Hungary, Poland, and the Czech Republic provide fascinating comparisons in many areas of economic transformation. Not the least of these is bankruptcy law and policy, where the three are taking different approaches. These differences reflect in part their varying approaches to enterprise restructuring. Bankruptcy cannot be evaluated, especially in these countries, in isolation from other aspects of the transformation program.

Multiple Roles

In the advanced market economies bankruptcy law plays at least three important roles:

- **Exit.** It provides ailing firms with an orderly means of exit and specifies rules for dividing remaining assets among claimants.
- **Restructuring.** It promotes the restructuring of those firms whose “going concern” value exceeds their liquidation value. It may promote such restructuring formally, as under Chapter 11 in the United States, or through informal debtor-creditor workouts in lieu of formal bankruptcy.
- **Debt collection.** It promotes the flow of credit by protecting creditors and serving as a final stage of debt collection.

All of these roles serve the underlying purpose of imposing financial discipline on managers. These same roles are relevant for transforming economies, but the picture is complicated by the presence of two potential "users": state-owned firms and the private sector.

- For state-owned firms, restructuring is of prime importance. Many of these firms need the opportunity to shed the legacies of socialism and adjust to the radically shifting incentive frameworks. Postsocialist governments could not close down all ailing state-owned firms overnight without risking massive economic, social, and political disruption. They must consider the fiscal consequences of large-scale labor-shedding. Bankruptcy-related reorganization schemes in advanced market economies work at the margin in relatively stable economic environments. Analogous schemes in transforming economies must work for 30 to 40 percent of the economy in rapidly changing economic environments.
- For the newly emerging private sec-
tor, in contrast, exit and debt collection (to facilitate the flow of credit) are probably more important than restructuring. This sector more closely resembles the advanced market economies, where judicial bankruptcy procedures function satisfactorily because they operate at the margin.

Sources of Confusion

There has clearly been confusion and tension in Central and Eastern Europe about bankruptcy policy, in part because of the failure to differentiate between these two potential users and the roles appropriate to each. Should a single bankruptcy law apply to both state and private firms? Should it provide for restructuring as well as liquidation, and, if so, what limits should be placed on each, and what links should join the two? Can the economy afford the massive exit of loss-making state firms that could result from a tough approach? On the other hand, can it afford a softer approach given the need for financial discipline and viable debt collection to spur credit to the newly emerging private sector? Are there alternatives to traditional judicial bankruptcy that could more effectively promote restructuring of loss-making state firms, especially in light of the weak judicial systems in these countries?

Adding to this confusion are the mixed messages emanating from the advanced market economies themselves. The U.S. Chapter 11 reorganization provisions are coming under increas-

What to do with Bankrupt Firms?
Dilemmas and Recommendations of a Conference

Current restructuring in the post-socialist economies requires policymakers to consider at least three possibilities when handling financially distressed companies: conciliation, liquidation, and exceptional rules for out-of-court settlement. That was the overwhelming view of a recent conference in Poland that focused on enterprise bankruptcies (mainly in the Czech Republic, Hungary, and Poland) and worked out policy proposals.

The conference, “Enterprise Bankruptcy in the Emerging Market Economies,” took place in Warsaw on April 23-24, 1993, under the auspices of the Institute for EastWest Studies. It was cosponsored by the Polski Bank Rozwoju, Bank Handlowy, Polski Bank Kredytowy, and the Polish Bank Association. About 60 experts participated, primarily bankers, lawyers, and economists from the Czech Republic, Germany, Hungary, Poland, Russia, the United Kingdom, and the United States.

Conciliation. In the emerging market economies, conciliation (financial agreement) between the debtor and its creditors should be given strong preference. The huge liquidity crunch in the economy, a consequence of radical changes in economic direction, and the collapse of intraregional trade, must be mitigated without liquidating the bulk of enterprises. Protection of assets during the negotiations is essential. Assets are particularly at risk in state-owned enterprises. The appointment of trustees should be an appropriate response, if there are enough individuals qualified for this job. If not, a second-best solution could be the appointment of administrators with limited supervisory roles. Once agreements are made, they should be carried out within a specific period; two years seems reasonable.

Liquidation. Liquidation must be as credible a threat as possible in a state-ownership-dominated economy, although liquidation procedures should take into account the embryonic state of capital markets and commercial courts. (The credibility of rules requires strengthening the court system, investing in telephone lines and computerized data banks, and increasing the salaries of judges.) Furthermore,

- Rules should be simple, transparent, and easily applicable.  
- Management should be replaced by court-appointed trustees to eliminate managerial abuse. This is especially important given the large number of state enterprises.  
- Trustees should receive much of their compensation after the process has been successfully completed. Their compensation should be established beforehand as a percentage of the realized liquidation revenue.  
- Strong incentives (including financial ones) should be established to complete the procedure relatively quickly. Dragged-out liquidation procedures have caused serious bottlenecks in the restructuring process.

Out-of-court settlements. Even in established market economies, financial difficulties are often settled between creditors and debtors without resort to bankruptcy procedures. This is even more justified in the postcommunist economies, where a large number of enterprises are in financial distress and the courts are weak. Even permissive conciliation rules might not be sufficient, in which case special rules should apply temporarily (say, for three years). If a firm is ready to change to a corporate structure and to present a credible privatization plan, finance ministries might voluntarily surrender a part of the enterprise’s tax and social payment arrears. In Poland, for example, commercial banks should take the leading role in the process by taking equity for unpaid debt. Regulation of bank equity holding should mirror the German model more closely than the American model—banks are still the most competent intermediaries for financial restructuring. Still, caution is in order as exceptional rules, not to mention unregulated bailing out of enterprises, could be harmful in the long run.

Kalman Mizsei  
Program Director, Institute for East-West Studies, New York  
ing criticism, with some observers claiming that they serve primarily to protect corporate managers at the expense of both creditors and owners. More than 90 percent of Chapter 11 cases eventually end in liquidation anyway, but after much time and expense. Other observers continue to support the U.S. approach, however, rightly pointing out that the process does facilitate workouts in some cases, particularly for larger firms (for which the long-term survival rate is considerably higher). All observers agree that the Chapter 11 approach in the United States could not work without strict legal standards in other, related areas, such as contract enforcement, accounting, and fiduciary liability—standards that are still in relative infancy in the transforming economies.

Hungary: Judicial Route

Hungary is the only Central and Eastern European economy pursuing the judicial bankruptcy route aggressively as a primary means toward enterprise discipline and restructuring. In late 1991 it adopted a strict law that requires managers to file for bankruptcy if a firm is more than ninety days in default on any debts.

The law provides two alternative procedures—reorganization (misleadingly called “bankruptcy”) and liquidation. The former gives a debtor’s management sixty days to prepare a plan to restore solvency, which must be approved unanimously by creditors or it automatically becomes a liquidation case. The number of bankruptcy filings has skyrocketed under the new law, increasing from 528 in 1991 to 14,300 (4,400 as reorganizations and 9,900 as liquidations) in 1992. An estimated one-quarter to one-third of Hungarian GDP is produced by firms that have filed for reorganization or liquidation under the law.

Although Hungary shows admirable resolve, its experience to date demonstrates the difficulty of applying the traditional solution—judicial bankruptcy proceedings—to the systemic problems of state enterprise insolvency. Simply from an administrative viewpoint, there are so many problem cases that courts quickly become overloaded. Of the 14,300 cases filed in 1992, about 40 percent of the reorganization cases (approximately one-third of which ended in an approved reorganization plan) and a smaller percentage of liquidation cases had been concluded by the end of the year.

Delays are common despite the strict timetables in the law, in large part due to the shortage of judges and qualified trustees and liquidators. (In the Budapest court there were only eight judges in mid-1992 handling about 4,000 cases.) Furthermore, the strictness of the law is a potential economic “time bomb”; not only will the 10,000 completed or pending liquidations (generally, of smaller firms) lead to rising unemployment, but if some of the approved reorganization plans fail and debtors again go into default within three years, these firms (generally much larger firms) will also be forced to file for liquidation.

Despite their admiration for Hungary’s bold steps, many observers now see the law as too strict, and there is a move to relax it somewhat—particularly, to omit the requirement of mandatory filing after ninety days in default and to soften the unanimity requirement for reorganization agreements. On the other hand, some critics doubt the law’s ability to force appropriate restructuring at all; a significant number of reorganizations may fail simply because they do not lead to fundamental change.

Poland: An Alternative Approach

Poland has been less aggressive in its approach to bankruptcy than Hungary. Its judicial bankruptcy procedures are contained in two 1934 laws, the Bankruptcy Act and the Law on Mutual Agreement, both revived in 1991. In addition, the 1981 Act on State Enterprises (as amended in 1991) provides liquidation procedures for state enterprises. None of these laws contains mandatory trigger mechanisms, and indeed there have been relatively few formal bankruptcy cases in the courts.

But Poland has recently adopted a new and innovative law, the Law on Financial Restructuring of Enterprises and Banks, which envisions a bank-led approach to restructuring loss-making firms. The law applies to majority state-owned enterprises with more than 15 billion zlotys in unpaid debt (or more than 30 percent of debt in arrears). Pursuant to a “conciliation” procedure, a debtor and its creditors (led by banks) have four months to work out a restructuring agreement that can involve debt cancellation or rescheduling or debt-equity swaps. If creditors holding more than 50 percent of the debtor’s obligations approve the agreement, it is binding on all creditors.

Banks holding problem loans (and benefiting from the ex ante recapitalizations also provided in the new law) have until March 1994 to handle these loans through either conciliation procedures, initiation of more formal bankruptcy or liquidation proceedings under the 1934 laws, or
The Czech Republic: Playing for Time

The Czech Republic, like Poland, has not used bankruptcy as a major restructuring tool. Although it adopted a new law on Bankruptcy and Settlement in 1991, a virtual moratorium was imposed on claims against state-owned firms until April 1993. The end of the moratorium was accompanied by several new protections, such as a further delay in its application to certain sectors, such as agriculture, and a “breathing space” of two months (after transfer of shares) for firms that are privatized more than 50 percent through vouchers. Thus, the new law has scarcely been put into practice.

It can be argued that the Czech privatization program is the primary restructuring tool to date. The program generates restructuring ideas by soliciting competing privatization plans. An average of four plans were submitted for each company privatized in the first “wave,” with some companies attracting up to twenty competing plans. The moratorium on bankruptcy coincided with this first wave, presumably on the assumption that privatization was a better means to effective restructuring of both individual firms and the economy at large than judicial bankruptcy procedures.

In sum, Hungary, Poland, and the Czech Republic are all actively pursuing enterprise restructuring, hoping to redress liquidity problems and harden budget constraints while keeping as many firms as possible alive through this turbulent period. But the three are doing it differently, and only Hungary is following the traditional bankruptcy/reorganization route. Poland and the Czech Republic are adopting other innovative means—whether bank-led “conciliation” or competitive privatization—to spur the restructuring of ailing state-owned firms. All three approaches have their pros and cons; the jury is still out on what works best. In any case, all the countries will continue to need workable bankruptcy rules for the private sector, and over the coming years will need to develop sound procedures and the judicial expertise to implement them.

Cheryl W Gray  
PRDTM,  
World Bank

Attali’s Swift Exit

Jacques Attali, head of the European Bank for Reconstruction and Development, announced his departure on July 16, after a sharply critical report on his flamboyant management style and the bank’s lavish headquarters. The swift exit came within hours of the publication of an auditors’ report that spoke of lax spending controls at the bank and faulted Attali for his personal expenses, accusing him of breaking the bank’s own code of conduct. The EBRD said in a statement that Attali had stepped down as president “to provide the bank (with) the opportunity to put this difficult period behind it.”

Cartoonist: Ingram Pinn (U.K.)
Where Have All the Dollars Gone?
Hungarian Minister Bela Kadar Queries Foreign Lenders

A. The leading industrial nations are busy reassessing their lending policies— their international assistance programs. What are the lessons of experience of Western aid policy after three years of dramatic change in Central and Eastern Europe?

A. Compared with the economic breakthrough of the Southern European and East Asian countries, which in the 1960s and early 1970s enjoyed a booming world economy and a huge influx of international capital, the simultaneous political and economic modernization of Central and Eastern Europe began three years ago under extremely adverse external conditions. The CEE countries, branded as “scarcity economies,” lacked technological, financial, and, to a certain extent, even human resources. Rapid, successful transition therefore assumed the removal of trade barriers, improved access to Western markets, and transfers of external financial, technological, and human resources. So far the transfer of external resources has not been substantial.

Q. Why should the West make extra efforts to transfer resources to the East?

A. Systemic change in a country implies a rapid decline in the ability to generate income. A radical cutback in government subsidies, for instance, will eliminate the less efficient, less competitive enterprises, and even entire economic activities. Trade liberalization brings about increased foreign competition, which again wipes out the inefficient actors in an economy. The insolvency of some Eastern European countries—and the radical shrinking by 60 to 80 percent of the earlier COMECON markets—also implies serious income losses. So it is not surprising that Hungary, after having lost 20 percent of its GDP in the past three years, needs external resources to restructure and to modernize its economy. Its economic integration into the world requires new production and export structures, and new specialization. All these assume an increase in investment activities, both domestic and foreign. In other CEE countries, where the decline in GDP was even steeper than in Hungary, the need is even more pressing.

Q. Can you suggest an economic policy that would attract investment and, at the same time, give ample consideration to the requirement of balanced monetary and fiscal policies?

A. If a country wants to carry out systemic changes, it has to be very careful in formulating its economic policy, because political and economic tensions could aggravate the income losses, and weaken the driving forces of the transition process. Thus, overzealous restrictions—for instance, promising short-term improvements in the macroeconomic equilibrium—could undermine the competitiveness of the productive sectors, slow down privatization, increase unemployment, and add indirectly to social and political disequilibrium, which, in turn, could endanger not only national security, but also subregional and even regional security. Therefore, a proper policy mix is necessary, combining masterfully the restrictive and stimulant ingredients of the modernization strategy.

Q. What is the real weight of Western aid dollars in the modernization of the postsocialist economies?

A. The public learns from official statements that the Western world has transferred resources on the order of $40 billion to $70 billion so far, to promote transition in the postsocialist countries. One has to ask, where have all these billions gone? In most cases these data merely mean commitments for export credits, investment guarantees, and commercial loans. In reality, up to now not more than 10 to 15 percent of these commitments have been utilized and transferred to the CEE countries—as credits or loans, or as foreign capital investments with expectations of normal returns. There is nothing wrong with that, but it has to be emphasized that this is not free money, but rather business opportunities for the donors. Genuine grants to Hungary have never represented more than a tiny fraction of its GDP in any given year. (Hungary’s GDP will reach about $40 billion in 1993.) A substantial part of these grants is used to sponsor Western advisers—to finance
The World Bank/PRDTM

the transfer of Western expertise. As for the most important grant contributors, the Community’s PHARE programme provides roughly $130 million a year; and the United States, through the Hungarian-U.S. Enterprise Fund, has transferred $48 million between 1990 and 1993—an average of $16 million annually.

Q. Just for comparison, Mississippi State University receives approximately $250 million annually in grants from federal, state, and private sources...

A. The most important part of the resource transfer to Hungary is of course not grants, but foreign direct investments, which have represented a steady 4 percent of GDP during the past three years. Investors, however, are not benefactors—they mean business, and rightly so.

**Mississippi Is Burning—With a Desire to Help the East**

Campus Workshop on Aid Policy

In late June, Starkville, Mississippi, a small town (population 28,000, half of them students) close to Mississippi State University (MSU), became a mecca for high-powered government officials, business representatives, and academics from Japan, the United States, the Czech Republic, Hungary, Poland, and Slovakia. On the university’s campus about 130 participants reviewed macroeconomic developments in Central Europe and candidly discussed ways to help the region’s transition process through coordinated aid policies to increase investment and to facilitate joint projects. The meeting was organized by the Center for International Security and Strategic Studies (CISS) at MSU, and sponsored by the Ford Foundation, the Japan-U.S. Foundation, and the Center for Global Partnership of the Japan Foundation.

It was the fourth meeting of the Japan-U.S. Committee for Promoting Economic and Social Development in Central and Eastern Europe. The Committee was established in 1990, with the aim of helping the postcommunist countries’ emerging private sectors, and supporting investment in agriculture, the food industry, environmental protection, and infrastructure. (The founder and director of CISS, Hungarian-born MSU history professor Janos Radvanyi, also played a major role in starting and organizing the Japan-U.S. Committee.)

The Committee’s recommendations have played an important role in independent and joint Japan-U.S. initiatives in the four Central European countries:

- Japan set up an Enterprise Facility (JEF) in May 1992 to promote private sector development in Central Europe. It is through this organization that the Japan International Development Organization (JAIPO), with $100 million in basic capital, offers direct equity investment for small and medium-size private enterprises in the region. For example, JAIPO has cofinanced, with the Hungarian American Enterprise Fund, the construction of a fast food chain in Budapest. And Japan’s ExIm Bank has provided loans to small and medium-size businesses in the region.

- A Productivity and Quality Control Center will be established in Hungary and will serve as a model for the whole region.

- The Overseas Economic Cooperation Fund of Japan (OECF) has designated $35 million to clean up a former Soviet military base in Hungary. The United States and Japan are working on innovative ways of providing additional environmental assistance to Central and Eastern Europe.

The next meeting of the Japan-U.S. Committee is slated for early 1994 in Japan.

Q. Coming back to the criteria of the rapid and successful transition—besides resource transfer, you mentioned the removal of trade barriers... What is the situation in that area?

A. In a period of protracted global recession, and bitter election campaigns, Western governments are sensitive to international trade issues, and the eternal dual between free traders and protectionists has escalated all over the world (see box on page 7). A small country like Hungary, which is necessarily sensitive to foreign trade, cannot afford the luxury of applying protectionist policy or relying on its tiny domestic market. That is why we are so worried about the outcome of the GATT negotiations. That is why, at the start of our transition process, we embarked on negotiations on European free trade. Our association agreement with the EC became effective in 1992. The Visegrad agreement between Hungary, Slovakia, the Czech Republic, and Poland came into force in March. And we hope that the free trade agreement with EFTA will be effective before the end of 1993. In that case more than 60 percent of the Hungarian industrial exports will be free from tariffs.
and quantitative restrictions, and 70 percent of our total trade will be with partners that have concluded free trade agreements with us.

Q. Is there any intention of developing the Visegrad free trade agreement into a more sophisticated payments union?

A. The Visegrad group started as a consultation forum; it has now become a free trade zone. But it is not an alternative to any regional integration. Take Hungary, for instance; the three other Visegrad countries combined do not buy more than 4 percent of Hungarian exports. Maybe in three to five years this trade will increase to 6 or 7 percent, but as far as I can see, intraregional trade will not reach a substantial level in the foreseeable future.

Q. Could not trade develop between, say, a Hungarian subsidiary of a French company and a Czech subsidiary of a U.S. company?

A. We expect that as a result of the free trade agreement more foreign capital investment will flow in, reaching a much larger subregional, and even regional, market. Broadening the potential for maneuver of foreign investors is advantageous for the whole region. Again, we must see clearly the relative importance of the subregional corporation.

Q. For a while “triangular business” seemed to be the panacea that could save at least part of the traditional COMECON trade, and help both the FSU and the CEE economies at the same time. The plan was that Western donors would reimburse Central European countries for supplies of food, consumer goods, and pharmaceutical products to the FSU markets. What happened to those ambitious plans?

A. In Hungary’s case the total value of such exports in the past two years to the states of the FSU represented only a few million dollars, about 0.3 percent of our annual exports to the successor states. Some donor countries are now supporting their own producers—for example, by subsidizing grain exports—thus destroying even more opportunities that the Central European countries might have had in the shrinking Russian markets.

Q. Russia’s share in Hungary’s annual foreign trade is about 10 to 11 percent. Without trying to restore the old compromised CMEA trading system, is there a chance of increasing regional trade to a reasonable level by establishing a regional bank?

A. As the last chairman of the Executive Committee, I spent thirteen months at the deathbed of the COMECON, signed the official document that liquidated the old organization, and have no desire to see its resurrection. However, there is room to develop regional trade. Central European exporters, because of the present liquidity shortage, are not competitive in markets that expect sellers to finance their investment goods, particularly engineering products. This explains, for instance, the rapid drop in machinery exports to developing countries, and to the states of the FSU. Setting up regional export credit institutions to finance CEE exports could be an important contribution to the transition and to the stimulation of regional trade flows. Some of those missing aid dollars might then reemerge....

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**EC and Eastern Europe: Not in the Same League**

The association agreement with the EC allows ten years for dismantling trade barriers for industrial products, and limits Central and Eastern European exports of “sensitive” products, such as steel, agricultural products, chemicals, clothing, and footwear. According to the latest EC trade figures—summarized in a recent article in the *Financial Times* (June 7, 1993)—the combined trade deficit of the “Visegrad Four,” plus Romania and Bulgaria, vis-a-vis the EC increased from Ecu 1.4 billion in 1991 to Ecu 2.5 billion in 1992. Until 1990 the region’s six economies ran a yearly trade surplus with the EC. Compared with 1988, EC exports to the region were up 130 percent in 1992, while imports were up only 82 percent. In the first quarter of 1993, Hungarian exports to the EC decreased by 25 percent. The two groups are simply not in the same league: while about 50 percent of the East’s trade is with the Community, the share of the six CEE countries in the Community’s exports and imports was only 1.7 percent last year. At present, per capita GDP in the countries of the Visegrad Four is between one-tenth and one-fifth of the EC average.

**EC trade with Eastern Europe**

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<tr>
<th>Year</th>
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<td>1992</td>
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Note: Trade with Bulgaria, the Czech Republic, Hungary, Romania, Slovakia, and Poland.

Source: Eurostat.

...despite Eastern Europe’s low labor costs

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<th>Country</th>
<th>1993 manufacturing sector forecast ($ per hour)</th>
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* Average for the Czech Republic and Slovakia.

Quotation of the Month: "A Free Trade Zone Could Strengthen Bargaining Position with the EC"
Senior Polish Economist's Plea to the Visegrad Four

In the postcommunist countries of Central and Eastern Europe, we have seen many situations in which political considerations prevail over economic ones. Once again political considerations are hampering the progress of transition in countries that early this year signed the Visegrad free trade agreement: Poland, Hungary, the Czech Republic, and Slovakia. Our economies are currently suffering from a dramatic contraction of domestic demand exacerbated by world recession. The major commercial partners, Germany and the European Community, are adopting protectionist attitudes, making future expansion of our trade more difficult. Any form of action that could offset these negative trends ought to receive serious consideration.

One option for our countries is to link our economies together in a free trade zone with increased cross-border cooperation. However, a number of politicians reject this option out of hand. They are either accustomed to looking inward or are convinced that for their countries, membership in the EC is the only possible solution.

For the foreseeable future, the Community will be preoccupied with integrating the EFTA countries that are expected to become full-fledged members in 1995. The Central European economies can hardly expect genuine progress before 1996 in their attempts to gain admission. The temporary impasse should encourage the four members of the Visegrad group to reconsider their economic relations outside the framework of bilateral negotiations with the EC.

It is risky to focus attention on a single market, even if it is as big a market as the EC. This was amply demonstrated when the Community imposed antidumping duties on seamless iron and non-alloy steel pipe from those four countries. Agricultural products and textiles are also subject to severe discriminatory measures in the EC. And the Visegrad countries certainly discriminate against each other, imposing higher customs duties on some imports from their neighbors than they do on many articles imported from the EC.

All of the Visegrad countries want to join the EC. A market-based Central European free trade zone of 64 million people could strengthen our countries' bargaining position in negotiations with the EC; it could attract more foreign investment and simplify complex and costly regulations, such as the "rules of origin" procedures. And it would put us in a better position to adapt our financial sector, customs, and trading standards and regulations, as well as legal and physical infrastructures, to the internal structures of the EC.

Cooperation and trade between enterprises and traders of the Visegrad Four ought to be considered as normal business opportunities.

Communist authorities typically proclaimed the virtues of internationalism while in reality they closely watched, or even restricted, direct cooperation between neighboring countries. Intra-regional cooperation was confined to exchanges of official delegations or folklore groups and to "COMECON integration," prescribed by communist bureaucrats.

Authorities and the media propagated the idea that tourist-blackmarketeers were at least partially responsible for shortages. Today, however, our currencies are internally convertible, and our economies, trade, and prices have been liberalized. There are fewer price disparities, no shortages, and the state no longer maintains a monopoly on foreign trade.

We do face problems, such as unemployment and the contraction of demand, unknown in our countries three years ago. Therefore, all viable solutions should be explored, including increased access to EC markets, or, whenever possible, increases in exports to the newly independent states of the former Soviet Union; and promotion of intraregional trade between the countries of the Visegrad group.

The free trade zone agreement signed by the Visegrad countries last December became effective in March 1993. It lays out a detailed time frame for the progressive reduction of tariffs up to 2001. In the first phase, customs duties will be reduced on "nonsensitive" products only. This includes mainly raw materials and semi-processed goods that will not jeopardize the markets of the domestic producers. Reduction of duties by 30 percent on many industrial goods will not be achieved until 1995. Liberalization of trade in agricultural goods will be similarly gradual and cautious.

The collapse of trade between the Visegrad countries has certainly contributed to their economic difficulties. Since these countries have become "almost capitalist" countries, cooperation and trade between enterprises and traders of the Visegrad Four ought to be considered as normal business opportunities.

Excerpts of Krzysztof J. Ners's recent article, "Free Trade Outside EC Is a Must, Too," published in the Prague Post. The author is Director of the Education Centre on Assistance to Transition, Warsaw, the Institute for EastWest Studies.

8 June 1993
Financial Reform in Russia: The Options
Enterprises Banking on Their Banks

Besides shifting relative prices and ambiguous property rights, the unstable macroeconomic situation in Russia also impedes the development of the banking sector. Output fell about 15 percent in 1991 and more than 20 percent in 1992, and it has not yet reached rock bottom. Inflation was about 90 percent in 1991, about 1,500 percent in 1992, and at a monthly rate of 18 to 22 percent in the first half of 1993. High inflation and high negative real interest rates triggered an abrupt disintegration of the ruble economy.

Four Options: Pros and Cons

In the long run Russia's banking should meet the banking standards of industrial countries regulated by the Basel Convention. While the strategies discussed here have a horizon of only the next three to five years, they still need to raise bank standards by raising minimum capital and establishing appropriate capital adequacy standards, limiting single borrower and connected parties' exposure, and setting accounting, disclosure, and reporting standards.

Any reform strategy would need to take into account the following constraints:

- The Russian Central Bank is not yet able to supervise banks, and its capacity will improve only gradually over the next five years.
- Closing or revoking the licenses of existing banks is extremely difficult.
- The pool of domestic capital that could be invested in the banking system is limited, and foreign interest in Russian cross-border exposure is only marginal.
- Banking skills are scarce—possibly the single most important constraint.

Several financial reforms are imperative regardless of the envisaged overall reform strategies:

- Upgrade the banking infrastructure, especially the payments system, bankers' training, and supervisory capacity.
- Phase out targeted credit programs supporting bankrupt state firms.
- Restructure, gradually downsize, and even eliminate several of the large, specialized banks (such as the Promstroi and Rosselkhoz banks).

Beyond these reforms, what should the Russian government do?

Do Nothing

Under this scenario the government abandons all great-scale financial policy reform. The banks improve their practices gradually and voluntarily, and the government restrains itself to promoting the development of the banking infrastructure, weeding out the banks' targeted lending program, and restructuring the big specialized banks. Although this approach is unlikely to lead to a sustained improvement in the banking system, it might nonetheless be adopted “by default,” because it does not require any clear decision or active role by the authorities.

Big Bang

Here, the government takes control of the banks and then initiates their privatization under a massive restructuring and recapitalization program. Under the big bang, compliance with reform strategy would be mandatory, and change would be abrupt and far-reaching. This strategy would be justified if most banks became insolvent and if large fiscal resources were needed to bail out bank depositors; another justification would be if bank managers were under the thumb of the enterprises that own the banks.

Currently in Russia the banking sector's exposure to systemic risk presents no clear justification for massive government intervention:

- The amount of household deposits outside of Sberbank (Savings Bank) is very small.
- Large enterprises are able to monitor the lending activities of the banks in which they keep deposits and are shareholders and borrowers.
- Most banks in Russia claim to be profitable, so it does not make much sense to use scarce public funds to recapitalize them. (The banks' claim seems plausible given the presently relatively low-cost funding in the presence of very high inflation.)
- Even if most banks were insolvent, recapitalization would be a very risky business; the Central Bank lacks the capacity to supervise banks and would not be able to prevent the kind of behavior that led to the banks' insolvency in the first place.
- The problems of connected and insider lending need to be dealt with by strictly enforcing regulatory restrictions—not by attempting a massive change in the ownership structure. It is likely that any attempt to change ownership will just reshuffle the same players, as there is no clear alternative source of skills and capital outside the present managers and owners.

All this could change—banks might become insolvent following attempts to stabilize the economy. In this case, a government-led comprehensive restructuring of the sector might be needed in the future. But such a move now can hardly preempt the possibility of future problems. Hence a gradual approach seems more appropriate for Russia's circumstances—and it would minimize disruptions to the economy. While such an approach will only gradually improve the overall soundness of the banking system and its efficiency in allocating resources, some degree of gradualism cannot be avoided since improvements in the banking system need to move in parallel with the gradual transformation of the economy in general.
Piecemeal Phasing-in

Under this approach the government uses a gradual, comprehensive, but mandatory approach in requiring that higher banking standards be applied by all banks. Imposing equal standards on all banks could prevent the emergence of a two-tier banking system; but if the standards were truly rigorous, they could drive a large number of noncomplying banks out of business. Revoking the licenses of all those banks would be highly disruptive as well as politically counterproductive. Besides, the Central Bank does not have the capacity to supervise or check the standards compliance of hundreds or even thousands of banks.

A Few Good Banks

In this case the government gradually creates a separate tier of model banks, which are better capitalized, professionally more skilled, and more closely supervised than the other banks. These banks would function as a driving force to induce overall improvement of the banking system. Other banks would be free to join the model banks, but once they do, they would have to comply with the higher banking standards, upgrading their operations. To soothe the inevitable pain of compliance, model banks would enjoy privileges over other banks: Central Bank loans under advantageous conditions, lower insurance premiums on household savings, and the like. This option is gradual and voluntary, and is the least comprehensive of all the alternatives.

What would be the likely effect of implementing this option? In Russia about twenty to thirty leading commercial banks are already working on improving their balance sheets and banking skills, and reducing their single borrower and connected party exposure. Most of them are expected to become model banks in no time. A gradual increase in the number of model banks and in their market share could be the main avenue to improving the allocation of resources. The present ownership structure of banks could constrain expansion of the model banks, however, because many banks may not be able or willing to reduce lending to shareholders. On the other hand, an important catalyst for high-quality expansion would be if the Central Bank began to close and liquidate insolvent banks and impose losses on depositors. This would probably lead to a "flight to quality," in other words, a shift of business to high-quality banks.

Ruben Lamdany
Privatization and Enterprise Development Division
The World Bank

The Rise and Fall of Russian Savings

The Sberbank traditionally raised household deposits, which were automatically channeled to the government to finance its deficit. (It still raises more than 90 percent of the total 570 billion in household ruble deposits. Its network of more than 40,000 branches and offices accounts for more than 90 percent of total bank branches.) In the past couple of years Sberbank's management has gained greater independence. It has developed new activities, such as the deposit base from enterprises, and has begun lending to enterprises and households. It has helped create the interbank market, where it is the main lender. It has more than 100,000 shareholders, the majority of them employees, but its shares are not yet tradable. The Russian Central Bank is the largest shareholder in Sberbank, and the two banks have the same chairman.

Interest rates on individuals' savings accounts vary from 100 percent to 120 percent, depending on the term and amount of the deposit. Interest rates paid for enterprise deposits, negotiated on a case-by-case basis, are currently more than 100 percent. Due mainly to the highly negative interest rates, in 1992 deposits increased by less than 100 percent, which implies a steep reduction in their real value. For the same reason, the share of time deposits fell from 46 percent in January 1992 to 28 percent in January 1993. Enterprise deposits grew from almost zero in 1991 to about 50 billion rubles in January 1993, representing almost 10 percent of total deposits. According to a government initiative, interest rates on personal savings accounts will triple across the board, but this measure still awaits parliamentary approval.

On the asset side, Sberbank has expanded its lending to households and enterprises in the past two years. More than 60 percent of this lending is by regional branches, which are free to choose borrowers. The head office sets interest rates and defines general loan conditions. For example, loans are provided 40 percent in cash and 60 percent in deposits; the combined debt service of a family may not exceed 30 percent of household income; and housing loans may not exceed 75 percent of the total cost.

In 1991, 98 percent of Sberbank's loans outstanding were to the government or the Russian Central Bank. Last year the bank lent to households (total outstanding loans in January 1993: 25 billion rubles), enterprises (130 billion rubles), and the interbank market (100 billion rubles), and the share of government assets in their portfolio fell to less than 50 percent by January 1993. Last April the government settled its debt (285 billion rubles), which will give Sberbank the opportunity to greatly expand its lending operations. Interest rates on loans vary, depending on whether the borrower is a shareholder or not; for interbank loans the rate is 130 percent and 140 percent, respectively. On loans to enterprises, Sberbank charges 135 percent and 145 percent, respectively. Interest rates are much lower on loans to households, to which Sberbank—in compliance with government and Central Bank regulations—lends at least 30 percent of all new deposits.
Until 1987 the Soviet Union had a monobank system in which the State Bank (Gosbank) ensured that resources were allocated in accordance with the government's economic plan. In 1987 Gosbank was converted into the Soviet Union Central Bank, and five specialized banks were assigned most of its non-Central Bank functions. Each of the specialized banks dealt with specific sectors and activities. For example, Agroprombank (Agriculture Bank) provided credit, deposit facilities, and payment services to the farmland and agrarian sector. Zhilsotsbank (Social Investment Bank) provided banking services to the housing construction sector. Promstroibank (Industry and Construction Bank) was responsible for serving credit and deposit needs as well as providing payment services to the industrial sector, including construction, transport, and communications.

New Commercial Banks

Between 1987 and 1991 parts of these banks were divested or chose to spin off. This reduced the size of Agroprom and Promstroibanks, and led to the disintegration of Zhilsotsbank. In 1991 the specialized banks were transformed into joint stock companies, chartered to act as universal banks. In 1992 most of the branches of Agroprom, Promstroibank, and Sberbank in the Russian territory were incorporated as Russian banks (Agroprom as Rosselkhozbank).

Since 1988 a large number of new commercial banks have emerged, organized as joint stock companies. At present there are more than 1,700 independent commercial banks in Russia. About 700 of them are spin-offs of the former Soviet specialized banks, including most of the larger banks. Large banks are often owned by hundreds or even thousands of shareholders. The state retains partial ownership in many of them.

The other 1,000 banks have been set up since 1990. Their initial shareholders were state-owned enterprises, cooperatives, social organizations, and research academies—entities aware that through these banks they could get access to the payments system and manage their cash flow. Over time some of these banks have begun to raise deposits and make loans outside of their shareholder circle. Most of the commercial banks are small; the 65 largest banks account for about 70 percent of total assets and loans in the system. The five largest banks hold about one-third of total loans in the banking system.

Privatization of the larger banks is gradually taking place in parallel with the privatization of the enterprise sector. Initially, all the larger banks were directly or indirectly owned by the state. Their shareholders were almost wholly state-owned enterprises or government agencies. This is changing quite rapidly as shares (existing or new issues) are being sold to cooperatives, joint stock companies, private companies, and private individuals, and as the banks' main shareholders become joint stock companies and are themselves privatized.

The new ownership structure, in which banks (although private) are still largely owned by enterprises, helps perpetuate the practice of connected and insider lending. It complicates any attempt to stabilize the economy and it delays the process of restructuring the enterprise sector.

New Age Lending

During 1992 commercial bank loans denominated in rubles grew tenfold, from about 600 billion to about 6 trillion. About 50 percent of these loans were funded by credit programs directed by the Central Bank and the government.

The other half of bank lending was mostly funded from enterprise deposits, with only a negligible portion coming from household deposits. Banks are free to set deposit and lending rates. In general, banks pay very low interest rates or no interest at all on current accounts, and enterprises maintain the minimum balances they need for their transactions.

Finance Minister Boris Fedorov, Prime Minister Viktor Chernomyrdin and Russian Central Bank (RCB) Chairman Viktor Gerashchenko recently produced a set of policy measures cutting credit creation and government spending. The RCB will eliminate its direct credit to enterprises and replace it with competitive auctions and commercial bank lending. The measures are intended to bring inflation down to 10 percent a month by the end of this year.

The RCB held its first treasury bond auction in mid-May. The face value of the non-interest-bearing, three-month bonds was 100,000 rubles. The bonds were generally sold to primary brokers at a discount of 16.8 percent, or 83,200 rubles. (Inflation is now running at about 20 percent a month.) The RCB raised 750 million rubles from the sales and reportedly has plans to auction off another 500-600 billion rubles worth by the year's end. Even then, the amount will represent only a small share of the Russian budget deficit.

(T)rouble-Free Zone?

Russian attempts to control monetary expansion in 1992 were undermined by credit expansion elsewhere in the former Soviet Union.
Purchases in Russia from countries of
the FSU surged, with no monetary oreal adjustments to offset the outflow
of resources. By 1992, Russia's sur-
plus with the other FSU states rose to
8.9 percent relative to its GDP, then,
in the first three months of 1993, dropped to 6.6 percent.

Since 1991, states of the FSU have
been pursuing independent, un-
coordinated credit and budgetary
policies, while Russia remained the
only source of ruble supply. Without
policy coordination, however, mac-
roeconomic stabilization cannot be
achieved in a shared-currency re-
gime. The aggregate inflationary ef-
fect on the Russian economy was ex-
acerbated by the printing of local,
supplementary currencies in several
states, alongside the ruble. In the
summer of 1992, the ruble zone began
to break up. Estonia and Latvia es-
established their own currencies and
succeeded in stabilizing them. By
1993, Ukraine and, more recently,
Kyrgyzstan have followed.

Last year Russia delivered more oil
to the other republics (76 million tons)
than it did to the rest of the world (66
million tons). On the other hand, that
rate of delivery was 39 percent below
1990 levels, and had fallen more than
Russian oil production.

The present trade pattern is inherited
from the old order: former Soviet re-
publics process Russian energy and
raw materials in a product mix that
in most cases can hardly compete on
the international market. The least
developed republics are exporters of
raw materials, mainly to Russia. Only
those with a major role in the tran-
sit of products between Russia and
the outside world—notably the Bal-
tic states—have substantial com-
pensatory advantages outside mer-
chandise trade.

Monitoring Settlements?

A year ago, the Russian Central Bank
set up a system to monitor ruble settle-
ments between banks of Russia and
the other CIS states. Payments go
through correspondent accounts at
the respective central banks.

The authorities aimed to limit the size
of Russia's surpluses with its part-
ners—and the corresponding infla-
tionary effects—by imposing credit
ceilings. They also tried to stimulate
coeoperation by varying the credit ceil-
ing for each state according to the
extent of its monetary cooperation
with Moscow. Barter, hard currency
payment, and settlement in cash
rubles continued as before, but ruble
bank accounts in different successor
states ceased to be freely transfer-
rable.

A payments union, financed by west-
ern assistance, has been suggested as
a mechanism to alleviate these prob-
lems. It would periodically clear, in
convertible currency, imbalances
among the former Soviet republics.
Rather like the European Payments
Union in post-war Western Europe, it
could help to maintain mutual trade
during the transition to convertible
currencies, but it is not clear how this
would reduce the large and persistent
imbalance in Russia's favor.

(Based partly on reports of Oxford In-
ternational Ltd., Oxford)
Russian Deputy Prime Minister Aleksandr Shokhin in mid-June urged the other former Soviet republics to speed up the issue of their national currencies or to adhere more strictly to Russian guidelines on monetary policies. He also stated that Russian credits to other former Soviet republics would be sharply reduced. Shokhin announced that Russia intends to double prices for natural gas sales to both domestic and CIS customers to “not less” than 42,000 rubles a cubic meter. The domestic price for gas is reportedly 15,600 rubles a cubic meter.

Aleksander Makouski, head of the bic meter, past deliveries, but Ukrainian offi- cers dispute this figure.

Ukraine’s budget deficit soared sevenfold in May following Russia’s imposition of price increases for gas and oil, and strikes in the energy sector. Ukrainian President Leonid Kravchuk issued a decree on June 16 creating an extraordinary committee of the Cabinet of Ministers for the “operational management” of Ukraine’s economy. Headed by Prime Minister Leonid Kuchma, the committee is charged with slowing inflation, stabilizing production, and increasing social protection for low-income groups.

The rate of Russia’s inflation rose slightly in May to 19 percent, bringing the increase for the first five months of 1993 to 16 percent. Monthly inflation rates in 1993 have been reported at 27 percent, 25 percent, 17 percent, 16 percent, and 19 percent. (The June figure is expected to be around 20 percent.)

Russia has cut oil supplies to Ukraine to one-fifth of its already reduced levels because of Ukraine’s debt arrears. Government ministries said Ukraine is receiving 15,000-20,000 metric tons of oil a day instead of the normal 80,000-100,000 metric tons. Ukraine needs 40 million metric tons of oil annually, of which only half was expected this year from Russia. Moscow claims Kiev owes $2.5 billion for past deliveries, but Ukrainian officials dispute this figure.

On June 25 Lithuania introduced its new national currency, litas. All of the bills and coins are to be introduced at one time. Initially, one litas will equal 100 coupons. (Coupons have served as interim currency since Lithuania left the ruble zone.) The changeover is expected to be completed by July 20.

Kyrgyzstan left the ruble zone and introduced its own currency, the som, in mid-May. However, the som is still not available in some regions of the country, and all enterprises have not yet received the new currency. The som is slipping against both the dollar and the ruble. The introduction of the new currency continues to paralyse economic links between Kyrgyzstan and its neighbors. In the meantime three more Central Asian countries—Kazakhstan, Uzbekistan, and Turkmenistan—are also preparing to introduce their own currencies.

Uzbekistan and Kyrgyzstan have agreed to use the dollar, not the ruble, as the basis for their bilateral interbank transactions, though barter trade will remain a large component of economic exchange. The prime ministers of the two countries met in Tashkent on June 16, and agreed to relieve tension between the two states over Kyrgyzstan’s introduction of its currency, the som; Uzbekistan had responded by cutting off much-needed supplies of natural gas and petroleum to Kyrgyzstan. Kyrgyzstan officially acknowledged that it has a debt of $13.3 million to Uzbekistan.

Armenia, Tajikistan, Azerbaijan, and Kyrgyzstan, already among the poorest CIS republics, had the largest GNP decline in the CIS in 1992, with Armenia’s economy shrinking by 42.6 percent and Tajikistan’s by 31 percent (compared with 1991). These figures were quoted by the Vienna-based Institute for International Economic Comparisons, in its latest survey for the CIS, published in Die Presse on June 15. Armenian industrial output sank by 52.5 percent, while Tajikistan’s agricultural output declined by 45 percent. Turkmenistan’s GNP decline of “only” 10 percent was the best result among CIS states. Kazakh- stan posted the best results in agriculture, with virtually no decline in production compared with 1991. While the Caucasus and Central Asia had markedly lower inflation rates than the other republics, this was mostly due to the fact that fixed prices for many goods have not been lifted. (Georgia, which is not in the CIS, was not included in the statistics.)

The Asian Development Bank (ADB) has agreed to admit six former Soviet republics—the five Central Asian states and Azerbaijan—as members. The ADB, of which Japan is the prime shareholder, could comple-
After meeting in Jurmala in early June, President Lennart Meri of Estonia, Latvian Supreme Council Chairman Anatolij Gorbunovs, and President Algirdas Brazauskas of Lithuania announced that they are sending a request to the European Community to admit the three states as associate members.

Bulgaria's economy, reeling from the effects of the embargo imposed against rump Yugoslavia, has recorded a trade deficit of $260.5 million accumulated during the first quarter of 1993, compared with a surplus of $102 million in the first quarter of 1992. On June 4 the prime rate was adjusted from 51 percent to 48 percent, as a response to a decrease in domestic inflationary pressure over the past months, as well as to a general drop in interest rates on international money markets.

The new official exchange rate in the rump Yugoslavia is 700,000 dinars to the German mark and 1.1 million dinars to the U.S. dollar, which is in line with black market rates. Prime Minister Radoje Kontic announced on June 16 the latest devaluation of the currency in an attempt to boost currency reserves and combat black market exchange rates. This is the seventh devaluation since April 1992. Kontic also introduced a draft federal budget bill that earmarks 75.5 percent for the Yugoslav Federal Army. Some 97 percent of the population in Serbia-Montenegro is living at the poverty level, according to an estimate by the Belgrade Economic Research Center. On average it takes three and a half months' salary to purchase the same amount of goods that could be purchased with one month's salary in early 1990. To buy a Yugo 45 subcompact auto now requires ten years and two months of salary compared with nine months of salary in early 1990.

Slovak Prime Minister Vladimir Meciar said he will form a special council to speed up the privatization process. The privatization council intends to sell 30 to 40 percent of all state-owned companies by the end of 1993, focusing first on small regional businesses, rather than large firms. In another development, Slovakia in late June introduced a 20 percent temporary surcharge above regular import tariffs. The extra revenue would be used to support the exports of small and medium-size businesses.

Hungary's parliament, on July 7, has approved a supplementary budget, revising the deficit from 5.9 percent to 6.5 percent of projected GDP for 1993. It is aimed at holding the deficit to 213 billion forints ($2.2 billion). The parliament also agreed to raise the value added tax (VAT) on a wide range of food and other staples from 6 percent to 10 percent and 25 percent, effective August 1, to provide part of the funds for the supplementary budget. (Approved by parliament in December, the 1993 budget projected a deficit of 185 billion forints. An additional 40 billion forint deficit was set for the Social Security Fund, which, while formally independent, was to be financed through the government.) By the end of July, the deficit amounted to 120 billion forints, resulting partly from external pressures, particularly the recession in Austria and Germany, Hungary's main trading partners.

Foreign investors will sign contracts with Chinese partners worth some $80 billion in 1993, according to Lin Kun, deputy director of foreign investment for China's trade ministry. He also said that China plans further steps to open its markets to overseas investors.

The head of the Czech Central Bank, Josef Tosovsky, said annual inflation should fall to around 16 percent by the end of 1993, from the current rate of 21.8 percent. In an interview he said there was an unexpected fiscal surplus in the first three months of 1993, as new taxes were paid more promptly than expected. A clear commitment by the government to restrain wage increases had helped dampen inflationary pressure, he added. Because of the healthy inflation picture, the Czech Central Bank cut its discount rate in early June by 1.5 percent, bringing the rate to 8 percent.

The EBRD has decided to lend Russia $174 million to modernize 300 oil wells, a project that will be accompanied by technical assistance in the areas of financial and operations management.

Members of the Black Sea Economic Cooperation Organization have agreed in principle on the distribution of shares in the Black Sea Trade and Development Bank. Greece, Russia, and Turkey will assume a 16.5 percent share in the bank, while Bulgaria, Romania, and Ukraine will take a 13.5 percent stake. Albania, Armenia, Azerbaijan, Georgia, and Moldova will contribute only 2 percent each. No agreement could be reached on where to base BSEC's regional bank; Bulgaria, Greece, Romania, and Turkey have each submitted bids to base the bank in their countries.

Poland's unemployment in May totaled 2,624,000, or 14.2 percent of the total work force (unemployment dropped by 0.7 percent in comparison with April). During the five months of 1993, prices for consumer goods and services rose by 38.1 percent in comparison with the first five months of 1992. In the first quarter of 1993 the number of private companies with both foreign and domestic capital increased by several thousand, while that of state-owned enterprises diminished from 7,344 at the end of 1992 to 6,838 at the end of the first quarter of 1993. Average industrial production for the first five months of 1993 was 8.8 percent higher than in the comparable period of 1992.

In the first six months of 1993, industrial production in Vietnam was up 10.2 percent, retail sales 14.7 percent, exports 17.5 percent, and imports 32 percent, compared with the same period in 1992. Monthly inflation had been kept low at 0.9 percent.
Michael Bruno Named World Bank Chief Economist

World Bank President Lewis Preston has appointed Michael Bruno, professor at the Hebrew University of Jerusalem, as Vice President, Development Economics and Chief Economist of the World Bank. Bruno, who holds a Ph.D. in Economics from Stanford University, will assume the position effective September 1. He served as the Governor of the Bank of Israel from 1986 to 1991, after playing a key role in the design of Israel’s successful 1985 stabilization program. Bruno has been associated with Hebrew University since 1963, where he served as Chairman of the Economics Department. He has also been a visiting professor at several universities in the United States. Bruno, born in Germany in 1932, immigrated with his family to what is now Israel the following year.

$1.5 Billion IMF Credit to Russia

The International Monetary Fund has approved a $1.5 billion Systemic Transformation Facility (STF) credit to Russia to support the government’s economic and financial program. (The IMF set up the STF as a temporary financial window to provide assistance to member countries facing balance of payments difficulties arising from severe disruptions of their traditional trade and payments arrangements.) Another $1.5 billion will be made available, provided that the government makes further progress in implementing the program. The program includes reducing the monthly inflation rate to less than 10 percent by the end of the year (from an average monthly rate of 20-25 percent in the first half of 1993), halving the enlarged government budget deficit to 10 percent of Russia’s GDP by late 1993, further liberalizing the trade and exchange rate system, and removing restrictions on land ownership. Russia has already drawn $1 billion as a first credit tranche of the IMF stand-by arrangement, approved in August 1992.

Mongolia: ESAF Loan Goes Forward

The International Monetary Fund has approved a $30.8 million Enhanced Structural Adjustment Facility (ESAF) credit to Mongolia over three years. The new loan comes seven months after the IMF stand-by arrangement ended.

Shokhin’s Shock

Russian Deputy Prime Minister Alexander Shokhin has called for changes in the $43.4 billion aid package agreed on in April 1993 by the Group of Seven. At the World Bank Consultative Group meeting on Russia (June 9, in Paris), Shokhin said that Russia would not be able to use half of the approximately $10 billion in bilateral credits included in the April package unless the terms were softened, interest charges lowered further, and maturities on credits extended. He also urged the West to assume responsibility—that is, set up guarantee funds—for covering foreign suppliers, currently owed an estimated $6 billion in arrears payments by Russia. He suggested that this could be financed with part of the G-7 aid package. Further, he said the aid plan should be reshaped to spur trade among ex-Soviet republics. World Bank Vice President Wilfried Thalwitz said that he was “encouraged by the economic reform program of the Russian government.” Thalwitz also said that the World Bank would lend $4 billion for a dozen projects in the coming eighteen months.

World Bank Injects $610 Million into Russia

On June 17 the World Bank approved a $610 million loan to help Russia’s $1 billion program to repair the western Siberian oil fields and to boost the ailing oil industry. The project is designed to boost annual oil production by 12 million tons and earn the country an extra $1.5 billion a year. The loan, the biggest ever made by the World Bank for a single project, is in addition to an expected $250 million loan from the EBRD and $6 million from the Netherlands. The World Bank loan is to help pay for repairing 1,300 oil wells, drilling 84 new wells, constructing a refinery, and replacing more than 1,000 kilometers of pipelines. Russian oil production fell from 570 million tons in 1987 to 396 million tons in 1992. Three oil producer associations in Siberia will contribute $169 million to the project.

The IFC Is in the Ring

The International Finance Corporation (IFC) has approved $71.5 million in financing for its first two projects in Russia. The combined cost of the two projects in the oil and gas sector is $377 million. (The IFC is the member of the World Bank Group that promotes private sector investments in developing countries. Russia joined the IFC on April 12, 1993.) Most of the IFC financing, a $60 million loan, will be provided to the Polar Lights Company to help finance the development of the Ardalin oil field in northern Russia. Polar Lights is a 50-50 joint venture between Conoco Inc. of the United States and Arkhangelskgeologia, a Russian enterprise. The Polar Lights project will drill development wells, establish a treatment facility, and build a 36-mile pipeline to connect with the existing Russian network. The EBRD, for its part, has approved a $90 million loan for the project, and the U.S. Overseas Private Investment Corporation (OPIC) is to lend $50 million.

The IFC will also provide a loan of $10 million to the Vasyugan Services Joint Enterprise and a $1.5 million quasi-equity investment to help finance a project that will increase the output of existing oil and gas wells in
the Tomsk region of western Siberia. (Vasyugan Services Joint Enterprise is a joint venture between Canadian Fracmaster and two Russian entities, Tomskneft Production Association and Vasyugan Production Division. The company will use modern oil well fracturing methods that are not yet widely used in Russia to attain a significant production increase from the wells it services. Additional financing for the project is to come from the EBRD.)

Saving China's Grain: $500 Million

To fund half of the $1 billion program to overhaul China's grain transport system, on June 17 the World Bank approved a loan of $325 million and the International Development Association (IDA) made a credit of $165 million. About 1 million tons of grain—6 percent of the annual grain production—is lost each year during shipping from production areas to consumers. Five major grain port terminals and about 60 intermediate and 300 primary depots will see their facilities upgraded and their stock of equipment increased by more than 2,400 bulk rail wagons and bulk trucks. By 2000, the amount of grain moved in bulk will increase from the current 5 million tons to 19 million tons. As part of the technical assistance, wholesale grain markets will develop into futures markets, with prices determined by market forces.

World Bank Increases Loan-Loss Provisions

On May 20 the World Bank increased its accumulated provision for loan losses from 2.5 percent to 3 percent of its loan portfolio. This increase will result in an additional $500 million charge to income for fiscal 1993, which ended on June 30. The main reason for the increase is a deterioration in the outlook for collectibility of loans to or guaranteed by the Federal Republic of Yugoslavia and the Republic of Bosnia-Herzegovina, which are in nonaccrual. The Bank has never incurred an actual loss on loans or guarantees to any of its borrowing members.

The Bank also announced plans to maintain its income-earning capacity by increasing its target for the ratio of reserves to loans to a range of 13 to 14 percent for fiscal 1994 to 1995, subject to a customary annual review. The reserves-to-loans ratio expected for the end of fiscal 1993 is about 11.6 percent. The Bank has an opportunity now to build reserves while continuing its practice of waiving some loan charges and transferring some of its net income to the IDA or to other uses approved by the shareholders.

IDA: Upscaling Albania's Roads and...

Albania's transport sector will move toward a more market-based system with the help of a credit of $18 million from the IDA. The project aims to repair 65 kilometers of roads, construct 16 kilometers of new roads, improve road maintenance, and provide spare parts and transport equipment.

...Tanzania's Public Sector

The IDA has approved a credit of $34.9 million for Tanzania, to help implement a public sector restructuring program. This credit is for forty years, including a ten-year grace period. A further $3.8 million would come from the Tanzanian government, and other donors will contribute $7 million. The $45.7 million program is to be completed in 1999.

New Chief of the IFC

World Bank President Lewis Preston on June 28 announced the appointment of Jannik Lindbaek as Executive Vice President of the International Finance Corporation (IFC), effective January 1, 1994. Lindbaek (54) will succeed Sir William Ryrie, who has led the IFC since 1984 and is to retire in December. Lindbaek, a Norwegian national, has been president and chief executive officer of the Nordic Investment Bank (NIB) since 1986. (NIB is a multilateral financial institution based in Helsinki and owned by the five Nordic countries.) Previously, Lindbaek was president and chief executive officer of Storebrand Insurance Group, Norway's largest insurance company, and executive vice president of Vesta Insurance Group.

Record World Bank Lending for Fiscal 1993

Commitments by the IBRD and IDA to the countries of Europe and Central Asia in fiscal 1993, which ended June 30, totaled $3.8 billion, up sharply from $2.1 billion in fiscal 1992. Part of this dramatic increase is attributable to the first lending commitments—totaling $1.63 billion—to eight countries of the former Soviet Union. Total new commitments (by the World Bank and the IDA combined) to member countries in the same period totaled a record $23.7 billion, according to preliminary figures published by the Bank in early July. (The comparable figure for fiscal 1992 was $21.7 billion.) In fiscal 1993, IBRD loan commitments amounted to $16.9 billion for 122 projects; IDA credits amounted to $6.8 billion for 123 projects. (The totals for the previous fiscal year were $15.2 billion for 112 IBRD projects and $6.5 billion for 110 IDA projects.) A gross total of $18 billion has been disbursed by the IBRD and IDA, compared with $16.5 billion a year earlier.

MIGA "First" in Russia

The Multilateral Investment Guarantee Agency (MIGA) has insured its first project in Russia. MultiServ Russia, S.A., a company incorporated in Belgium, has obtained political risk insurance coverage from MIGA for its investment of up to $11 million in machinery and equipment for a steel slag processing recovery operation in Magnitogorsk, Russia. MIGA has provided $9.9 million in insurance to MultiServ Russia against the risk of war and civil disturbance for fifteen years. MIGA's participation has played a critical role in securing financing for the project.
Conference Diary

Forthcoming

Portfolio Investment in Developing Countries: A World Bank Symposium

Organized by the Debt and International Finance Division of the World Bank, this conference will focus on the rapid increase in portfolio flows to several developing countries. The conference will discuss the trends in these flows, the investors (who are they, what are their objectives, what are their constraints), the barriers, the various methods that can be used to monitor investments, the benefits of those investments from the investor countries' point of view (what is the evidence on diversification benefits, what are the expected returns if certain barriers are removed), and the policy issues facing developing countries (are these flows sustainable, are they volatile, what micro/macroe policies are required to attract benefit from these investments).


World Bank Conference on Environmentally Sustainable Development
September 30-October 1, 1993, Washington, D.C.

Under the motto "Valuing the Environment," the First Annual International ESD Conference will focus on three priorities: Environmental Accounting, Water Resources Management, and Follow-up of the Rio Earth Summit. Invited include Albert Gore, Vice President of the United States, Professor Partha Dasgupta of Cambridge University, Jacques Cousteau, the Cousteau Foundation, Nitin Desai, UN Commissioner for Sustainable Development, David Pearce, Director, University College, London. Ismail Serageldin, ESD Vice President, will present the World Bank view.


New Books and Working Papers

PRDTM regrets that it is unable to supply the publications listed.

World Bank Publications


World Development Report 1993, the sixteenth in the annual series, examines the interplay between human health, health policy, and economic development. To give our readers some flavor of the report, the following is a summary of a box titled "Reform of the Russian Health System" (page 164):

Before the Soviet breakup, 3 to 4 percent of Russia's GNP was spent on health care, financed from general government revenues. This 'highly centralized and bureaucratic system led to inefficiency and indifference toward quality of care, and neglect of preventive measures to combat industrial pollution, alcohol and tobacco dependency, and poor nutrition. Despite the large number of doctors and hospitals (relative to the 150 million inhabitants), life expectancy in 1990 for Russian men was just 64 years, 10 years less than in Western Europe, and the infant mortality rate, at 22 per 1,000 live births, was twice the Western European average.

Russia's new, democratic government is decentralizing health financing and management. Medical practice is be-
ing privatized, and under the new health insurance law, each region is to have a social insurance fund. A national fund will equalize resources across regions. These insurance funds will receive a combination of compulsory payroll deductions and budget transfers from general government revenues. They will sign contracts for care with public and private providers. Individuals can then voluntarily purchase supplementary private insurance to cover additional health services. Implementation of the health insurance legislation—in effect since late 1991—has been slow.

Some important unresolved issues include:
- The role and extent of competition among public and private insurers
- Whether risks are to be rated on an individual basis or across larger pools of individuals
- How the insurance funds will pay providers, on a fee-for-service basis, through capitation, or by some other method or combination of methods.
- A number of international agencies, including the World Bank, are working closely with Russian health officials on designing and carrying out health policy reforms.


Seventy-five Polish entrepreneurs, mostly between the ages of 36 and 45, were interviewed in late 1992-early 1993. Each ran a small-to-medium-size business, employing from 20 to 400 people. Sales of the 75 operations averaged $2 million in 1992, with net profits averaging $100,000. The survey found that many entrepreneurs
- Have no difficulty with entry and exit, or with switching quickly into other businesses.
- Are forced to use their personal savings and borrow from friends and family to get their companies off the ground, as local banks refuse to lend to untried private clients, who have no security to offer.
- Suffer mostly from high taxes and burdensome regulations, bad telephone systems, incompetent bureaucrats, and poor labor.
- Regard personal contacts as the most frequent and efficient way to find clients.
- Consider manufacturing and service sectors as more profitable than trade. In 1992 private companies and businesses yielded half of Poland's economic output, marking a big departure from the past four decades of socialism.


Working Papers of the Gdansk Institute (Poland)


This survey on the Polish private sector was carried out in December, 1991 (thus preceding the above survey by almost a year). Managers from 300 small and medium-size businesses in the regions of Cracow, Lodz, and Gdansk were interviewed. Highlights:
- Two-thirds of the small and medium-size businesses were not even three years old. The entrepreneurs were well-educated and two-thirds of them had graduated from universities. Most had some experience in private business before creating their own firms.
- Cash was still the major means of settlement. More than half of all orders were executed in cash, as legal procedures for collecting receivables have been time-consuming, working capital expensive, and the ratio of overdue receivables extremely high (often reaching 45 percent of total receivables). Insurance and wage tax are high—taken together, they are higher than customs dues, turnover tax, and income tax combined.
- Seventy percent of businessmen have never applied for a loan, due to the high cost and difficulties in meeting the collateral requirements. Nonetheless, two-thirds of the firms were expected to increase their working capital and fixed capital.
- Most private businesses supplied primarily the local, that is, domestic market; their primary competitor was the informal (grey) sector, more dangerous than the state sector, which provided more than 75 percent of industrial output in 1991.


IMF Working Papers


The budget deficit, calculated by looking at the behavior of budgetary revenue and expenditure, has far less informational value than generally assumed if the role of the government has yet to be determined; if the budget must assume responsibilities now carried out by state enterprises; and if property rights within the public sector are vague. The true fiscal deficit for the whole public sector—including the fiscal activities of the state enterprises and the central bank—may be completely different from the budget deficit and may even move in a different direction. Containing the budget deficit will not necessarily make more resources available to the private sector, and it might even slow down the structural reforms. Fiscal policy, however, is very
relevant. The most comprehensive and economically sound measure of
the fiscal (not budget) deficit should be the guide to policymaking. Trans-
fer of functions from state enterprises to the government will need to be
taken into account in setting limits on the size of the deficit. Some other com-
ments of this paper:
* A reduction in taxes relative to GDP in transition economies is almost in-
evitable in future years. Taxes should be as simple as possible. “Transplant-
ation” of industrial countries’ fiscal institutions may lead to costly mis-
takes.
* Social expenditure should be streamlined and reduced. Public
spending probably will fall more slowly than public revenue; efficient
institutions must be developed for the management of public expenditure.
* Ownership rights need to be clari-
fied within the public sector. Fail-
ing this, fiscal signals sent by those
most responsible for the budget will
not carry the clear instructions nec-
essary for the conduct of an efficient
fiscal policy.

Tamim Bayoumi, Daniel Hewitt, and
Jerald Schiff, Economic Conse-
quences of Lower Military Spend-
ing: Some Simulation Results, IMF
WP 93/17, Washington, D.C., 1993,
43 p.

Hugh Bredenkamp, Conducting
Monetary and Credit Policy in
Countries of the Former Soviet
Union: Some Issues and Options,
IMF WP 93/23, Washington, D.C.,

Xavier Maret and Gerd Schwartz,
Poland: The Social Safety Net
during Transition, IMF WP 93/42,

Peter J. Montiel and Jonathan D.
Ostry, Real Exchange Rate Target-
ing in Developing Countries,
PPAA 93/2, Washington, D.C., 1993,
19 p.

Gonzalo Pastor and Amer Bisat, Ar-
menia: Reform and Growth in
Agriculture, PPAA 93/3, Washing-

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ington, D.C. 20431, tel. (202)
623-7430, fax. (202) 623-7201.

New Books

Michael Keren and Gur Ofer, eds.,
Trials of Transition—Economic
Reform in the Former Commu-
nist Bloc, Westview Press, Boulder,

This is a collection of updated papers
that were first presented at a 1991
Conference on Economic and Social
Transformation in Eastern Europe
and the FSU. The studies compare
different reform stages, analyzing
countries on opposite ends of the spec-
trum and examining the diverse—
political, social, and economic—
spheres of reform, and the inter-
dependencies between them.

Shlomo Avineri remembers the pre-
communist era with its frightening
ethnic, national, cultural, and reli-
gious frictions, now rekindled by
the demise of communism. Silviu Brucan
discusses economic reform and democ-
ratization in a Romanian setting.
Fabrizio Coricelli and Mario Blejer
focus on macroeconomic stabilization
and the monetary overhang issue.
Grzegorz Kolodko and Stanislaw
Gomulka argue about the Polish “Big
Bang,” and whether or not it repre-
sents an overshooting. Joseph Ber-
liner, Gur Ofer, Mario Nuti, Marton
Tardos, and Michael Keren address
privatization and sequencing at dif-
f erent stages of transition. The con-
sequences of trade liberalization and
changes in trade patterns are demon-
strated, using the (former) East Ger-
many as an example, by Keren, Gunter
Notzold, Maria Haendeck-Hoppe-
Arndt; these subjects are discussed
further by Sandor Richter and Arye
Hillman.

The book portrays the dynamics of
change across Europe, though it seems
to come down on the side of caution
and more gradualism. In the opening
chapter, Joseph Berliner (to whom
the book was dedicated) asks: What
legacy, if any, will socialism leave for
the 21st century?

Colin Mayer and Xavier Vives, eds.,
Capital Markets and Financial In-
termediation, Cambridge Univer-
sity Press for CEPR, Cambridge

On the future role of banks in financ-
ing enterprises, this book concludes:
* Technological improvements and
deregulation may pull back the bound-
aries of bank activity, but there is no
question that banks will continue to
perform a central function in evaluat-
ing and monitoring medium-size and
smaller customers.
* Banks will remain a more im-
portant source of corporate finance than
securities markets: in most countries
only a small segment of the corporate
sector has access to bond markets;
the maximum size of finance that is
available from syndicated banks is
well in excess of that from Eurobonds;
Eurobonds do not provide the rela-
tionships with investors that are an
important aspect of bank finance.
* Control of and by banks is particu-
larly crucial in Eastern Europe, where
enterprise sectors in most countries
are bankrupt. The role for stock mar-
kets will be limited for several years
to come and, even then, it may be
restricted to specific functions, most
notably in the high-technology sec-
tors. Banks will perform a central
function in the development of these
economies. Once restructured and re-
capitalized (to prevent an inherited
stock problem from distorting the ef-
fficient allocation of credit), they will
play a central role in enterprise re-
form throughout Eastern Europe.

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don WIX 1LB, tel. (4471) 734-9110,
fax (4471) 734-8760.

Patrick Artisien, Matija Rojec and
Marjan Svethcic, eds., Foreign In-
vestment in Central and Eastern
Europe, St. Martin’s Press, New York,
Bibliography of Selected Articles

Staff may contact the Joint Bank-Fund Library, (202) 623-7054.

African Economies


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