At the Economic Crossroad: Will the Independent Republics Join Forces?

A leading Russian reformer discusses new realities

The daunting task of consolidating the economic situation of the independent republics of the ex-USSR is generating intense debate among economists. This is underlined by the sometimes-complementary, sometimes-contrasting viewpoints—especially on currency reform—of a leading Russian reformer and a well-known Swedish economist, as follows.

Leonid Grigoriev is an economist at the Moscow Institute of World Economy and International Relations and co-author of last year's radical 500-Day Plan to convert the Soviet economy into a free market economy. During Grigoriev's recent visit to Washington, TRANSITION editor Richard Hirsch interviewed him about the current Soviet economic situation and the chances for achieving a common economic space in what was once the Soviet Union.

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able transition requires at least some kind of social consensus to win sacrifices from the public while the process of stabilizing the macro economy, liberalizing prices, and implementing a privatization program goes on. We were aware, of course, that a market economy cannot be "created" in a mere 500 days, but we wanted to reach a "point of no return."

Q: This might be the case now, but in one scenario, 15 new sovereign nations out of the former republics would implement 15 different economic reform programs. Is this likely?

A: In fact, we anticipate no more than three or four major reform variants—one plan for the Baltics, another for Russia and the Ukraine, and probably a different one encompassing the Central Asian republics. All the states will eventually create market economies although at various speeds: in Russia, reform probably will proceed faster than in some other republics, where Gosplan-minded people are still in charge of the economy. [Gosplan is the State Planning Agency.]

Q: Can the aspirations of the republics—to be responsible for their own destinies, to recover their lost identities—be harmonized with the endeavors of the reformers to create a common economic space for them?

A: Geography has condemned us to live together. It is impossible to change overnight the common currency and the common legal system, nor is it possible to ignore our common history. Under those circumstances, political independence is no reason to stem the traditional trade flow. The Baltic States, for example, can hardly afford to give up their major fuel and energy sources and simultaneously lose the largest markets for their manufactured products. Of course, if the republics implement widely different types of reforms, and at very different speeds, the coordination of economic policies, taxes, and customs regulations, among other things, will be hard, if not impossible.

Q: Do you think that a Great Depression-like slump will hit the economies of the republics, as predicted by some American economists?

A: The GNP in the ex-USSR has already dropped 10 percent this year, and it could plunge 15 to 20 percent by the end of 1991. Naturally, much depends on the Soviet harvest. Even more, however, depends on whether the republics can agree in a timely manner on the new rules of the game and on coordinating monetary and fiscal policies, prices, and commerce, and on sharing union assets— as well as sharing the burden of the $60 billion dollar external debt.

Q: Could you quote some specific issues that are awaiting inter-republic settlement?

A: One example involves the question of how to finance the Soviet Union's remaining activities, such as defense and foreign policy—would this be from a central budget, through some kind of federal tax, or from contributions by individual republics? Another thorny issue is the fate of the inter-republic subsidies. If the support that Russia, the Ukraine, and the Baltics has provided to the Central Asian republics ends, how will this affect the price of oil, cotton, and other trade commodities? How can the new states—with their budgets all virtually in the red—avoid overspending in the social area or overtaxing the new enterprises and avert the looming fiscal, financial, and social crisis?

Q: In your opinion, what will happen to the already huge monetary overhang?

A: The worst occurrence would be that a number of independent central banks in an interdependent economic space would pursue uncoordinated monetary policies. Certainly, the monetary overhang issue will hurt the republics, and I hope that they will not print new money just to overcome their fiscal problems. As a matter of fact, ruble-printing facilities are all located in Moscow, so if the newly
independent states want more rubles. They must buy them from Russia. True, some republics want to create their own money, but I see very little room for local currencies at the start. Rubles should remain the common currency for the time being, at least in this most crucial stage of reform, if only to preserve the normal flow of inter-republic trade. I believe that eventually there will be a three-tier currency system in the new states: rubles, dollars, and local currencies all will circulate.

Q: And the question of internal trade within the union: might it turn into external trade overnight?

A: Again, this is a tremendous problem. Historically, the USSR's production has been highly monopolized at the enterprise level. More than half the monopolies comprise machinery and equipment manufacturers, and they supply at least 60 percent, but quite often 100 percent, of the total production of certain items. For example, 99 percent of industrial conveyors are produced in Lvov in the western part of the Ukraine. The single producer of commuter trains in the union is in Riga, Latvia. Trade among the republics was regulated by contracts imposed and supervised by Gosplan. Now this "command contract trade" is being transformed into free trade and, what is more, into de facto foreign trade among the republics. Right now, contractual discipline has dissipated, with former administrative prices having no relevance any longer. Consequently, supplier-buyer links are shaken; industrial production is falling. The republics' authorities might persuade enterprises under their jurisdiction to loosen their ties with their traditional trading partners and instead try to procure what is possible from within each republic. This kind of narrow-sighted attitude could generate price-wars and hyperinflation and could result in a collapse of inter-republic trade altogether.

Q: Turning to another major issue, what do you propose for accelerating privatization?

A: Restitution or compensation for appropriated property has become an issue only in the Baltics, at least for now. In my view, privatization of the retail trade, small industries, and services will go very fast and will be relatively easy, especially in the smaller Baltic Republics. In Russia, because of an ingrained mentality that is suspicious of private property ownership, privatization will be more complicated.

To privatize agriculture, different approaches are needed, not only in each republic, but also in each region of Russia. This is because of the variations in climate, traditions, agricultural technologies employed, and products cultivated. In my opinion, only bankrupt state farms and collective farms should be left alone to disintegrate. Peasants and, perhaps, even industrial enterprises should take over these lands, renting or buying them or establishing agricultural subsidiaries. Primarily, it is important not to undermine agricultural production, which currently is dependent on the best one-quarter of the collective farms. The process of converting them to joint stock companies, limited partnerships, and genuine cooperatives already has started, and this is what should be encouraged, but without disrupting production.

Concerning industrial enterprises, I oppose — and I am one of the few in Moscow to do so — the voucher system, which is the free distribution of shares to the public. The voucher system was approved in early July by the Russian parliament, along with the Law of Privatization, but without any elaboration on how to carry it out. My belief is that investment funds should be set up, by sectors and regions, to handle state properties, with a mandate for eventually privatizing the bulk of them. Much of state-owned industry — food and consumer goods production, services, etc. — should be sold as soon as possible, to both domestic and foreign investors, and these sales should include concessions to working collectives. Privatization of the machinery and agroindustrial sectors should proceed more cautiously, preserving "golden" shares for the investment funds. The railways, pipelines, and some telecommunications services should be administered by the funds for the time being. The proceeds from the sale of state enterprises should not be transferred to the state budget but be retained by the funds and used to restructure companies for privatization. The government may borrow this money, but strictly on commercial terms.

Q: Finally, how do you see the West's role in helping the republics and the new Union of Sovereign States?

A: Some regions of the ex-USSR — first of all in the Ural, in Siberia, and in certain European regions of Russia that are landlocked and hardly accessible in harsh weather, even by truck or railway — probably will suffer the most this winter because of shortages. Because they will need emergency aid, logistic preparations for the transport of food and medicine should start right now. I do not be-
lieve in massive, free foreign aid to the central government or to the republic governments. However, if such support is available, it makes sense to set up an emergency entrepreneurial fund, or funds, under a board of directors that would include local government representatives, Western privatization specialists, banking experts, and local economists and consultants. The funds should channel investments to various sectors to ensure fast improvement of communications, food-storage facilities, food processing, and distribution. Money also should be available to regions facing structural crisis, especially the areas where the military and heavy industries are concentrated. Investments should help the restructuring and privatization as well as the development of new enterprises. The funds should attract foreign investors by providing the necessary guarantees.

Massive long-term investment will come only after the republics create a suitable legal and financial infrastructure. As for the IMF and World Bank, their support cannot solve our basic economic problems. Just consider our sheer size. Our new union, even streamlined, will have a population 15 times larger than eastern Germany. Nevertheless, the Fund and the Bank can be extremely useful by providing technical assistance, sharing their huge stock of experience, and financing special projects, thereby encouraging private foreign investments.

The Case for Swift Currency Reform in the New Republics
Anders Aslund on dumping the ruble as common currency

The foiled coup of August fundamentally changed the Soviet political scene. First, the coup caused the death of communism. Second, the all-union institutions were discredited. As a result, the flagging power and legitimacy of the center devolved to the institutions in the republics. Third, the democratic aspirations of the people came to the fore. On the down side, economic problems are likely to accelerate, with the key problem being shortages. And because money has little value, most incentives toward work have been weakened. At the same time, complex barter deals are occurring, which involve extraordinary transaction costs; various rationing systems are proliferating; and the republics, regions, and enterprises are refusing to deliver goods to one another.

Economic collapse?
A major crisis comes from the enlarging budget deficit. Wages began rising steeply in 1988 and social benefits in 1990, but this year state revenues have virtually dried up — during the first quarter of 1991, the union budget received only 37 percent of its planned revenue, and it is reported that the union budget has received only 15 percent of its needed revenue so far in 1991. Even if union expenditures were to decline at a rate commensurate with the decline in revenue, the budget deficit would amount to at least 10 billion rubles. Furthermore, the newly-established union stabilization fund is based on expenditures of 114 billion rubles, and a union-level pension fund has also been set up. Both funds have already experienced a shortfall in their revenues, although their expenditures have been cut.

Even larger deficits are occurring in the republics. At present, Russia's budget deficit is moving toward 120 billion rubles, and the Ukrainian budget deficit might be around 38 billion rubles. Altogether the consolidated budget deficit will surely exceed 400 billion rubles, or more than 20 percent of GNP. Because of the remaining price regulations in the USSR, inflation stands at about 100 percent, but it is bound to rise as prices are gradually relaxed. Thus, hyperinflation is an immediate risk.

So far, however, it is the old command economy, although weakened, that has kept the economy going. The obvious danger is that the economy will grind to a virtual halt, as has happened in Albania, where the level of national income in the third quarter
of 1991 fell to about one-quarter of its level a year ago. After the Soviet coup, there is nothing holding the old economic system together. Barter cannot support this highly specialized and monopolized economy, if only because of the enormous geographic distances. The Soviet currency is widely perceived as close to useless, and a swift price liberalization without stabilization would probably provoke hyperinflation. Some nightmare scenarios could include severe disruptions in railway transportation or in deliveries of food to the large industrial centers of Russia. A swift decline by half in the national income is all too close at hand.

Swift action required

A time of frightening crisis can also be a time of action and aid. Both in the short and long term all the Soviet republics need as much technical assistance as they can absorb. The main aim should be to develop the skills for instituting and maintaining a market economy, since in the Soviet Union virtually all such skills are lacking in the fields of macroeconomics, auditing, and law. Concomitantly, a multitude of foreign consultants will be required. Whatever happens, the supply crisis in parts of the country is likely to grow so serious that humanitarian aid — food and medicine, to begin with — will be necessary this winter.

The overwhelming need is for the Soviet Union — or its republics — to go ahead and introduce radical systemic changes as quickly as possible. The lesson from Eastern Europe is that a comprehensive package of macroeconomic stabilization, price liberalization, privatization, liberalization of foreign trade, and the establishment of a social safety net is required. There is a surprisingly broad consensus among Western and East European experts on what such a program should comprise. Therefore, the main question for the Soviet Union has less to do with what should be done than with how will execute the program. Considering the severity of the economic crisis and the political complexities, it seems vital that the switch to new systems be attempted very fast indeed. The economy might collapse before a change in the system can be effected.

When such a shift to a market economy takes place, the republics will require — and they deserve — the same kind of financial support that East European countries have received: financing for stabilization funds, refinancing of foreign debts, some balance of payments support, and infrastructure financing, as well as continued technical assistance. Indeed, without such assistance, any attempt at systemic reform is likely to fail. It is hoped that the need for humanitarian assistance will subside soon. (The West could also assist — if it were allowed to — by repairing and maintaining oil wells that are underexploited at present. Foreign companies' work in the oil fields could start a substantial flow of hard currency income relatively fast, which could limit the disruption caused by the Soviet Union's sharply falling oil exports.)

However, a stabilization program in the ex-USSR can hardly take place without a decision about currency areas. For stabilization to succeed in such an unbalanced economy, the budget deficit will have to be eliminated in one step. Such a drastic cut in state expenditures calls for a government of considerable legitimacy. Given the current political situation, the republics seem the only plausible units of stabilization. The important corollary is that each republic will, in fact, require its own currency.

What the West should do

At least four republics are already introducing their own currencies: the three Baltic states and the Ukraine. When the Ukraine changes its currency, the rest of the Soviet Union will be forced into swift currency reform in the same way that West Germany's currency reform in June 1948 prompted instant counterpart reform in East Germany. In the new union, competitive currency reform could be harmful because certain republics may be flooded with rubles from the other republics.

Preferably, each new currency should be pegged to an outside standard, such as the ECU, because there is no reason why the failure of one currency should be allowed to drag the others down. The republics that are successful in their stabilization will find their currencies indirectly pegged to one another. Since the ruble does not inspire confidence among the non-Russian republics, it seems particularly badly suited for the role of international standard.

Since Western nations might have to support financially the introduction of each new currency and will have to refinance old debts, they and the international economic organizations should be allowed to coordinate introduction of the new currencies. This should also be in the interest of all the republics that want swift reform. It would be very dangerous if the West were to insist on the maintenance of a common currency because no stabilization is likely to take place at an all-union level, and such a Western stand would presumably delay reform and aggravate the economic crisis and political instability.

My basic assumption is that considerable economic disruption will take place no matter what, and therefore everything should be done to try to maintain the existing economic links within the socialist economy until systemic changes come about. To date, the ideal seems to have occurred in Czechoslovakia, where the old command economy was intact until the end of 1990, when the government created a comprehensive new system.

The West will have to accept the introduction of 15 new currencies and realize that little can be achieved until each republic undertakes its own comprehensive reform and stabilization. Any further Western insistence on action at the union level will only delay reform and could lead to extreme economic and political instability over one-sixth of the earth's surface. But time is short, and swift action on the part of experienced agencies such as the World Bank and the IMF is vitally needed by all the former Soviet republics.

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Social Care in Romania — Strategy for the Nineties

In the late Nicolae Ceausescu's Romania, social sectors—labeled "non-productive sectors"—were politicized, underfunded, and isolated from the rest of the economy. As a consequence, physical infrastructure deteriorated, equipment and supplies became scarce, and the quality of human capital declined. Social standards in Romania, reflected in relevant data, were worse than in neighboring command economies (see table). The education system basically taught people not to think, but to be mere factors of production whether semi-skilled and skilled workers or managers; according to the projected needs of the economy as embodied in the central plan.

Alarming indicators

Romania's health indicators are among the lowest in Europe. In an attempt to raise the population growth rate, abortion and contraception were outlawed in 1966. Despite harsh penalties for performing or having abortions, fertility kept declining. At the same time, the estimated one million illegal abortions a year caused maternal mortality to rise to 150 per 1,000 births, 15 times the rate for Romania's neighbor Poland and the highest in Europe. In addition, hundreds of thousands of unwanted or unhealthy children whose families could not take care of them — given the overall levels of deprivation in the country — were "warehoused" under poor conditions and damaged for life. The lack of equipment to test the blood supply, as well as a shortage of syringes and spare parts sterilizers, spread AIDS in these institutions.

One of the first steps of the post-revolutionary government was to legalize abortion and family planning (December 1989). Social sector spending rose from 14 percent of GDP in 1989 to 17 percent in 1990, and international assistance began to trickle in. Conditions in hospitals and orphanages now are beginning to improve. Computers and other educational materials are appearing in schools. The government is setting up adult training programs and employment service centers throughout the country, and the first steps toward decentralization are being taken.

But Romania has a long way to go; a strategy for social sector reform has yet to be developed. With the support of the World Bank, problems in different sectors are being identified and reform priorities set. For example, the social insurance and assistance system, designed under the communist regime to redistribute income, is unaffordable and encourages inefficient resource allocation. Entitlement payments do not adequately protect the poor and do not provide enough income to the unemployed. Therefore, it is advisable to:

• restructure support for families and improve targeting. Currently, as an incentive for couples to have more children, family benefits increase progressively for each additional child (up to three children) to reach about 30 percent of an average wage. A flat rate seems more desirable. The recently introduced wage tax provides a 20 percent tax credit to employees with children: these parallel benefits should be reviewed and only one of them retained.

• reduce the abuse of sick-leave benefits. At present, workers are eligible for up to two years of leave, financed from the social insurance fund. By reforming the incentive system, short-term sick leave should be financed by the workers themselves and the firms.

• develop a strategy for pension reform and begin implementation. The current pensions, paid out of a number of small pension funds, are too small for the many people, are poorly related to contributions, and are administratively complex. Therefore, consolidate all mandatory funds into one fund operated on a pay-as-you-go basis; alter the structure of the pension benefits; provide incentives to workers to stay in the work force; guarantee a minimum pension benefit to all workers; and develop voluntary insurance schemes regulated by the government.

• develop a means-tested social cash-assistance program, administered at the local level, for implementation within 12 to 24 months. Fundamental restructuring will be needed to create an affordable social safety net, to prevent households from falling below a minimum level of consumption. Existing locally-administered social assistance programs — primarily targeted at the elderly, the disabled, and the handicapped — could be expanded to protect a broader cross-section of society that is likely to need help in the first years of transition.

Suggested therapy

The current over-centralization wastes resources at every level. Not only are more resources needed, but a complete overhaul of resource allocation and decentralization of management are needed as well. Therefore:

• remove unnecessary regulations on the organization and use of hospitals and health facilities (such as decreasing the minimum size of hospital departments, restricting patients' choice of hospitals and doctors, etc.);

• reduce waste by developing programs to close/consolidate/transfer hospital facilities;

• reform financing to facilitate the autonomy of health units, foster the private health sector, and develop a proper regulatory framework;

• improve maternal and child health by developing an integrated reproductive health education and family planning program;

• formulate a national health strategy on the future of the country's health care provision and financing, including the roles of consumers, government, and the private sector.
Educational reform will be needed from top to bottom, with provisions that include:

- For pre-university education: reform the curriculum to provide more emphasis on basic science, math, languages, humanities; change the structure of secondary education, reducing specialization and the vocational emphasis; publish new textbooks with private sector involvement; introduce national examinations for entrance to secondary education.
- For higher education: introduce new disciplines, such as public policy and administration, Western-style economics, psychology, finance and business, pedagogy, biotechnology, and environmental science, using external resources as required. Resource allocation should be decentralized, transparent to all actors, with an element of competition for resources.
- Through modern pre-employment training and adult training programs, redirect excess capacity in industries, especially heavy industry, to areas with expected high demand in the next five years, such as management and finance, communications skills, commerce and trade, and entrepreneurship.

In terms of the labor market, an unemployment insurance fund was set up last February to provide benefits and to fund a national network of labor exchanges. However, further steps are necessary such as:

- removing tax-based controls on individual wages, replacing them with tax-based controls on companies’ total payrolls, setting a limit on absolute or average wage increases;
- legalizing flexible employment contracts and implementing existing legislation with a labor code; and
- accelerating the development of nationwide employment centers, possibly with international assistance.

For the time being, only a few Romanian experts are familiar with the structure, institutions, organization, and management of the West’s social sectors. (In November, 1990, as I was discussing the advantages of wage decentralization in the Ministry of Labor, officials asked, “How will enterprises know how to pay workers if we don’t tell them?” “How can we be sure that labor will get paid its value?”)

The role of economists in the social sectors is not yet widely accepted by policymakers; economists were told to do what they were told, with respect to resource allocation. The idea, for example, that the Ministry of Health should have something to say about cigarette pricing, or about export-biased commercial policy that creates shortages of domestic medical supplies, was completely foreign. This expanded view of the role of the social sector ministers and technocrats in the government is beginning to take hold, however.

Consensus is a must

The World Bank has recommended that the Romanian authorities adopt — as a first step — a reform strategy of social sector management in a decentralized market structure, as well as seek consensus on issues such as education, health, and social security. For example, examinations for entry into secondary and higher education can be revised only after both parents and teachers (as well as students) agree that mere information recall or learning by rote should not be rewarded as highly as the analytical skills of evaluation and synthesis. The Bank has also suggested that the government seek technical assistance from bilateral and multilateral agencies and from non-governmental organizations to assist with the strategy development process.

The first World Bank loan to Romania since the revolution — $180 million for technical assistance and critical imports — was approved last June. It entailed support to the Ministry of Labor to develop an employment services program, restructure social insurance benefits, and monitor the social costs of adjustment, using a living-standards measurement study. Probably it will be followed by a health rehabilitation loan (comprising technical assistance for the development of a health strategy), which is scheduled for Board presentation in the last quarter of 1991. Before the end of the calendar year, a structural adjustment loan should also be ready, which will include support for policy reforms in the social insurance system.

Louise Fox, EMSHR World Bank

**Romania: Comparative Social Indicators**

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<td>Maternal mortality</td>
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**Education**

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<th>Gross enrollment rates</th>
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<td>Primary (% school-age group)</td>
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<td>Secondary (%)</td>
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<td>Pupil-Teacher ratio: primary</td>
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<tr>
<td>secondary</td>
<td>10</td>
<td>10</td>
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<tr>
<td>Literacy rate - 1985 (% pop &gt; 15)</td>
<td>n.a.</td>
<td>n.a.</td>
<td>98</td>
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/ Includes Poland, Yugoslavia, Bulgaria, Czech., and Hungary; arithmetic average
b/ Includes Portugal, Spain, Greece, and Ireland; arithmetic average

Source: International organisations
My remark last year that “we need a market economy without an adjective” was a response to repeated attempts to coax us into accepting a mixed economy, a kind of third way (neither socialism nor capitalism). Adjectives like “social” or “environmental” are merely efforts to limit, to confuse, the clear definition of the market economy and introduce market-alien elements. We need an untainted market economy, and we need it now.

There is no room for the “socialism with a human face” or “socialist market economy,” dream of western social democrats and trade unions. The core of the reforms — that is, the critical mass of the systemic change — is limited to a few easily identifiable steps: early, fast, and massive privatization; freeing prices; liberalization of trade and exchange rates; and a prudent macroeconomic stabilization policy. “Crossing the Rubicon” can begin with any one of those steps, but to get to the other side all steps have to be taken. If we want real reforms, however, privatization enjoys priority.

Western advisors (sometimes well-paid experts at international institutions), in tandem with domestic opponents, voice their misgivings about fast privatization. They assert that appropriate means are not available to measure the real value of state enterprises. Their argument: as long as market forces are not able to determine the cost of production and how much profit is to be expected, the value of an enterprise cannot be calculated; thus, privatization has to be postponed. This is a false interpretation, Charles Wolf rightly says in the Wall Street Journal, and I would like to add: it is not that important for the state to extract maximum revenue out of privatization.

Liberalization of prices is a precondition for a normally functioning market economy. This drastic step is, of course, controversial, as prices were fixed for decades. Liberalization is only possible through shock therapy; incremental steps would cause more trouble. Partial deregulation would scramble the price structure and would result in new subsidies; the old game would start all over again.

Liberalization of foreign trade and exchange rates is an effective means of international competition, which is the only useful way to beat the monopolies’ rule. Dismembering of large concerns is a delicate operation, takes a long time, and, as a matter of fact, is inappropriate: restructuring should be left to the new owners. Privatization should come first.

Liberalization should precede the devaluation as the exchange rates approach the market value of the currency. This implies, however, two short-term, but very unpleasant consequences: domestically fueled inflation (following the price liberalization) will accelerate through imported inflation. If a country like Czechoslovakia is forced to import a major part of its energy and raw materials, the imported inflation spills over into the country, kicking off a dangerous inflationary spiral. The second is that market exchange rates will produce unexpected winners and losers among industries and entrepreneurs, often contradicting the predictions of government and (mostly technocratic)
Thus, devaluation kindles demand for the government to introduce industrial policy, and to resist is difficult. Reformers are under strong pressure to give up prudent economic and finance policy. They are accused of restricting demand, deliberately, on a low level. The industrial and trade statistics prove, however, that a sudden increase in supply is highly unlikely; an increase in demand thus would drive up inflation.

The question of whether “shock therapy” is appropriate for pulling down a command economy is wrongly put — shock therapy would be impossible to implement. On the economic and financial front, of course, fast changes are necessary. Currency reform, price liberalization, and elimination of trade restrictions are relatively easy. More time-consuming are the tasks of correcting the tax laws, auditing regulations, and introducing new economic laws. Privatization is impossible overnight. The reform is progressing in a multitude of dimensions, each with its own dynamic.

One more word on the speed of the reforms: my experiences disprove what I have read in the economic literature. I would say there is no political implication in the process or speed of implementing transition, as neither factor can be controlled. Now I know that East European reformers are mistakenly assailed for that. In a democracy, the results of the transition process cannot be engineered from outside. Only a dictator, a social engineer, experimenting in a (political) vacuum could take full control of such a transformation. But we live in the real world, and it imposes on us many legal restrictions; we have to accept them, we have to respect them.

Vaclav Klaus is the Minister of Finance in Czechoslovakia; this quotation is excerpted from his recent essay in the Swiss weekly, Weltwoche.

### Instant Convertibility — or Gradual Liberalization?

**Gabor Oblath**

In Central and Eastern Europe, “declaring” convertibility is in vogue. Spurred by the zeal for economic reform, recommendations from Western advisors, and the wish of governments in the region to produce spectacular results, the rush toward convertibility could lapse into a mere public relations exercise or, if serious, become a movement that will involve substantial economic costs. This is because until recently, CEE countries were much more insulated from the world economy than most of the strongly “inward looking” developing countries.

The experience with “instant convertibility” is mixed in the region. External economic liberalization, — the real issue behind convertibility — is a difficult process that needs proper sequencing and timing. As economist Jeffrey Sachs emphasized in a 1989 study, "structural reform (especially

Later, while an advisor to the Polish and Yugoslav governments, Sachs changed his mind. In his recent study, *Poland and Eastern Europe: What is to be done?*, he recommends the immediate introduction of convertibility simultaneously with stabilization. "From the outset... the economy should be opened wide to international trade... to have free trade, the currency must be convertible.... Convertibility has long seemed a distant dream to many economists in Eastern Europe, yet it can be accomplished through sharp devaluation combined with restrictive macroeconomic policies and financial control over state enterprises."

**Some experiences**

Poland and Yugoslavia, as part of their stabilization programs, intro-
duced resident (internal) convertibility early in 1990, allowing both enterprises and households to purchase foreign currency legally.

Poland's zloty was sharply devalued in January 1990, primarily for introducing and sustaining convertibility. Experts do not agree on what caused the extremely strong recession that followed the introduction of the stabilization package. However, the view that the recession was aggravated by the sharp devaluation, which itself was contractive and which partly induced the extremely strict financial and incomes policies, is both plausible and persuasive. Moreover, devaluation hindered the effectiveness of the Polish government's measures to contain inflationary pressures. Simple economic logic suggests that if there is a strong overshooting of the exchange rate, sooner or later the price level will have to adjust to it. It is partly this adjustment that seems to have taken place commensurate with the high rate of inflation in Poland.

Meanwhile, in Yugoslavia, dinar convertibility was introduced rapidly without significant devaluation, thus avoiding the costs Poland suffered.

For Hungary, in the view of many advisors, announcing convertibility would be a simple step. Analysts rightly claim that a certain degree of de facto convertibility has already been achieved, as roughly 90 percent of imports (corresponding to about 70 percent of industrial production) have been liberalized, i.e., de-licensed, and repatriation of profits on foreign investments has been guaranteed. However, Hungary should not follow — although it could — the example of the other East European countries rushing to convertibility.

Hungary's balance of payments position is still difficult. The country's debt-service obligation amounts to 15 percent of GDP (of which interest payments equal at least 5 percent of GDP). For the third straight year, industrial production is falling, probably by more than 5 percent. The annual inflation rate is almost 40 percent.

Introducing resident convertibility under such macroeconomic conditions would either imperil or raise the costs of stabilization. But an excessive burden on the population might endanger the democratic political framework of the transition to a market economy. Large devaluations would add to the already strong inflationary pressures, while stronger anti-inflationary measures could reinforce the current recession. On the other hand, if resident convertibility were introduced without substantial devaluation, in order to sidestep these costs, it could give rise to a run on international reserves. In the end, the authorities would be forced to give up their plan for convertibility. For these reasons, a more gradual approach to convertibility seems warranted.

But what about simply declaring convertibility de jure with respect to those transactions where convertibility already exists de facto? Two good reasons support not doing this. First, if convertibility were declared, without first removing the legal limitations on domestic households to buy foreign currency, the public would certainly feel deceived. Second, the claim that declaring convertibility improves a country's image abroad and thus encourages foreigners to invest is unconvincing. Potential investors are more interested in the performance of the economy and what is actually being done. It is safe to conclude that there is no point in announcing currency convertibility if convertibility covers only a limited assortment of international transactions.

Of course, the debate is not on convertibility itself, but on type, timing, and the kind of supportive measures needed to introduce it. It is hard to grasp the reasons for prescribing unduly hasty action for Central and Eastern Europe, a region that has been so strongly isolated from the world economy for the last 50 years. Instead, a phased approach to convertibility, based on stabilizing each economy and implementing institutional market reforms, is warranted first.

The author is an economist at the Hungarian Institute for Economic and Market Research, Budapest. His recent publications include The Terms of Trade Effects from the Elimination of State Trading in Soviet-Hungarian Trade (with D. Tár), WPS 690, The World Bank, 1991.
**Milestones of Transition**

Algeria's economic situation is deteriorating, with the country in arrears on its $900 million foreign debt payments this year, according to Prime Minister Sid Ahmed Ghozali, and with the dinar having lost half its value. Credit Lyonnais is attempting to generate a credit of up to $1 billion to refinance Algeria's payments on commercial bank debt. Eventually a $560 million loan guarantee — approved by the EC in early July — will be activated. EC finance ministers also approved a $450 million balance-of-payments support loan, and the IMF granted a $400 million stand-by credit in June. The Algerian government vows to ease its rules against foreign investment.

Although Hungary has made progress toward a market economy, its communist past and current debt burden remain a handicap, says the OECD in its first report on the Hungarian economy. Hungary's GDP will likely fall 6.8 percent this year, after a 5 percent drop in 1990. Inflation is on the rise — already above last year's 29 percent — and production is still falling. [The jobless rate hit 4.64 percent: at the end of July, with 217,000 jobless claims in a population of 11 million.] Debt service will cost Hungary up to $4.3 billion a year until 1995, says the report, which urges the OECD members to support Hungary financially and improve market access for its products.

Statistics on China show that the economy grew 6.1 percent in the first half of 1991. The country's trade surplus hit $880 million in August; and exports grew 17.2 percent above the same month last year, to $6.48 billion, while imports were up 21.9 percent, at $5.59 billion. Foreign trade involving China's five special economic zones surged 30 percent to $8.3 billion in the first half of the year on the strong growth of foreign-invested businesses. [China's overall trade reached $57.2 billion during the same period.] Inflation is accelerating, however. Retail prices were up 4.3 percent in July, compared with the same month last year. The cost-of-living index for 35 major Chinese cities jumped 11.6 percent in July, compared with an average increase of 6.9 percent in the first six months of the year.

When large-scale privatization starts in Czechoslovakia on January 1, 1992, approximately $8 billion worth of state property will be sold off to foreign and local investors, according to Economic Adviser Miloslav Zamecnik. Managers of all state-owned enterprises are to submit privatization projects to the Finance Ministry by the end of October. Preliminary data for July show prices beginning to flatten in Czechoslovakia after inflation soared to an annual rate of 59.1 percent in June. This was six months after the abandonment of most of the central-pricing mechanisms of the former regime. Unemployment rose 20 percent in July, the steepest monthly rise this year. Official figures showed 363,000 jobless, or 4.8 percent of the labor force.

Albania's Council of Ministers recently agreed to intensify privatization and adopt measures to attract foreign investment, although the government has declared stabilizing food supplies its immediate task. Falling industrial output and exports resulted in a $343 million trade deficit for the first half of 1991. After a meeting in Brussels, 24 donor countries and international organizations pledged more than $150 million in emergency aid and long-term economic help to Albania.

Inflation is on the retreat in Poland, but per capita industrial production fell by 16 percent from July 1990 to July 1991. Unemployment now stands at 1.75 million, almost 10 percent of the workforce. The cuts in budget expenditures have hit health, education, and science. For example, Poland uses 75 percent less medicine than other developed countries, and life expectancy for all male age groups fell in 1990. At birth, life expectancy is now 68.5 years for men and 75.5 years for women — more than six years lower than in the Scandinavian countries, according to Poland's Central Statistical Office. Infant mortality rose from 15.7 per thousand in the last quarter of 1989 to 16.1 per thousand a year later.

Positive data on output and new orders are signs of recovery in the eastern part of Germany, noted Economics Minister Jorgen Mollemann. He acknowledged that German unification will require the annual transfer of DM42 billion in official resources to the eastern half of the country until 1995. The President of Germany's Federal Labor Office, Heinrich Franke, said east German unemployment could swell to 1.5 million this winter. Joblessness in the region is running at 1.07 million, or 12.1 percent of the labor force. By the end of July, the Treuhand privatization agency had sold 2,986 east German firms for $6 billion, with foreigners buying 115 firms.

Grigory Yavlinski, the architect of the draft plan to steer the Soviet economy toward the free market system, has warned that an enormous amount of work remains. His plan provides for the republics to issue their own hard currencies, but within the framework of a standardized union-wide currency system. The plan also calls for the creation of a new banking regulatory body, along the lines of the U.S. Federal Reserve Board. The Soviet central bank would be replaced by a council of central bank governors from the republics.

The European Parliament in Strasbourg is urging the European Community to initiate a major Soviet aid plan, in cooperation with other industrial countries and international financial institutions. The plan would cover currency transfers for balance-of-payments deficits, long-term capital to finance investments, and money for food and medicine. In Brussels in mid-September, a Soviet delegation suggested that the Soviet Union wants $10.7 billion in food aid and credits from the international community to cover its food import needs in the coming year; Soviet officials believe about half the total should come from the EC.

The first international conference on Mongolian assistance, co-hosted by the World Bank, ended in Tokyo on September 6, with a pledge to extend more than $155 million to the country.

The United States, Germany, France, South Korea, Australia, New Zealand, and Singapore were among the 14 countries that sent representatives to the conference, along with officials from the IMF and the Asian Development Fund. China and the UN Development Program sent observers. The loans will cover critical imports such as food, medicine, fertilizer, and industrial spare parts. The participants agreed to hold a second Tokyo conference in 1992.
On the World Bank/IMF Agenda

Trust fund for the USSR

To support market reform in the Soviet Union, the World Bank is setting up a trust fund of $30 million to finance technical cooperation and advisory services in such areas as economic stabilization, private sector and financial sector development, privatization and restructuring of state enterprises, and agriculture, energy and housing reform. Training for reform officials will be provided by the Bank’s Economic Development Institute, and the Bank will cooperate with the IMF and other organizations in providing various other support packages.

Preston on helping the USSR

The World Bank stands ready to assist the Soviet Union but has to do so as a “reactive strategy,” said the IBRD’s new president, Lewis Preston, at a recent press conference. “We can tell them how important we think a monetary union is, but that is their decision to make. I expect we will be able to react positively to whatever role they want us to play.” He stressed that the demand from Eastern Europe and the Soviet Union for an infusion of capital will not prompt a shift in IBRD lending priorities since there is room for increased lending.

New regional office

IBRD president Lewis Preston has announced management changes at the Bank, including the creation of a new regional office for Europe and the Soviet Union. As of December 1, this office will be managed by Wilfried Thalwitz, currently senior vice-president for policy, planning and research. The office will respond to “the historic changes and opportunities... and pave the way for increased lending to the Soviet Union and Eastern European countries,” Preston said.

IDA credits to China

IDA is supporting China’s irrigation project in the Tarim Basin of the Xinjiang Uygur Autonomous Region with a credit of $125 million. (IDA is the World Bank affiliate that lends on concessional terms to the poorest countries.) The investment will nearly double the income for almost 140,000 poor farm families, will generate up to 135,000 new jobs, and will boost production of crops and livestock on about 200,000 hectares. Another IDA credit of $60 million will help reduce traffic congestion and improve road safety in the Shanghai Metropolitan Region, which has a population of about 13 million.

Fund/IDA to help Tanzania

The IMF has approved a loan equivalent to $242 million to support Tanzania’s economic and financial reform program. The loan from the Enhanced Structural Adjustment Facility and an IDA credit of $11.2 million will help with implementation of urban infrastructure investment and maintenance programs in nine cities. The Tanzanian government wants to achieve a 5 percent growth rate for 1991-92, reduce inflation to 14 percent, and limit the budget deficit to 5.8 percent of GDP.

Cambodia seeks readmission

Prince Norodom Sihanouk, head of Cambodia’s Supreme National Council, has asked the World Bank and the IMF to readmit Cambodia to membership in time for the country to participate in the Bank/Fund annual meetings in Bangkok, October 15-17. The Southeast Asian country has not sent a delegation to the meetings since 1974, when the Khmer Rouge seized power.

Estonia and Lithuania

The Baltic republics of Estonia and Lithuania have applied for IMF and World Bank status. Latvia, the third newly-independent Baltic republic, is also expected to apply for membership. (Membership in the IMF is a prerequisite for World Bank membership.) The United States has already announced it would support the Baltics’ bid to join the IMF/World Bank, the United Nations, and the EBRD.

Nicaragua paying arrears

Nicaragua has fully cleared arrears ($218.9 million) on its loans from the World Bank, allowing the resumption of disbursements and new lending. The country is also paying off about $100 million in arrears to the Inter-American Development Bank. Contributions and credits from 17 countries, as well as a $193 million bridging loan from Colombia, Mexico, Spain, and Venezuela, made the overdue payments possible. Nicaragua also wants to renegotiate its $1 billion Paris Club debt. The IMF has approved a $55.7 million stand-by credit for Nicaragua — the country’s first in 12 years — to support government’s 1991-92 economic program.

MIGA conference on business

Business managers from Angola and Mozambique were among two dozen Portuguese-speaking African participants attending the executive program “Doing Business with Foreign Partners” (September 23-27 in Portugal). Organized by the Policy and Advisory Services of the Multilateral Investment Guarantee Agency, the conference was co-sponsored by the government of Portugal and private companies. MIGA expects the program to accelerate privatization and private sector development in Lusophone Africa.
Conference Diary

Reprivatization of Industrial and Commercial Enterprises in Eastern Europe
May 31-June 1, Ljubjana, Yugoslavia

Roundtable sponsored by the International Center for Public Enterprises (ICPE), the Economic Development Institute of the World Bank, and the Republic of Slovenia's privatization agency. Participants included officials from privatization agencies; legal and economic advisors from Czechoslovakia, Hungary, Poland, Romania, and Yugoslavia; experts from ICPE and EDI; representatives of former property owners; and a university research group from the Berkeley Roundtable on International Economics (BRIE). Some conclusions were that:

- Assets that are easily transferable can be restored in kind, and non-transferable ones via financial compensation.
- Productive assets may be privatized even while claims by former owners are still outstanding.
- Assets should be evaluated simply and transparently.
- Former owners should not be awarded full compensation for former property calculated at present market value.

A workshop report and country reports on reprivatization will be published soon by ICPE and EDI.

Soviet Economic Reform
September 1-3, Washington, DC

Organized by the Washington Area Forum on Economic Reform. Stanley Fisher of MIT spoke; he urged the West to establish an office of Soviet aid coordination.

Forthcoming:

Financial Market Reform in Eastern Europe
October 3, Washington, DC

Organized by the National Economist Club. Eugene Rotberg, former vice president/treasurer of the World Bank will speak at a luncheon.

From Field to Table: Reforming Soviet Agriculture
October 17-20, Middlebury, VT

Seminar organized by the Geonomics Institute. Western and Soviet agricultural specialists, farmers, policymakers, scholars, and representatives from agribusiness will review legislative reforms, the role of government, and strategies to funnel investments into field-to-market processing and distribution.

Information: George Bellerose, Director, Geonomics Institute, 14 Hillcrest Avenue, Middlebury, VT 05753, Tel: (802) 388-9619.

Toward a Post-Communist World
October 22-23, Washington DC

Conference sponsored by the U.S. Information Agency to observe the 40th anniversary of the publication, Problems of Communism. Jiri Dienstbier, George Napolitano, Ferenc Feher, Vladimir Tismaneau, and Richard Lugar will participate. Two panels, on Adapting to Modernity and Democratic Institution Building, will discuss challenges and opportunites in the post-communist world.

Information: Tracy Harrington, USAID, Tel: (202) 205-0400, fax: (202) 619-4173.

Ukraine: Economic Realities and the New Nationalism
October 28, Washington, DC

Organized by the National Economist Club. Alexander Goncharenko of the North American Institute, Academy of Sciences, Kiev, will speak at a luncheon.

Information: (703) 532-9048.

Eastern European Automotive Industry
November 7-8, Budapest, Hungary

An international workshop, organized by the IFC and the Hungarian Automotive Industry Association. Government officials, industry experts, and representatives of leading companies will discuss global changes in the industry and their influence on local industries in Central and Eastern Europe. Topics include: implications of shifting from public to private ownership, possibilities of components exports from Eastern Europe, and improving quality in automotive manufacturing.

Information: Yannis Karmokalias, IFC, Tel: (202) 473-0778.

New Risks and Opportunities in the USSR and Central Europe
November 12-13, New York

Conference on corporate strategies in a changing environment, organized by Business International. Topics will include: shifting corporate strategies, chances of a unified Soviet market, viability of reforms in Eastern Europe, optimal forms of entry into the East European marketplace, and setting up an office and distribution system there.

Information: Marie Duarte, Business International, 215 Park Ave.South, New York, NY 10003, Tel: (212) 460-0600, fax: (212) 505-1809.

23rd National Convention of the AAASS
November 22-25, Miami FL

Hosted by the Southern Conference on Slavic Studies. Topics will include: Yugoslavia in the 90s; Is Latin America the Future of Eastern Europe?; East Central Europe Today, Continuity and Change; NEP as a Market Economy: Model or Myth? Company Laws and Property Rights: a Comparative Analysis; Beating the System: Borrowing, Earning and Spending Rubles; Demonopolization and International Competitiveness in Eastern Europe; and a roundtable debate on current Soviet economic development.

Information: 128 Encina Commons, Stanford University, Stanford, CA 94305-6029, Tel: (415) 723-9683, fax: (415) 723-7737.
Jan Winiecki

THE INEVITABILITY OF A FALL IN OUTPUT IN THE EARLY STAGES OF TRANSITION TO THE MARKET: THEORETICAL UNDERPINNINGS

The author suggests that much of the steep fall in industrial output in post-communist economies actually has no impact on the welfare of the population. This is because in Soviet-type economies, the costs to the state of controlling enterprise managers (agency costs) were enormous. Fictitious plan fulfillment figures were routinely reported to the authorities, and manipulative price practices took advantage of a country's economic isolation and persistent excess demand. Hoarding strategies further aggravated shortages and created more uncertainties. Households were forced into excessive, precautionary purchasing to overcome chronic shortages.

With the introduction of positive real interest rates and with cuts in state subsidies, demand has fallen, as has output. A large percentage of output has disappeared from the statistics, depending on how great the agency costs were. Enterprises are becoming less wasteful, and with that, demand is adjusted downward. This adjustment has also translated into a fall in output. After the alleviation of recurrent shortages, household behavior changes and hoarding abates, resulting in a further drop of output.

Welfare is reduced only by the fall in demand and output resulting from a restrictive macroeconomic policy. This is the actual cost of transition. Other output losses do not reduce welfare. Theorists who recognize the wastefulness of the Soviet-type economies usually ignore the phenomenon that a fall in output also results from an efficiency increase during transition.

If the fall in demand and in output is a result of a change in the economic regime, stimulative demand management policies in the short term could drive up prices and in the longer term reduce pressure on enterprises to adjust. Measures for social safety nets are necessary to soften the consequences of the uneven distribution of loss in output and income — caused by the adjustment to the higher efficiency level — concludes the author.

Steve H. Hanke and Kurt Schuler

A CURRENCY BOARD SOLUTION FOR THE ALBANIAN LEK

The future of Albania's national currency, the lek, depends on the government's actions in the next few months. If the money supply continues its rapid expansion, the people will conduct their own monetary reform and replace the lek with the dollar. The authors suggest establishing a currency board to issue notes and coins, which would be convertible on demand to a foreign reserve currency (or basket of currencies or gold) at a fixed rate. The currency board would hold high-quality, interest-bearing securities on reserve, equal to 100 percent, or slightly more, of its notes and coins in circulation, denominated in the reserve currency (or currencies or gold).

The board could generate profits from the difference between the interest earned on its securities (or on loans of gold) and the cost of maintaining the money circulation. With a stable monetary environment, Albania would be able to take the next steps toward a market economy.

The study is available from the International Freedom Foundation: 200 G St. NW, Washington, DC 20002. Tel: (202) 546-5788.

Eric Rice

MANAGING THE TRANSITION: ENHANCING GOVERNMENT EFFICIENCY IN POST-SOCIALIST EASTERN EUROPE

Compared to the sweeping political and economic transformation in Central and Eastern Europe, the reform of the day-to-day relationship between society and government has barely advanced in most countries of the region, claims the author. Burdensome administrative and regulatory procedures persist, and the culture of the ancien regime bureaucracies remains. Major reform of government institutions is required for them to...
operate with new goals, attitudes, and behavior. Such reform should focus on the following:

- delegation of functions to sub-national governments and private enterprises, with laws clearly defining the jurisdictions and responsibilities of each;
- improvement of communication between governments and citizens to ensure transparency and a voice for the public in policymaking;
- creation of a hospitable business environment, including clarification of property rights;
- consistency and accountability;
- low-cost provision of government services and infrastructure; and
- efficient government administration at all levels, under the scrutiny of elected legislatures, citizens groups, internal audits, and review agencies.

In terms of implementation this would mean:

- replacing or retraining top managers;
- granting citizens access to unclassified information about government activities; a "freedom of information" code and/or institutionalizing the parliamentary testimony of government officials;
- making civil servants accountable for their actions (with private citizens having recourse to challenge the legality of government policy via class action suits, for example); and
- providing the public with a clear exposition of a medium-term, comprehensive, coherent and credible program of economic and social priorities, goals, policies, and trade-offs.

New Books and Working Papers *

The World Bank
Annual Report 1991 (238 p.)

Bulgaria: Crisis and Transition to a Market Economy

Oleh Havrylyshyn and Lant Pritchett
European Trade Pattern After the Transition

Roberto de Rezende Rocha
Inflation and Stabilization in Yugoslavia

Martin Schrenk
The CMEA System: The Legacy and the Aftermath of its Termination

Esra Bennathan, Jeffrey Gutman, and Louis Thompson
Reforming and Privatizing Poland's Road Freight Industry

Commission of the European Communities
The Path of Reform in Central and Eastern Europe
Order: Office for Official Publications of the European Communities, L-2985 Luxembourg.

Anthony R. Boote and Janos Somogyi
Economic Reform in Hungary since 1988

Ronald I. McKinnon
The Order of Economic Liberalization: Financial Control in the Transition to a Market Economy

To order: CDC, 2021 K Street NW, Suite 215, Washington, DC 20006, Tel: (1-800) 394-1945.

James Hughes
Stalin, Siberia and the Crisis of the New Economic Policy

David Marples
Ukraine under Perestroika: Ecology, Economics, and Workers' Revolt

Peter Danton de Rouffignac
Doing Business with Eastern Europe: a Guidebook for the 1990s

Peter Palankai
The European Community and Central European Integration: The Hungarian Case

* The CECSE unit of the World Bank regrets that it is unable to supply the publications listed.
BIBLIOGRAPHY OF SELECTED ARTICLES *

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