusiveness; and Environmental Protection. Information: Professor Demetrius Iatridis, Boston College Graduate School of Social Work, Chestnut Hill, MA 02167, USA, tel. (617) 552-4041, fax (617) 552-3199.

Competitive Position of the Banking Systems in East European Countries
July 10-11, 1995

Conference organized by the Jagiellonian University. Faculty of Law, Applied Economics Division. Planned sessions are the following: The Banking System and the Non-Financial Sector; Competitive Position of the East European Banks in a Global Economy; and Future Evolution of the East European Banking System. Information: Ms. Ewa Miklaszevska, The Jagiellonian University, Faculty of Law, Applied Economics Division, Kupnicza 2-4, 31-123 Kraków, Poland, tel. (48 12) 21 64 84 or 21 20 81, fax (48 12) 22 63 06 or 23 00 85.

Environmental Economics and Policy Analysis
June 12-July 14, 1995, Cambridge, Massachusetts


Qualified applicants will have a university degree in economics, business administration, public policy, or environmental or natural sciences; intermediate background in economics, English proficiency; intermediate computer competency. The application deadline is March 31, 1995. Cost is $8,500 (including tuition, housing, course materials, health insurance, use of computer facilities, and scheduled recreational events). Information: Dr. Theodore Panayotou, Program Director, Harvard Institute for International Development, One Eliot Street, Cambridge, MA 02138, USA, tel. 617-495-9173, fax 617-496-3956, E-mail: Pholbroo@hiid.harvard.edu.

New Books and Working Papers

The PRDTE unit of the World Bank regrets that it is unable to supply the publications listed.

World Bank Publications


EDI Development Study


Steps to a more efficient allocation of labor resources and a well-functioning labor market in the transition economies depend on sound macroeconomic policy. In Eastern Europe and Russia the social costs of transition are significant. For workers who find themselves unemployed, the chances of reentry into the labor force are not good. The average 10 to 15 percent unemployment rate in the Central and Eastern European countries exceeds by about 3 to 4 percent the West European average. In the transition economies, on average, more than 50 percent of those on the dole are long-term unemployed.

The large social costs will clearly play back into the political arena and future decisions on reform. If equilibrium unemployment is high, reducing the unemployment rate is difficult. Labor market rigidities should therefore be softened up, and impediments to labor mobility eliminated. That translates into better access to housing and infrastructure, and a reduction of regional inequalities, as well as accelerated divestiture of social assets by enterprises. Government's labor policies—besides initiating training, retraining, and other skills development programs—could include selective use of marginal wage subsidies to companies hiring long-term unemployed. (Based on the Foreword, by Michael Bruno, Vice President and Chief Economist of the World Bank.)
Discussion Paper


Country Studies


Weak traits of the expanding Polish economy:
- Decline of Poland's national savings and slow flows of external capital. These trends should be reversed, or at least halted. Investment prospects hinge as much on a turnaround in savings, as on improved capital inflow. Poland could have better access to international private capital markets if it safeguards economic stability, removes impediments to foreign direct investment, and eliminates uncertainty about property rights.
- Large state-owned enterprises, including coal, steel, and rail transport, employ about 15 to 20 percent of the industrial labor force, thus postponing painful reforms.
- Consensus for reform is weakening. Social strains have emerged, as some groups of society voice concerns that the fruits of recovery are not being shared equally.

Despite these weaknesses, Poland's economy could prosper, based on recent strong performance. Policy goals should include reform of public finances and an acceleration of privatization and structural reforms.


Policy Research Working Papers


Transition societies face acute conflicts. The socialist era was characterized by stagnant incomes, rationed goods, and lack of liberties, but also by a high degree of income security. The early days of reform have brought civil liberties, but also fewer and less-secure jobs, less social security, and greater inequality in the primary distribution of incomes.

Should transition societies use transfers to stem the rise of insecurity and poverty? The history of cradle-to-grave state protection and the ideal of the West European welfare state notwithstanding, the transition economies don't have the underlying productivity levels, or the tax bases, to sustain transfers on a very large scale. Sustaining high-level transfers could result in insufficient private and public capital accumulation, further weakening competitiveness. This would hurt primarily the poor, the old, the disabled, and the unemployed—precisely those that transfers are supposed to protect.

Societies have to choose between security and growth. Transfers should be consistent with macroeconomic imperatives and should have relatively low adverse-incentive effects (lower dole or severance pay; localized, rather than generalized, income-tested social assistance). Strict saving on transfers inevitably puts more pressure on the individual to cope and will, at least in the short run, increase the risk of social and political destabilization. To order: Maria Estrella, the World Bank, Rm. H12-081, tel. (202) 473-2665.


Tax-sharing of central government revenues based on district of origin cannot be the only means of local finance in Albania, as most revenues collected come from only a few districts. To meet financial needs, local governments need some authority over significant own-source revenues such as user charges and property and vehicle taxes. Privatization revenues can also help local governments, but only in the short run, as they are nonrecurrent.

For low-income regions incapable of meeting their spending needs on their own, a transparent, equalizing transfer system should be developed. Albania's draft laws allow for this possibility, having established constituent and independent budgets for the local level. To order: Gemma Langton, the World Bank, Rm. H11-075, tel. (202) 473-8392.


"Ruble overhang" and ruble shortages in the Soviet Union and its successor states were manifestations of the same economic phenomenon: the household sector's inability to convert financial assets into purchasing power for commodities.

To order: Lenora Suki, the World Bank, Rm. H2-096, tel. (202) 473-3974.


The Atlas provides key social, economic, and environmental data in three languages: English, French, and Spanish. The latest edition provides for the first time per capita GNP estimates converted at the national currency's purchasing power parity (PPP). The higher the prices of goods and services in an economy, the less money can buy and the lower the real per capita income. Conversely, the lower the prices, the farther your money will go and the higher a person's income in comparison with other countries. The richest nation in the world in per capita terms is Switzerland with $36,410. Luxembourg is next, followed by Japan, Denmark, Norway, Sweden, the United States, Iceland, Germany, and Kuwait. Eight countries in Africa and three in Asia are among the poorest in the world: Mozambique is the poorest with a per capita income of $80 in 1993. Ethiopia ($100), Tanzania ($100), and Viet Nam ($170) are also part of this group. Guinea-Bissau has the lowest life expectancy at birth: 39 years. Japan has the highest: 79. The infant mortality rate per 1,000 live births is highest in Afghanistan and Mozambique: 162. Japan, Singapore, Ireland, and Sweden have the lowest: 5. During 1985-93, prices rose the most in Nicaragua, which had an average annual inflation rate of 1,836.2 percent.


Flows of private sector capital to developing countries continued to expand last year to reach a record $173 billion, but slowed sharply from the surges in flows experienced earlier in the decade. Portfolio equity investment in emerging stock markets fell to $39.5 billion last year from 1993's peak of $46.9 billion. Private sector bank and bond finance continued to grow in 1994, to $55.5 billion, up from $45.7 billion a year earlier while foreign direct investment expanded to $77.9 billion last year, up from $66.6 billion in 1993. All told, private sources of capital accounted for three-quarters of the net resource flows to the developing world, while in 1990, government development loans and grants made up more than half the developing world's capital flows.


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Other Working Papers

From the Institute of Economics, Latvian Academy of Sciences, Riga, Latvia


Land reform in rural Latvia provides land usage rights for both individuals and legal entities. In the first stage of land reform, those who owned land on 21 June 1940 [when the Soviet Union overran the country] or their heirs, as well as current land users and individuals requesting first-time land use, had to submit applications by 1 January 1993. Those requesting first-time use of land had to indicate the date on which they would undertake utilization of the land, by 1 November 1996 at the latest. In the second stage, lasting ten to fifteen years, land ownership rights will be restored, but ownership will be restricted to Latvian citizens. The total area of a farm may not exceed 100 hectares.

By 1 January 1994 only 0.5 percent of the total farm area was under private ownership, and land registration continues to drag. The slow pace at which farms are being established, together with the capitalization and structure of these farms, jeopardize production levels. The number of cattle and fowl in early 1994 sank back, respectively, to levels seen in 1920 and 1945. During 1993 the number of cattle dropped by 38 percent, and of pigs by 26 percent, and milk production fell by 55 percent.


OECD Publications


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The household responsibility system and the new rural land system in China have unleashed the economic energy of China’s farmers. However, further reform is needed to improve tenure security and facilitate the development of a rural land market. A series of policy options, based on rural fieldwork in China and a comparative background of land reform issues, could lead to a much improved rural land system and, in turn, to land improvements, greater agricultural growth, higher farm incomes, and increased stability in China’s countryside. These include:

- Granting permanent land use rights to farm households, with continuing public ownership.
- Allowing the sale of use rights as a reallocation mechanism.
- Implementing constraints on using arable land for nonagricultural purposes.
- Establishing rules and procedures relating to the rural land system.
- Clarifying collective ownership.

The dramatic drop in industrial and building activity has led, with a lag of some years, to rising unemployment, which is closing in on 400,000 (more than 15 percent of the workforce). Industrial activity is largely dependent on the success of conversion of military hardware producers. Scientific research, which once employed 14 percent of the city’s labor force, will also shed most of its employees because the state and the army have cut much of their former funding to science.

But the city’s emerging gateway functions in Russian foreign trade are creating new opportunities and jobs. St. Petersburg has become Russia’s largest port, and is the center of the region’s transport and communications facilities. Private small business, the retail trade, banking, insurance, and, to some extent, tourism are expanding. In addition to its gateway location, the city’s strength is its culturally attractive milieu, the presence of high-level educational institutions, a skilled workforce, and engineering capacity—factors that may attract investors even if the overall prospects for Russia remain dim.

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László G. Tóth, Trade among the CEFTA Countries in the mid-1990s: How to Promote the Expansion of Intra-Regional Trade Flows in Central Europe, Kopint-Datorg Discussion Papers 27 (special issue), November 1994, 50 p. To order:

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NewsNet, the newsletter of the AAASS (American Association for the Advancement of Slavic Studies), January 1995, Summer Language Programs Issue. Information: NewsNet, Jordan Quad/ Acacia, 125 Panama Street, Stanford, CA, 94305-4130, USA, tel. (415) 723-9668, fax (415) 725-7737.

Privatization Newsletter of the Czech Republic and Slovakia, Institute for Economic Studies (IES), Faculty of Social Sciences, Charles University. To order: CIPE, 1615 H Street, NW, Washington, D.C., 20062, USA, fax (202) 887-3447.

St. Petersburg Review, a bimonthly analytical review by the International Centre for Social and Economic Research—the Leontief Centre—of the socioeconomic situation in St. Petersburg. Also, among various reports, documents, and commentaries on business, prospects in St. Petersburg: a Special Issue on Transport and Communications, 1994. To order: International Centre for Social and Economic Research—Leontief Centre—190000 St. Petersburg, Voznesensky Prospekt 16, tel. (812) 319-90-26, fax (812) 319-98-14, E-mail: Sln@leontief.spb.su@ Internet.
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