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From the Editor:

Dear Reader,

As with the previous issue of **BT**, which discussed the economic prospects of the Central Asian states, this issue also has a geographic focus. It examines the recent experiences of Central and Eastern European countries as new EU members, as well as their prospects. The issue highlights the challenges these countries face as they prepare to join the eurozone (Slovenia is already the EMU member) and analyzes some of the economic and political consequences of EU accession. The New Member States (NMS) have much higher inflation volatility compared to the old members, so their EMU membership could come with substantial adjustment costs (Maier and Hendrikx). Yet, for small countries the losses from being outside the EMU may outweigh the costs associated with the membership: the Bank of Estonia has calculated that the country can cumulatively lose 10 percentage points of GDP growth in five years due to delayed membership (Ross). Tighter financial integration can help the NMS to improve risk sharing. The potential welfare gains in this case can amount to 5.2% of consumption (Demyanyk and Volosovych).

Reducing barriers to labor mobility and trade would allow the NMS to decrease adjustment costs. Pierella Paci et al. provide concrete recommendations on how to improve labor market flexibility. The proposed measures include the facilitation of commuting, investments in education and lifelong learning, and improvements in social protection systems. Mihails Hazans reviews the recent trends in the Latvian labor market and documents the increase in external labor mobility and the narrowing of the ethnic gap after EU accession. As for the trade dimension, since the new members are still lagging behind in port efficiency, customs regimes, regulatory policy and IT infrastructure (Wilson, Luo and Broadman), they can gain relatively more compared to the "old" members if they lower behind-the-border barriers to trade.

Country-specific evaluations of post-accession experiences offer interesting insights and valuable lessons for other countries. Eva Balcerowicz maintains that most fears regarding Poland's accession turned out to be unfounded and shows some unexpected benefits of EU membership, such as an increase in exports. The prospects of EU accession provided Bulgaria with powerful political and economic anchors to the reform process, which helped to boost the country's competitiveness (Kaminski and Ng). Positive economic developments in the post-accession period have perhaps contributed to public support for EU membership in Poland (Balcerowicz), and further EU enlargement and eurozone entry in Slovakia (Haughton and Malova).

In the New Findings section Michael Lokshin et al. explore one area where the transition countries still differ much from Western Europe — that is, an individual's attention to health. In Russia and Albania, a whopping 60% of men smoke. The authors show that the economic burden smokers impose on themselves and their societies is far from being trivial: smokers lose 15-28% in wages and GDP is decreased by 2%.

Other articles in the New Findings section look at financial deepening and development of the banking sector, highlighting the role of foreign banks (Havrylchyk and Jurzyk; Dushkevych and Zelenyuk), as well as the barriers to doing business — specifically access to land for large and small businesses in Russia (Kisunko and Coolidge), which remains difficult despite deregulation.

Ksenia Yudaeva, Managing Editor

EMU Enlargement: Why Flexibility Matters

Inflation differentials can contribute to nominal and real adjustment, but may come with costs

Philipp Maier and Maarten Hendrikx

The European Monetary Union (EMU) continues to expand with Slovenia being its newest member since January 1, 2007 and several others in the waiting room. As exchange rates become irrevocably linked to the euro, regional inflation differentials become an important adjustment mechanism: for instance, when countries grow at different speeds, inflation differentials can emerge. Similarly, inflation differentials that emerge due to regions being hit by asymmetric shocks need not concern a central bank. A more difficult situation for a monetary policymaker occurs when persistent inflation differentials emerge because of inflexible labor and product markets. These could potentially lead to large adjustment costs, a loss of public support for the euro and a weakening of the external value of the euro. To avoid this, sufficient flexibility in labor and product markets is important to ensure smooth and sustainable nominal and real convergence of the New Member States (NMS).

The level of inflation dispersion in the EMU is close to levels observed in other monetary unions (see Figure). For the EU25 (all EU members except for the UK and Denmark), however, the average level of dispersion has been considerably higher. This is because the NMS are in a process of real and nominal economic convergence. Taking into account current nominal price levels and the recent speed of convergence, it is estimated that most NMS need several decades to achieve price level convergence (see Table). That is, if the NMS fixed their exchange rates to the euro tomorrow, they would have a higher average inflation rate than the current euro area member states for a sustained period of time.

Unable to Deliver Monetary Stability?

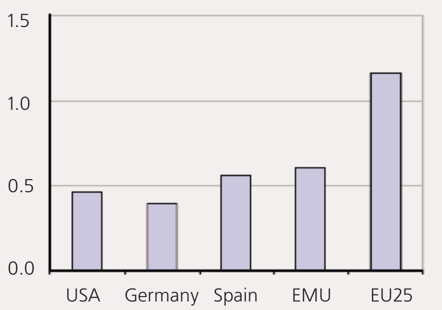
Arguably, monetary policy making by the ECB would be easier if most member states were located closely around the average rate of inflation. In contrast, a situation where two groups of countries persistently deviate from the union's average rate of inflation might expose the monetary union to tensions. As nominal and real convergence in the NMS is still far from being achieved, there is a risk that in an enlarged monetary union, two groups of countries will emerge that have a different rate of inflation, and hence different needs for monetary policy.

While the economic impact of the NMS accession to the EMU would be limited due to their relatively small economic weight, the NMS would represent a substantial political/social factor as they account for about 25% of an enlarged euro area's population. The ECB may not be able to deliver price stability for a considerable part of the population of an enlarged monetary union. Since 1999, the average share of total population that has an inflation rate within a ± 1 percentage point band around the GDP-weighted average inflation rate is about 80% for the current EMU and slightly more than half for a hypothetical monetary union of the EMU and NMS.

Conclusion

The EMU has extended monetary stability throughout Europe. Arguably, one of the factors contributing to the success of the EMU has been the high degree of convergence among its members when they formed the monetary union. To continue the success story, European policymakers should pay close attention to the economic circumstances of the candidate countries. Inflation differentials can contribute to nominal and real adjustment, but may come with costs: insufficient economic flexibility increases the risk of persistent regional inflation divergence, which could raise adjustment costs, complicate monetary policymaking and erode public support for the euro. Policymakers therefore need to be aware of the importance of economic flexibility to ensure smooth and sustainable convergence of the NMS to the euro area level.

Inflation dispersion



Note: Unweighted coefficient of variation of regional inflation rates. Data for the USA (12 FED districts) is averaged over 1951-1999, for Germany (9 Bundeslander) 1951-1996, for Spain (50 provinces) 1961-1998 and for EMU (13 countries) and EU25 1999-2007.

Relative Price Index 2005, EU15=100

Country	GDP Deflator	Household Consumption
Czech Republic	54	56
Estonia	56	63
Latvia	48	55
Lithuania	47	53
Hungary	59	62
Poland	52	58
Slovakia	53	56
Bulgaria	35	42
Romania	43	52
Lowest 3 Eurozone		
Portugal	80	82
Greece	82	85
Spain	87	87

Source: Lewis (2007), Eurostat

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Gains from Risk–Sharing in the EU

The new EU countries could gain more from financial integration than the EU-15

Yuliya Demyanyk and Vadym Volosovych

In 2004 ten countries joined the European Union. In addition to political unification, the EU is moving toward a unified market with a joint economic policy, single currency, and reduced restrictions on flows of goods, services, labor, and capital.

Unrestricted international trade is widely believed to be one of the most beneficial aspects of economic integration. The merits of greater financial openness and larger cross-border flows of money are more often disputed because of the recent financial crises and following instability they brought to a number of the emerging markets. In addition, the economies within the euro-zone cannot reduce the impact of adverse country-specific events (such as sudden falls in output due to, for example, natural disasters) by monetary policy instruments at a country level. This, in turn, can lead to the further instability of individual economies and the economy of the Union as a whole unless mechanisms that allow diversifying country-specific shocks are in place.

Diversification of economic and financial risks within a group of countries is known in economic literature as "risk-sharing." In case of full risk-sharing, all country-specific output shocks are completely diversified across the group members so that individual country's output volatility is not reflected in that country's income (full income risk-sharing) or consumption (full consumption risk-sharing).

We estimate the benefits from financial integration from international risk-sharing among the 25 EU countries and do not discuss any other aspects of the integration that may improve the well-being of the EU residents. We compare potential gains form risk-sharing among country-members and determine the countries that would benefit the most under conditions of the larger Union fully achieving risk-sharing.

Domestic Macroeconomic Volatility Higher for the NMS

The ten new EU countries have generally higher and more volatile average GDP per capita growth rates (4.2% per year) compared to the rates of the EU-15 (2.5% per year). The variability of output growth is three times larger for the NMS than for the EU-15. Both the rate of per capita consumption growth and its variability follow a similar pattern.

Income risk-sharing gives insight on how effectively a country uses international asset markets to insure national income against country-specific output shocks and thus how well it is integrated into those markets. On average, the new EU countries have a larger degree of income risk-sharing than the EU-15 members. The average extent of income risk-sharing is 26% for the new members and 9% for the EU-15 (100% means full risk-sharing). This may not mean that the new EU countries are more open to capital flows. Instead, this may imply they mostly share risk within the EU, while the EU-15 countries are more likely to engage in risk-sharing with the rest of the world, including investing in North America and Asia.

All 25 countries will benefit from financial integration, and the total average welfare gains of the NMS could amount to 5.2%

Income risk-sharing would contribute to consumption risk-sharing (or "consumption smoothing"). On average, the EU-15 exhibits a much higher degree of consumption risk-sharing (47%) than the new EU countries (15%). A lot of consumption smoothing within the EU-15 is achieved through international transfers, national government spending, and corporate and private saving.

Larger Gains for the NMS

To quantify the potential benefits from risk-sharing, we estimate a welfare gain from risk-sharing as a permanent increase in the level of consumption of a representative individual when a country achieves full risk-sharing. We estimate total potential welfare gains the countries obtain from moving from financial autarky to full risk-sharing. The measure is estimated using GDP per capita data under the proposition that in autarky a country consumes its own GDP and under full risk-sharing it consumes a portion of pooled group-wide GDP. Judging from the estimated extent of risk-sharing, none of the economies we study is in financial autarky. Therefore, we also estimate unexploited gains from risk-sharing when a country moves from the actual level of consumption to the level under full risk-sharing conditions.

The countries with more volatile output should, in theory, gain relatively more than countries with stable output from pooling the individual output risks. In addition, a country whose output is counter-cyclical to other countries in the Union would be "compensated" for stabilizing the group-wide output.

We find that the new EU members could on average gain more from financial integration than the EU-15. The total average welfare gains amount to 5.2% (permanent increase in the level of per capita consumption) for the new EU countries and to 1.2% for the EU-15. The welfare gains are larger for smaller economies and are especially large for Lithuania, Estonia, Malta, the Czech Republic and Slovakia. The average unexploited welfare gains are again much larger for the NMS (6.6%) than those for the EU-15 (0.9%). The larger value of the gain for the NMS is primarily attributed to a higher volatility and sometimes the counter-cyclical pattern of output and consumption spending.

Thus, the empirical results show that if financial integration advances and the EU member countries move closer to full risk-sharing conditions, the welfare gains will be substantial for all the countries.

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Postponing Euro–Area Expectations?

While honoring the Treaty, the interpretation of the inflation criterion could be given a fresh look

Tanel Ross

For a number of the New Member States, including Estonia, adoption of the euro is the key priority. This short article discusses some political and economic issues of the enlargement and provides a brief update on Estonia's position.

The starting point for the adoption of the euro is rather straightforward. Eliminating exchange rate risk and promoting real exchange rate stability boosts both intra-EU trade and GDP growth. Adopting the euro would foster financial diversification and investment flows. The enlargement of the eurozone so far has provided substantial benefits for the new and old member states alike.

If the cost-benefit analysis is so straightforward, why do doubts about the pace and breadth of the eurozone enlargement linger? In general, two lines of argument caution against a speedy enlargement. First, an economic line of skepticism notes the eurozone and most of the NMS are at different stages of the economic cycle (or medium to long term development). Second, a political line of skepticism focuses on eurozone governance and, indeed, on EU governance in general.

Economic Skepticism

The economic line of skepticism notes that the New Member States are in a fundamentally different cyclical position compared to the old ones. Economic convergence leads to higher GDP and productivity growth rates, a somewhat higher CPI inflation, and often to current account deficits, as well. Nominal exchange rate flexibility, in this skeptical view, is needed at some point to adjust to a slower growth path. Premature entry to the eurozone would make that adjustment too painful.

These arguments, however, omit the single most important feature of the EMU — its members' economies should be agile enough to make use of the opportunities a stable monetary framework provides. To this end, economic flexibility is needed in all eurozone member states. On some occasions, the Balassa-Samuelsson effect will push an equilibrium inflation rate above the eurozone average. Yet on other occasions shocks to retail trade or telecom services that cannot be easily traded across the single market, would result in real exchange rate depreciation and lower inflation. In either instance, divergence of inflation rates is a result of normal and manageable economic adjustment, and is not a sign of weakness.

Clearly, eurozone members will continue to specialize in the single market and face asymmetric shocks. The divergence of inflation rates and external positions is thus expected to continue irrespective of the enlargement. The corresponding adjustment path of real exchange rates depends predominantly on the flexibility of economic structures. Therefore, the suggestion that the NMS should postpone joining the eurozone simply because of rapid output growth or current account deficits is not entirely correct. Potential eurozone entrants are likely to be flexible enough to adjust in the currency union without recourse to nominal exchange rates.

Political Skepticism

Political arguments that caution against too rapid enlargement can be divided into two broad categories, even leaving aside general enlargement fatigue.

One of these arguments points to the assumption that the enlargement of the eurozone will be difficult without further political integration. This implies that the credibility of the euro would suffer without closer coordination among fiscal and structural policies, or among other policies.

The existing toolbox for policy coordination within the EU, however, is already impressive. The renewed Stability and Growth Pact and the new Lisbon strategy for growth and jobs together provide a full framework for coordinating policy and applying peer pressure. The fulfillment of commitments by individual member states would suffice for the efficient functioning of the monetary union for years to come. Enlargement of the eurozone would not hinder the proper functioning of any of these mechanisms.

Nor would the views of representatives of new entrants likely disrupt monetary management. Central bank governors from the NMS, according to some, are somehow more accustomed to inflation rates exceeding 2%. Ironically, it could be also argued that governors from the NMS would be too hawkish, as higher interest rates would be preferable in their home countries.

Estonia's costs of delayed eurozone entry could amount to 10 percentage points of a cumulative loss in GDP growth over five years

It should be underlined that the members of the Governing Council do not represent their central banks, but the entire eurozone. This applies equally to the present and future members of the eurosystem. Nevertheless, local economic conditions may still count in the voting pattern on the board. It is interesting to note that in the Federal Open Market Committee (FOMC), regional conditions may have a stronger impact on board members in Washington, DC than on FOMC members from the regional banks.

Estonia will Stay on Course

Estonia, by adhering to a fixed exchange rate and the currency board framework, has been a *de facto* member of the common currency area since June 1992. With complete liberalization of capital movement and full integration of the financial system with the European markets, Estonia has been as close to currency union as an independent country can possibly be. Hence, early adoption of the euro is the only realistic policy goal. Estonia has met all the Maastricht criteria with ease — except for the current interpretation of the inflation criterion.

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European Accession and Capacity-Building Priorities

Almost 40% of the trade gains for the new members come from improvements in IT infrastructure

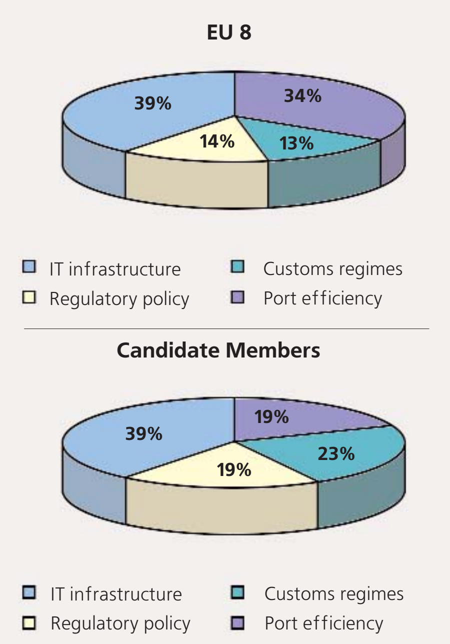
John S. Wilson, Xubei Luo, and Harry G. Broadman

In the transition countries of Europe reducing barriers to trade is increasingly seen as the key policy priority to accelerate integration into the world economy, including through membership in the European Union. A broad definition of "trade facilitation" involves not only improved efficiency in logistics at ports and customs and the use of advanced technology, but also streamlined regulatory policy, deeper harmonization of standards, and conformance to international norms.

EU membership should, over time, facilitate the movement of goods between member states. The harmonization and implementation of the *acquis communautaire* also require new member countries to make major improvements to their overall economic environment both at and behind the border.

In our research paper, we examine the four dimensions of trade facilitation — increased port efficiency, customs regimes, regulatory policy, and information technology infrastructure — in order to estimate the gains from trade to the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia (hereafter EU-8); and Bulgaria, Romania, and Turkey (candidate countries).

Relative Trade Gains due to Improved Trade Facilitation Indicators



Facing Different Challenges

We first measure how far a country's performance is from the best-practice country in each of the four dimensions. The best-practice country is indexed to a value of 1.0.

The 15 EU member countries are relatively advanced in all four areas, with an average value of 0.82, 0.87, 0.79, and 0.78 in port efficiency, customs regimes, regulatory policy, and information technology infrastructure, respectively. The EU8 countries, however, are less developed in these four areas with an average value of 0.60, 0.73, 0.65, and 0.64, respectively. As for Bulgaria, Romania and Turkey, the development of their trade facilitation is further behind, with the state of their customs regimes estimated at just 58% of the EU-15 level.

The level of development of the new and candidate member countries varies most in port efficiency, where Estonia and Latvia are the top performers with 70% of the best EU-15 performers. In regulatory policy, the development levels of all the examined countries are more homogeneous.

The three largest economies — the Czech Republic, Hungary, and Poland — are not only less developed than the EU-15 in trade facilitation as a whole, but also constrained in particular dimensions. Hungary's customs regime approaches 95% of the EU-15 level, while its ports efficiency does not exceed 60% of the this level. The Czech Republic is relatively developed in IT infrastructure but much less so in port efficiency. Poland, the least developed among the three, exhibits a level around 70% of the EU-15 benchmark in all the four areas. In sum, in order to achieve the trade facilitation levels of the EU-15, the new member and candidate countries have to overcome different challenges.

Large Gains from Behind-the-Border Improvements

The new EU members have exhibited rapid economic growth in the last several years (around 2.5-3%), despite the relatively weak performance of Western Europe and the world economy. Does economic growth enable building trade facilitation capacity? There may be a relationship, as the more developed a country is, the more resources it can devote to investing in trade facilitation capacity. By the same token, it is likely that the larger the economy, the higher the rate of return on investment in improving trade facilitation.

Yet, the gap in economic development of the EU-15 and the EU-8 and candidate countries does not fully account for the lagged progress in the latters' trade facilitation capacity. The only exception is Estonia, which performs stronger than the benchmark level in all four indicators but also has a far higher GDP growth rate than the regional average. Compared with Hungary, a country with similar economic characteristics, Estonia is 40% more developed in port efficiency, 30% in IT infrastructure and 20% in regulatory policy.

Does trade facilitation promote development? Our analysis suggests that barriers to trade facilitation in the EU-8 and the candidate countries may weaken their development potential. For example, export growth is one of the most important factors that contributed to recent economic growth in the Czech Republic, Hungary, and Poland. If infrastructure is upgraded and transactions costs lowered, trade volumes could be expanded.

Modeling the impact of hypothetical improvements in port efficiency, customs regimes, regulatory policy and IT by half of the EU-15 level on bilateral trade flows, we find that that behind-the-border factors will lead to the increase of import and especially export volumes. For example, the greatest absolute trade gains — US$49 billion and US$62 billion respectively — could be expected if port efficiency and IT infrastructure of the studied countries reach half the average level of the EU, and 70% of trade gains are associated with export expansion.

Improvements in behind-the-border factors by half of the EU-15 average also result in large relative trade gains of around 11%. For instance, Lithuania's trade volume would rise more than 25% if its IT infrastructure level reaches 50% of the EU level.

Trading Partners Also Benefit

Trade facilitation improvements benefit not only the countries that implement them, but also their trading partners. The more intense trade relations are between countries, the greater the potential benefit partner countries will enjoy. Given the importance of intra-regional trade between the EU-15 and the EU-8 and the candidate countries, the expected total trade gains to all of them may amount to almost US$10 billion if all four dimensions of trade facilitation improve by up to a half of the EU-15 level. Of these, 74% accrue to the EU-15 countries.

Almost 40% of the total estimated trade gains for the EU-8 and candidate countries come from improvements in IT infrastructure (see Figure). The second largest potential gains for EU-8 — almost 30% — come from port efficiency. These two dimensions should be therefore given a higher priority for improvement. Bulgaria, Romania, and Turkey receive more widely dispersed gains with investments in port efficiency, customs regimes and regulatory policy at around 20% of the total trade gains.

Improvements in trade facilitation in the New Member States and Turkey will also bring sizable benefits to EU15

In relative terms, the EU-8 and the candidate countries will benefit more than the "old" members, thanks to the existing relatively intense trade relationships. In particular, their relative trade gains are quite large should the largest economies among them — the Czech Republic, Hungary, and Poland — improve trade facilitation. For example, if Poland increases its IT infrastructure to half of the EU-15 average, the other seven new member countries will enjoy a trade gain of 0.8%; Bulgaria, Romania, and Turkey will gain 0.25%, and the EU-15 — 0.29%.

Concluding Remarks

As our analysis has shown, improvement in IT infrastructure could lead to the largest gains for the new members and the candidate countries. If clearance procedures could be streamlined, the attendant time could be shortened and costs saved.

In general, improvements in port facilities and IT infrastructure may be more costly than the administrative reforms at the center of customs regimes and regulatory policy — but they could have correspondingly high payoffs. The eligibility for additional EU financing with accession should provide more scope for improvements in these areas.

John Wilson is at Development Research Group, Xubei Luo is at Europe and Central Asia Region, and Harry Broadman is at Africa Region, the World Bank, Washington, DC. Full text of the authors' paper "Entering the Union: European Accession and Capacity Building Priorities" is available at: http://econ.worldbank.org (World Bank Policy Research Working Paper No. 3832). The findings, interpretations, and conclusions expressed in this paper are entirely those of the authors. They do not necessarily represent the view of the World Bank, its Executive Directors, or the countries they represent. The findings and conclusions here do not necessarily represent the views of U.K. government or the U.K. Department for International Development, which has provided support for the project. **BT**

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Against this backdrop, a few suggestions for future work could be made.

All the Treaty provisions should, of course, be honored. Within this framework, however, taking a fresh look at the interpretation of the inflation criterion is possible. The three countries with the lowest inflation rates are not necessarily the three best performers of the EU-25. Indeed, it has been almost customary in recent convergence reports that two out of the three reference countries were ones with floating exchange rates that might not serve as the most suitable benchmark for joining the currency union. Thus, new ways should be explored, for instance, by taking into account the european Central Bank's explicit numerical target for calculating the reference value of the price stability criterion, or only looking at the inflation rates of eurozone members.

The new interpretation of the criterion would not set an unwelcome precedent for any future enlargements. It would demonstrate that the adoption of the euro would be assessed only by economic policy merits. Indeed, it is not entirely clear why a combination of low inflation and a fluctuating nominal exchange rate would be preferred to a strictly fixed rate when deliberating over eurozone membership.

It has been customary to ask what will happen if entry to the eurozone is indefinitely postponed. The Bank of Estonia's calculations put the economic costs of delay in terms of a cumulative loss in GDP growth at 10 percentage points over five years compared to the baseline. Of course, strong policies can reduce the impact of the postponement or even render it negligible. In any case, the fixed rate of exchange remains the sole anchor for Estonia's monetary policy. Over the medium term the inflation rate is expected to move closer to the eurozone average thus providing an opportunity to adopt the euro in the not so distant future.

Tanel Ross is Director of International and External Relations Department of the Bank of Estonia. He has contributed this article to BT. The views expressed here are the author's and do not necessarily reflect those of the Bank of Estonia. **BT**

Internal Labor Mobility and Regional Labor Market Disparities

In Central Europe and the Baltic region, commuting — but not migration — may facilitate transitions out of unemployment

Pierella Paci, Erwin Tiongson, Mateusz Walewski, Jacek Liwinski, Maria Stoilkova

The transition to a market economy had dramatic labor market consequences in many of the countries in Central Europe and the Baltic region: the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia. At the beginning of the transition, these countries had essentially no official unemployment and a very egalitarian distribution of wages. Structural reforms led to a sharp decline in employment with a related increase in unemployment and inactivity.

Many of these countries began to experience an economic rebound by the mid-1990s. However, the recovery had a limited impact on unemployment. In some cases, the late 1990s brought further increases in unemployment in the wake of slumps in economic performance and macroeconomic stabilization programs designed to restore macroeconomic equilibrium and support structural reforms. On the eve of the 2004 EU enlargement, most of these countries had substantially higher unemployment rates than the EU average and, in Slovakia and Poland, considerably higher than those of any other EU member. The wide and persistent disparities in unemployment rates across the regions in Central Europe and the Baltics are a particular concern.

Labor Mobility is an Important Adjustment Mechanism

The persistence of regional disparities over time indicates, in part, a lack of flexibility in the prevailing adjustment mechanisms. In principle, adjustment to regional imbalances may take place mainly through a number of channels:

- Where unemployment is high, wages are expected to fall and the prospect of higher returns and lower unit labor costs should attract more firms into the region as well as encourage existing firms to hire more workers.
- If factors of production respond to unemployment disparities, capital should flow into lagging regions in response to lower unit costs and workers should move out of high unemployment, low wage regions into those where the returns for labor are higher.
- Government action aimed at addressing regional imbalances could take a number of forms.

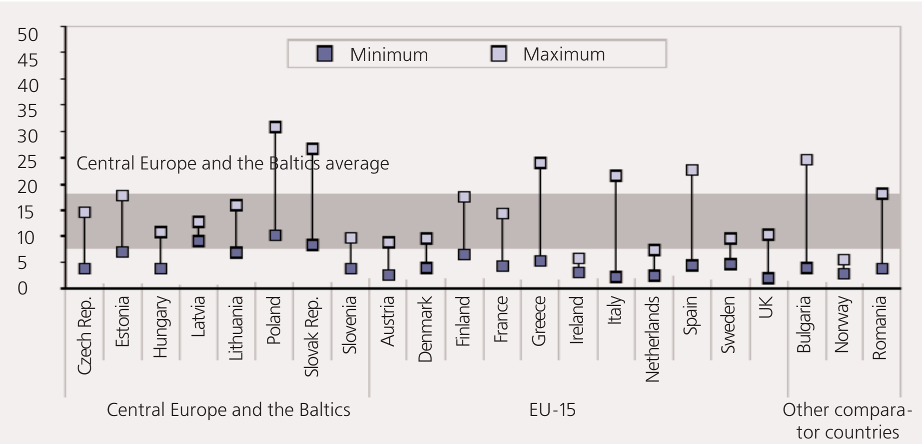
Capital flows in Central Europe and the Baltic region are generally not serving to help correct regional imbalances. In particular, capital typically flows to booming regions, where the human capital stock is high and where economic activity is concentrated. Wages adjust slightly but the measured wage elasticity (in absolute terms) may be insufficient to offset persistent and high rates of unemployment. In addition the responsiveness of wages to unemployment may be declining as the level of unemployment increases so that at very high unemployment levels wages may persist in staying down. Because adjustment mechanisms have not been effective in reducing regional unemployment disparities, labor mobility is a potentially important adjustment mechanism.

Labor Mobility is Weakly Related to Unemployment

Our findings are based on the 2004 Labor Force Survey data and various waves of the International Social Survey Program as well as summary information from the Eurobarometer Survey. Our study focuses on internal labor migration alone, which, however, may have an impact on the results because international migration may serve as a substitute for internal migration.

In the countries analyzed, internal migration is found to be low, to have fallen over time, and to be generally lower than that of the older EU members. In addition, migration is, at best, weakly related to regional unemployment rates. Moreover, commuting rates are higher than migration rates but vary substantially across countries. In 2004, commuters accounted for 1% of all employed workers in Poland and for 10% of such workers in Hungary. In contrast, internal migrants accounted for less than 1% of all employed workers, on average. There is also evidence that commuting rates are growing.

Figure 1: Minimum and Maximum Regional Unemployment Rates (NUTS 3)*, 2004



**NUTS is the EU's system of classifying territorial units.*
Source: Eurostat and World Bank staff estimates

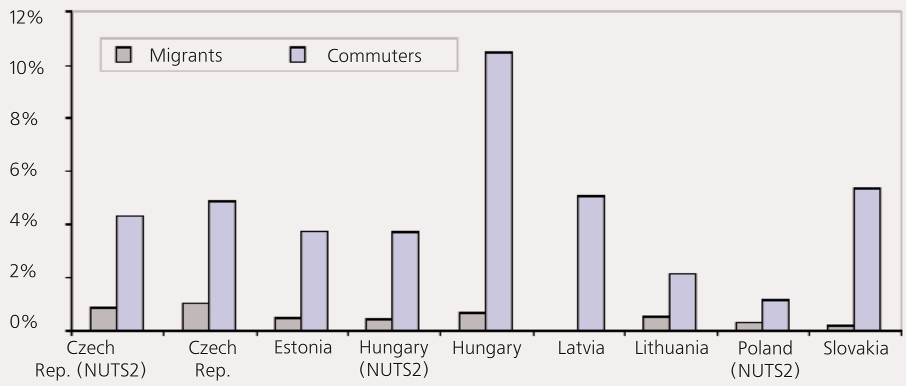
Unsurprisingly the probabilities of both commuting and migration are highest among men, the young and the better educated and among single or separated/widowed workers. In Lithuania and the Czech Republic, those who are engaged in continuing education or training are also more likely to commute. Commuting appears to be much more prevalent among workers employed by large firms. With respect to previous employment status, commuting may facilitate the transition out of joblessness. However, in the Czech Republic and Hungary, there is evidence that being previously unemployed is associated with lower probability of migration. This suggests that, at least in the case of internal labor migration, the already employed and the better skilled are more able to benefit from better employment opportunities in other regions than the unemployed. In addition, some occupations or workers in selected sectors are much more mobile than others. For example, agricultural workers tend to be less mobile than service or industry sector workers. At more disaggregated levels of employment sector, construction workers are relatively more mobile while education and health workers seem less mobile.

For understanding the growth and persistence of regional unemployment rate disparities, some findings are noteworthy:

- Migration is generally not responsive in a consistent way to regional economic indicators but commuting is.
- Commuting but not migration may facilitate transitions out of joblessness as, in general, those previously inactive or unemployed are more likely to commute. In contrast, unemployment is only weakly associated with a higher probability of migration.

Furthermore, the results of the analysis of individual preferences suggest that habits matter: many individuals express a stronger attachment to their local communities and such attachment, in turn, is reflected in lower propensities to migrate. In addition, workers rely on informal sources of employment information. In regions where unemployment is high, informal job search methods may be much less effective outside the unemployed worker's region of residence.

Figure 2. Migrants and Commuters: Labor Force Survey 2004
(In percent of the employed population; NUTS3 level unless otherwise indicated)



Source: LFS and World Bank staff estimates

Policy Implications

Appropriate policy measures are necessary to promote labor market flexibility. In particular, we propose the following policy considerations:

- *Promote measures to facilitate commuting*. Measures to facilitate commuting, rather than migration, may be more viable in areas where residential mobility is traditionally low and where there are institutional barriers to changing residences. In addition, since most of the studied countries are relatively small, commuting is a more attractive option than migration. Policy interventions to encourage commuting include reducing the monetary and time costs of transport, such as improvements in infrastructure and enhancing efficiency of the transport services market via a combination of private provision and public regulation.
- *Invest in education and lifelong learning*. As our findings suggest, those unemployed who are left behind in lagging regions are predominantly the low skilled workers with the lowest employment prospects. As such, investments in education and training may facilitate the adjustment process, as workers acquire the necessary skills to find jobs in more dynamic regions and move away from lagging parts of the country.
- *Enhance flexibility in labor markets*. For those left behind in lagging regions, a policy package designed to support job creation, encourage capital to move into the area and enhance productivity is critical. Policy measures designed to promote wage flexibility in local labor markets — such as through decentralized wage bargaining systems — are a critical component of this package.
- *Ensure that social protection does not inhibit mobility*. There is compelling empirical evidence demonstrating that generous unemployment and welfare benefits may serve to dampen labor mobility, by raising reservation wages and reducing the incentive to look for work among unemployed workers. It has also been observed that regional disparities in real disposable per capita income may not be as large as suggested by differences in regional per capita income. This is due in large part to different price levels and social transfers. The policy challenge is to strike the right balance — providing unemployment and welfare benefits to mitigate income shocks while preserving job search incentives by the tightening of eligibility criteria.

But policy has its limits. Individuals may be unwilling to relocate, despite the promise of better employment prospects, due to a legacy of central planning and permanently secure jobs. Attachments to local communities, ancestral lands, and social networks, among other reasons encourage individuals to stay. Furthermore, employment is often not the only motivation for geographic mobility; family matters, housing amenities, utility costs, and living standards are often important determinants of mobility. The report finds evidence that preferences, attitudes and habits do restrain individual mobility.

This summary is based on Pierella Paci, Erwin R. Tiongson, Mateusz Walewski, Jacek Liwinski, Maria M. Stoilkova (2007) "Internal Labor Mobility in Central Europe and the Baltic Region", World Bank Working Paper No. 105, Washington, DC. The report was written prior to the 2007 EU enlargement process. **BT**

Latvian Labor Market before and after EU Accession

Labor market flexibility in Latvia has considerably improved after the EU accession

Mihails Hazans

Between 2002 and 2005, the Latvian labor market witnessed dramatic changes related both to unprecedented economic growth — 28% in three years — and to a massive outflow of the labor force after EU enlargement in May 2004. This emerging shortage of labor has led to strong growth of real wages and reduction of unemployment. Moreover, it has improved the labor market position of ethnic minorities, the elderly, fixed-term workers, the low-skilled, and other disadvantaged groups. Wage growth, in turn, has increased labor force participation, resulting in further increase of employment rates. In fact, employment rate in Latvia has been rising faster than in any other New Member State and faster than in the "old" EU except Spain.

We conduct a detailed analysis of these changes before and after Latvia's EU accession, using micro-level data from Latvian Labor Force surveys for 2002-2005.

Unemployment Risk Much More Even

Unemployment risk has become spread much more evenly across social groups. Unemployment rates have declined in all age groups for men and in most age groups for women; and youth unemployment is no longer considered a serious problem.

Latvia's regions have become less polarized in terms of both unemployment and earnings. While wages in the capital city remain significantly higher than in the rest of the country, and wages in Latgale region significantly lower than in other regions, both gaps have declined since 2002. Similarly, the rural-urban earnings gap has declined considerably in the three year period — in fact, in 2005, average earnings of rural workers were statistically indistinguishable from their peers in urban areas. Plausibly, two factors — improved internal labor mobility and the external mobility shock in connection to the accession — have contributed to these positive developments.

Ethnic Gap Narrowed

While the minority population still has a somewhat lower employment rate, the overall gap reduced from more than six percentage points in 2002 to less than three percentage points in 2005. Moreover, the increase in employment between 2002 and 2005 took place primarily (and as far as women are concerned, exclusively) within minority population. For men, ethnic gaps both in participation and employment disappeared. The ethnic gap in employment rates narrowed in all age groups except the young and the elderly. Nevertheless, for people with tertiary education the ethnic gap in employment remains substantial at ten percentage points, and has not changed significantly since 2002.

Latvians are over-represented in highly skilled non-manual occupations, in non-market services and agriculture, and in the public sector. Non-Latvians are found more frequently in skilled manual and elementary occupations, in industry and market services, and in the private sector. "Vertical" segregation (among nine main groups of occupation) is modest, on average; just 12% of non-Latvians would have to change occupation to make their occupational distribution identical to that of Latvians. This can be largely explained, according to a recent survey of employees in Latvia, by differences in language skills. Among employees with good Latvian language skills just 7% would have to change occupation to make their occupational distribution identical to that of native Latvian speakers, while for workers with medium and poor Latvian language skills 25% and 49%, respectively, would have to change their occupation.

There also exists a wage gap of 9.6% between ethnic groups, which is almost completely unexplained by education, age, occupation or similar characteristics. However, once differences in Latvian language skills are accounted for, the "unexplained" gap in earnings (compared to native Latvian speakers) becomes substantially smaller: 4%, 7%, and 1% for workers with good, medium, and poor knowledge of Latvian language respectively (see Table).

Occupational Segregation and Wage Gaps between Native Latvian Speakers and Other Workers, by Self-Reported Latvian Language Skills Level. Full-time Employees Aged 18-64, 2005, Percent

Knowledge of Latvian Language	Share of Workers	Duncan Index of Occupational Segregation	Gross Wage Differential	Productivity Differential	Unexplained Wage Gap
Native	62.3	-	-	-	-
Good	19.9	7.0	-2.1	-5.7	3.8
Medium	12.2	24.7	10.0	3.0	6.8
Poor	5.4	49.0	13.4	12.4	0.9

Source: Calculations based on data from survey of wage earners for the national program of labor market studies.

Returns to Education Unchanged

What has not changed much in 2005 compared to 2002, are the high returns to tertiary education and low returns to secondary education — by international standards. In 2005, people with higher education earned, on average, 76% more compared to people with basic education, other things being equal; this differential was especially high for females, native Latvians, public sector employees and the rural population. Returns to secondary education remained modest at 10-20%.

As in many post-communist countries (but unlike the Czech Republic for example), returns to experience in Latvia have been decreasing compared to the socialist wage setting system and are at an extraordinarily low level. In a typical industrialized country age-earnings profile in most education groups rises up to the age of 50 (except for female college graduates, for whom the peak is recorded somewhat earlier), after which it decreases. In Latvia, the male earnings profile peaks at the age of 38 for workers with higher education, and at 34 for workers with secondary and basic education. The earnings of a 38-year-old and a 23-year-old only differ by 9% for men and 7% for women — this is a remarkably small difference compared to the US, where the earnings difference between the same age categories amounts to a whopping 100% for men and 70% for women. However, compared to 2002, return to experience has slightly increased for highly skilled male workers.

In sum, the findings of our study suggest that labor market flexibility in Latvia improved considerably after the EU accession. Responding to strong economic growth combined with increased external labor mobility, the Latvian labor market in just three years underwent changes on a scale which is well beyond expectations.

Mihails Hazans is Associate Professor at the University of Latvia. The full text of his paper is available at: http://ssrn.com /abstract=971198 **BT**

The Impact of EU Accession on Poland's Economy

Most fears concerning EU entry turned out to be unfounded, except for the increase in prices

Ewa Balcerowicz

Poland's integration into the EU has been a gradual and lengthy process, and it is not yet complete. It is important to note that the developments in the Polish economy in 2004-2006 were influenced to a large extent by institutional and regulatory reforms undertaken in the years prior to the accession.

The transposition of EU legislation allowed Poland to profoundly reform the way in which its economy is regulated and restrict government intervention in the private sector. Changes in such areas as financial markets, company and competition law, accounting, and intellectual property rights have created a better environment for business and have led to economic growth. Poland has also benefited from access to EU structural funds, which can potentially contribute to the improvement of public infrastructure.

Various studies undertaken before the enlargement estimated gains from the enlargement at 1.3-2.1% of additional GDP growth per year. Estimates by CASE showed that trade liberalization and the reduction of technical barriers would bring an increase of 3.4% to Poland's GDP in the long run. The real wages of unskilled workers in Poland were estimated to increase by 1.7%.

Economy Grew 4.2% a Year

In the first two years of EU membership, Poland enjoyed sound economic growth at an average rate of 4.2% a year, and the trend seems to have continued in 2006. At such a rate, Poland ranked eighth among the EU-25 countries, yet lagged behind other new members, such as the Baltic states and Slovakia. Poland's convergence with "old" members is clearly taking place: its GDP per capita (in PPS) increased from 40% of the EU-15 average in 1997 to 46% in 2005, but the pace is too slow and on account of this Poland lags behind most of the New Member States.

GDP, Exports and Imports in 1997–2005, Growth Rates (%)

	1997	1998	1999	2000	2001	2002	2003	2004	2005
GDP	7.1	5.0	4.5	4.2	1.1	1.4	3.8	5.3	3.4
Exports	12.2	14.4	-2,5	23.2	3.1	4.8	14.2	14.0	8.1
Imports	21.4	18.6	1.0	15.5	-5,3	2.7	9.3	15.2	4.9

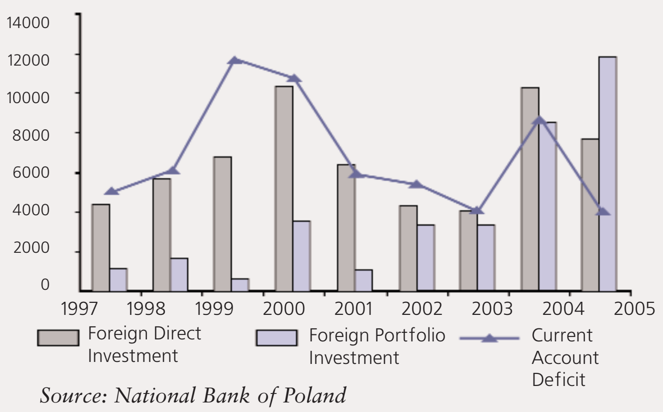
Source: Poland's Central Statistical Office data

Contrary to pessimistic expectations, export growth rate outpaced that of imports and the foreign trade deficit shrank for a sixth consecutive year. In 2005-2006 the trade balance with the EU countries became positive, implying that the current trade deficit has been generated by trade with non-EU countries. Adoption of the Common Customs Tariffs for trade with third countries led to a drop in average tariffs from 8.9% to 4.1%. Not surprisingly, imports from developing countries (mainly China) rapidly increased. Exports to third countries (mainly to Russia and Ukraine) also reached record levels, helped by export subsidies to trade in foodstuffs that now also apply to Poland. Liberalization of trade in foodstuffs generated an increase of Polish exports to the EU.

FDI Reaches Record High

As forecasted, there was a spectacular increase in FDI inflows in the year of the accession compared to 2003 (see Figure). Altogether EUR 10.29 billion was invested in 2004, nearly reaching the peak level of 2000, when most privatization deals occurred. In 2005 FDI inflows went down by 22%, however forecasts for 2006 are very good. Portfolio investment in Poland also increased.

Foreign Direct Investment and Foreign Portfolio Investment in Poland,1997–2005 (in ECU/EUR million)



Source: National Bank of Poland

Until now, Poland has been the main recipient of FDI among the recent EU entrants, and understandably so, considering the size of the Polish economy. In relative terms, however, the cumulative foreign investments in Poland have been less impressive: they amount to only 31% of GDP, which places Poland close to the end of the rankings (ahead of only Slovenia and Romania).

The EU-15 was the major investor in Poland, accounting for over 83% of total FDI at the end of 2005. The Netherlands, Germany and France topped the list with almost 61% of the cumulative FDI inflow to Poland. Capital flows to Poland from other New Member States, although still at a low 2% of cumulative investments, have recently been increasing.

Also Polish investments abroad increased spectacularly, more than doubling in 2004 (to EUR 636 million) compared to the previous year, and jumping further to EUR 2,493 million in 2005.

Increased Migration Pressured Wages but Increased Remittances

As forecasted, the external mobility of the labor force intensified after the EU accession, and as predicted, the inflows were mostly concentrated to the three EU countries that had opened their labor markets: the UK, Ireland and Germany. In 2004, approximately 250,000 Poles stayed abroad for at least two months, and most of them worked. This is 20% more than in 2003.

Polish migrants are generally younger and relatively better educated than the population on average, and the share of young people (below 35 years) among migrants further increased: from 51% in 2000 to 61% in 2004. The migrants are, unfortunately, very often overqualified for jobs they take abroad.

Fears that the massive migration from Central Europe will have a devastating effect on destination countries have turned out to be unfounded. The size of inflows to the UK, Ireland and Germany turned out to be below these countries' absorptive capacity, according to the World Bank. The inflow of foreign workers supplemented domestic labor rather than replaced it, and the wages in destination countries remained stable.

In Poland, shortages of skilled workers have been noted in several sectors, particularly in health care. Wage pressures have increased, mainly in agriculture and construction. As a result, Poland may be forced to import labor, and will have to relax its immigration policy vis-a-vis non-EU countries. On the positive side, Poland has benefited from increased remittances and expects to regain some of the labor that has acquired new skills and knowledge.

Using EU Funds

In 2004, Poland was a net beneficiary in the EU budget. Net transfers reached EUR 1.7 billion and accounted for 0.75% of the country's gross national income (GNI). The supply of EU funds to Poland is expected to reach 1.5% of GNI in 2007 and 3.25% of GNI in 2008. Among the new financial instruments available to Poland since the accession, funds for agriculture and rural development and transfers for structural reforms accounted for the biggest shares of transfers, at 27% and 23%, respectively.

Yet absorption of EU budget funds has been slow. The decentralized system of managing structural programs, the poor quality of relevant legislation, insufficient public financing for infrastructure development projects and the co-financing of infrastructural investments, and the inadequate capacity of public administration are to blame for the slow absorption. During 2006, the situation improved, as domestic regulation concerning the use of EU funds was relaxed and administrative capacity increased.

Public Attitude More Positive

The share of people who positively assess the impact of EU membership on Poland has been constantly growing. Two years after the integration, 54% of respondents believed that EU membership brought more benefits than it did costs for the country. This is 15 percentage points more than after the first three months and 8 percentage points more than after the first year of the accession.

The positive perception of Poland's EU accession and its impact on the country and personal well-being dominates in all socio-demographic groups and across the political spectrum, and is especially visible among those who are younger, wealthier, have completed tertiary education, and live in big cities. According to public opinion, the most important benefits are the possibility to legally work in other member countries, open borders, support to agriculture, and the availability of EU funds.

Conclusions

The widespread fears raised in Poland concerning EU entry turned out to be unfounded, except for, to some extent, the increase in prices after the accession. However the monetary policy secured price stability in the years of 2004-2006. Simultaneously there were positive phenomena which were unexpected. Contrary to pessimistic expectations, the rate of growth for exports outpaced the rate of growth for imports. Polish exports of foodstuffs to the EU flourished. Surprisingly, public support for Poland's EU membership has been constantly and substantially increasing since accession.

Finally, it should be noted that until now no precise assessment of the total impact of the accession on Poland's economy has been made.

Ewa Balcerowicz is the President of the Board of CASE — Center for Social and Economic Research. Full text of the paper can be accessed at: http://www.case.com.pl/upload/publikacja_plik/13286555_sa335.pdf (Studies and Analyses No. 335, 2007). **BT**

Bulgaria's Integration into the Pan–European Economy

The gap in export peformance between EU-8 and Bulgaria has been slowly closing in recent years

Bartlomiej Kaminski and Francis Ng

Bulgaria stands apart from new EU members in one important respect which has had huge implications for the process of industrial realignment to pan-European markets: while the country initially moved swiftly to implement first-generation reforms in 1991, the original bold program of dismantling central planning and overcoming transformational recession was quickly abandoned with the re-introduction of central controls. To make things worse, progress towards creating institutional conditions conducive to development driven by private entrepreneurial dynamism has been uneven since the collapse of central planning in 1989-1990.

It appears that weaknesses in state capacity combined with the state's capture by private interests groups stood in the way of moving quickly along with structural reforms until the 1996 financial collapse. The consequence of this was another transformational recession, with two consecutive years, 1996 and 1997, of falling aggregate output. Bulgaria, together with Romania and Moldova, are the only transition economies that experienced this second transformational recession, i.e., at least two consecutive years of contracting aggregate output. Technically, the Czech economy also experienced two consecutive years of falling aggregate output in 1997-1998. But the contraction of 0.8% and 1% was just a fraction of the fall experienced in a single year by Bulgaria, Moldova or Romania.

"Real" Structural Reforms Only in 1997

Hence, the real transition to competitive markets began only in 1997. In contrast to the first aborted transition, the conditions under which the second stabilization program was launched in 1997 were much more adverse and demanding than the ones in 1991. For one thing, almost half a decade of mismanagement wiped out the financial sector and led to a massive stripping of assets of state owned firms. Many state owned firms, which five years earlier might have been successfully privatized, lost any attraction to potential investors, foreign and domestic alike. Furthermore, human capital skills that were still available in early 1996 either disappeared due to migration or were simply depleted because of a lack of employment opportunities.

In consequence, it took much longer for the usual returns from macrostability, privatization and liberalizing structural reforms to materialize. Delayed —almost a decade into transition — structural reforms combined with a historically high dependence on "socialist trade" had deeply affected Bulgaria's path of restructuring and integrating into world markets. While initially Bulgaria's progress away from central planning appeared to be similar in terms of macroeconomic and export performance to that of other bold reformers, the differences surfaced rather dramatically during and immediately after the second transformational recession. The abolition of the state monopoly over foreign trade combined with the collapse of "socialist markets" initially resulted in an impressive reorientation of exports, albeit from very low levels, to EU markets. However, stagnation replaced initial growth in 1996-99. Had it not been for the rapid expansion of clothing exports under the EU-driven outward processing, total exports would have significantly contracted.

Structural reforms were delayed almost a decade, but in 2000-2004 export performance improved and FDI increased

Improved Competitiveness of Bulgarian Producers

Thanks to structural reforms and a liberal regional trading environment, Bulgaria successfully, though belatedly, began taking advantage of opportunities offered by participation in the EU-driven Eastern Enlargement regional integration project. Unfinished reform of the economic regime, on hold until the 1996 financial crisis, was responsible for lackluster foreign trade performance, a strong indication of the absence of industrial restructuring and development. The 2000-04 period witnessed improvements in export performance indicating that liberal reforms have activated some creative restructuring.

First, although one might have expected a stronger rebound in Bulgaria's exports after a contraction in 1998-1999, performance over 2002-2003 showed a significant improvement in the ability of Bulgarian producers to withstand competitive pressures in global markets. This refers also to their competitiveness in a single European market for industrial products, the so-called pan-European market. Particularly noteworthy is the fact that the largest increases occurred in 2002 and 2003. Rates of export growth stood at 12% and 31% respectively, despite the fact that the latter was tainted by the significant increase in the intensity of competition in preferential markets due to the removal of all tariffs on industrial products among signatories of the Pan-European Cumulation of Origin Agreement. The Agreement paved the way for the establishment in 2002 of a single European trading bloc for industrial products, encompassing the EU-25, EFTA, Bulgaria, Romania and Turkey.

Second, progress in implementation of structural reforms and converging to the EU *acquis communautaire* led to a significant enhancement in the quality of the domestic business climate.

Last but not least, there was a significant increase in FDI inflows accounting on average for around 8% of GDP over 2000-03. Although clothing and footwear dominated its export basket in 2003, there were some shift towards skilled labor and capital intensive exports usually associated with FDI.

The evolution of Bulgaria's total exports in terms of factor intensities before the second transformational recession was a testimony to aborted economic reforms. It not only defied expectations derived from the experience of other Central European economies and its production factor endowments but also dramatically increased the cost of adjustment to market conditions for the economy.

De-Industrialization in Early 1990s

The derailed economic reforms appear to have been responsible for a very unusual evolution of the factor content of Bulgaria's exports indicating a very significant de-industrialization that occurred during 1991-1995. Three different phases in the evolution of the factor content of EU-oriented exports illustrated this process. While the first phase in 1992-93 witnessed what turned out to be peak levels in the share of unskilled labor intensive products in EU-oriented exports from these countries, the second phase, 1994-1996, witnessed a major realignment in the export growth pattern, with skilled labor and capital intensive products emerging as major contributors to Bulgaria's exports.

The third phase following the 1996 crisis was reminiscent of developments in the early 1990s in European transition economies that launched radical first-generation reforms in terms of both its dynamism and change in export offer. While 1996-2000 witnessed little or no gains in the overall competitiveness of Bulgarian producers in world markets, except for clothing mainly in EU markets, there has been a significant increase in the presence of Bulgarian exporters in world markets more recently, especially in 2003. Although exports of unskilled labor intensive products continued towering over other exports, the top performers in EU-15 markets (with an increase in EU imports of at least 2.85 times between 2000 and 2003), accounted for 16% of Bulgaria's EU-oriented exports in 2003 up from 4% in 2000. The star performers are mostly from the electro-engineering sectors indicating the shift towards more processed goods. Among emerging fast growers, i.e., products whose exports growth exceeded annual changes in EU import demand by at least 30% in 2000-2003, capital intensive products stood out.

Shift Towards Higher Technology Content

New exports came mainly from restructured industrial capacities, auguring well for future competitiveness in international markets. Of the electro-engineering products that performed well on EU-15 markets exports of machinery top the list, contributing almost 40% to the total of top performers' exports. In consequence, the share of manufacturing in Bulgaria's trade did not only significantly increase but there was a shift towards products with higher technology content and capital goods. Simultaneously, the share of traditional inputs, i.e., products used for further processing, in Bulgaria's exports were accompanied by a marked increase in the share of machinery. This, combined with the increase of more technologically advanced manufacturing in Bulgaria's exports, suggests a gradual shift towards more processed exports.

The gap between Central and Eastern European economies and Bulgaria in terms of export performance and its factor embodiments appears to have been closing, albeit slowly, as exports of capital and skilled-labor intensive products began growing. While overall Bulgaria has a long way to catch up with other new EU members in terms of participating in "producer-driven" network trade, there were healthy symptoms of growth in 2001-2003. Bulgarian producers did not become part of the division of labor based on production fragmentation in vertically integrated sectors on any significant scale. But by 2002 they had made significant strides in information communication technology products and automotive parts with the share of parts and engineering products growing from 3.1% of Bulgaria's EU-oriented exports in 1998 to 5.4% in 2003. Furthermore, the shift towards furniture (more exactly, furniture parts) within "buyer-driven" networks' exports, information communication final products and automotive parts within "producer-driven" exports and strong expansion of exports of other parts and engineering products point to significant progress in industrial restructuring and ensuing gains in competitiveness.

Lessons Learnt

Bulgaria's economic development as observed through the lens of its EU-oriented exports offers valuable lessons for other economies. First, subsidization of exports is not sustainable and ultimately leads to a very high cost of adjustment. Second, the prospects of deeper, policy-induced integration into a more developed region provide powerful political and economic anchors to the reforms process. Last but not least, the returns usually associated with liberal reforms, i.e., gains in competitiveness combined with shifts towards products in line with a country's endowments in production factors take time. They began to surface only around three years after the reform process was launched. In contrast to the period preceding the second transformational recession, gains in competitiveness derived from corporate and industrial restructuring and not from subsidies.

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Bulgaria and Romania: Strong Growth, Likely to Moderate in 2007

	Real GDP growth			Real Exports Growth			Growth of Industr. Output			FDI Net (% of GDP)		
	2004	2005	2006	2004	2005	2006	2004	2005	2006	2004	2005	2006
Bulgaria	6.6	6.2	6.1	12.7	8.5	9.0	17.1	6.7	6.1	9.1	14.5	15.9
Romania	8.5	4.1	7.7	13.9	8.1	10.6	5.4	2.2	7.1	8.9	6.6	9.4

Source: the World Bank

Forming Preferences on European Integration: the Case of Slovakia

Preferences are based on the country’s history, size, party politics and the power of interest groups

Tim Haughton and Darina Malova

What shapes a country's stance on European integration? We use Slovakia as a case study to illuminate preference formation in the New Member States and explore a number of explanations, highlighted in previous research.

History and Its Legacies

Slovakia's sinuous transition path is an important component in explaining the country's stance on further integration. During the mid 1990s, due to a combination of nationalist policies, a series of murky privatization deals and a disregard for democratic norms, Slovakia became what Madeleine Albright called "the black hole of Europe" and was consequently not invited to begin accession negotiations in 1997. The new broad-based coalition government led by Mikulas Dzurinda in 1998 placed a high priority on EU accession, and in 1999 Slovakia was invited to begin negotiations.

For most of the period until May 2004 the focus of debates was on catching up with other prospective entrants and achieving membership *per se* rather than what type of a European Union the country wanted to belong to. This allowed the government to shape the country's stance on EU integration, particularly in the first years of membership. With accession achieved, parties, which had EU entry at the centre of their campaign, shifted focus to more ideological concerns.

In addition, the process of accession helped to strengthen the power of the executive and weaken the parliament. This has important consequences for domestic politics, because it is structurally easier for the government to pursue a radical agenda if there are no strong domestic institutional brakes.

Size

As a relatively small state, Slovakia is likely to have a stronger preference for more powerful common institutions and cede some degree of sovereignty. Indeed, the country knows that by acting unilaterally it is unlikely to have much impact in foreign affairs, but acting in concert through EU channels it may have more influence. One area where Slovakia built on its expertise and displayed activist tendencies has been enlargement towards the Western Balkans.

Ideology

During Dzurinda's second term as prime minister there was an increased emphasis on the ideological dimension of politics. After 2002 the government began to implement radical socio-economic reforms, such as the introduction of a flat tax, cuts in welfare benefits, as well as pension and health reforms. For these, the EU represented a threat. The formation of a more leftist-orientated coalition government in 2006, however, suggests that ideology is less important than had been earlier thought. Indeed, despite parties of a different ideological hue holding the reins of power there has been a striking continuity of policy vis-a-vis the EU.

Public Opinion

Public opinion can play a significant role in constraining a government's European policy. In Slovakia, citizens are satisfied with being members: the latest Eurobarometer survey suggests 61% consider membership a "good thing", well above the 53% EU average. Public opinion supports eurozone entry, further EU enlargement and integration in defense and security policy, but opposes harmonization in the fiscal sphere and, thus, has been in line with the governments' positions on a range of European issues.

Powerful Groups, Dependency, and Party Politics

Slovakia is dependent on the European Union, both as a significant net recipient of EU funds (3.27% of GNI), and as an exporter. This suggests that Slovakia would be very much in favor of further economic integration.

Although many societal groups such as trade unions are rather weak, others, most notably big businesses have appeared to be much more powerful. Slovakia's neo-liberal economic agenda under the Dzurinda-led government became increasingly fuelled by powerful business lobbies. This pressure has continued since the new government came to power. Businesses have pushed for easier access to European markets and the fast adoption of the euro, but have opposed harmonization, especially in the fiscal sphere.

The influence of business interest groups has been facilitated by domestic party politics. The political scene has been fluid over the past years, with many new parties — often elite creations — formed. Not only do elite-created parties tend to be closely associated with their founders and leaders, they also often lack developed mechanisms of accountability, and can be dependent on and beholden to the generosity of initial financial backers.

Conclusions

Thus, we contend that ideology is not such a good indicator of shaping preferences. Rather, preferences are based on the country's recent history and size, and linked to the nature of party politics and the power of particular interest groups, with the latter being particularly important in the socio-economic domain.

Attempting to assess preference formation and the behavior of the NMS is made more complicated by the fact that while two of the variables are largely fixed (size and history), two others are subject to change. Indeed, there are some indications that party politics is becoming less fluid in Slovakia. The 2006 elections, for example, were the first since independence when no new parties entered the legislature. Additionally, domestic interest groups, such as trade unions, clearly have the potential to become more organized and influential in shaping policy. At the same time the business lobby may not necessarily retain its powerful position.

More broadly, the overarching bases of political contestation in Slovakia until the early 2000s, such as the character of the political regime, illiberal democracy, nationalism and entry into Euro-Atlantic clubs, have largely gone. The contemporary political scene has become focused primarily on domestic issues of distribution, allocation and socio-economic organization.

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Whither Europe?

The IMF-World Bank seminar, held in Singapore in 2006, brought together distinguished speakers representing founding, new and aspiring European members, and the Asian economic community representatives to debate the future of Europe and implications for Asian integration. Panelists discussed some of the findings emerging from the reflection and consultations that have taken place in Europe over the last year, with a particular focus on the following questions:

- What is the future of the constitution? Will it be abandoned in favor of a "political declaration" or will it be resurrected in a slimmed down version?
- Might the rejection of the constitution and the popular vote of no confidence promote a return to the approach of quiet incremental reform that has served the EU so well in the past?
- Where should Europe's borders lie? Is Europe's current neighborhood policy working?
- Can Europe's "social model" survive in the face of global pressure?

Mr. Joaquin Almunia (Commissioner for Economic and Monetary Affairs at the European Commission) argued that the failure of the constitutional process in France and the Netherlands has indeed created a political crisis as a growing Union needs a new distribution of responsibilities between national and supra-national levels. However, there may be a new window of opportunity with the 2007 German presidency, and elections in France and the Netherlands. Further, Europe is far from paralyzed by the set-back on the constitution as evidenced by the important decisions made in the last year on integration and expansion. In addition, the economic situation in the EU improved last year. In sum, there is a political problem but the EU is gaining momentum economically and forging ahead on political integration.

Mr. Leszek Balcerowicz (President of the National Bank of Poland) emphasized that the constitution is not essential from an economic perspective. Instead the EU should focus on the Lisbon agenda and the country level actions to achieve it. This includes reducing fiscal pressures — Europe is overtaxed compared to Asia, and this is because European countries spend too much particularly on social protection: public expenditure to GDP ratio in Europe is around 40% compared to only 20% among the Asian Tigers. In addition, the countries need to do more to deregulate, especially in labor markets. More can also be done at the European level: this will require abiding by the growth and stability pact. As to integration of service markets, the much weakened final version of the adopted service directive needs to be strengthened if Europe is to develop a single market for services that can compete with the US. However, an appropriate communication strategy will be essential to any further reforms.

H.E. Ali Babacan (Turkish Minister of State in charge of Economy) agreed with the importance of communication, arguing that the rejection of the constitutional treaty was largely due to voters' perception that Brussels is removed from their cares and concerns. As to the limited economic dynamism of the EU, it can be helped by further enlargement and the associated growth in the goods and labor markets. In addition, the integration of Turkey into the EU would promote democracy, security and stability, and therefore be fully in line with the original goals of the European project. It will also help demonstrate that democracy and Islam can co-exist and provide a bridge between civilization that is crucial to the safety of the EU.

H.E. Heidemaries Wieczorek-Zeul (German Minister of Economic Co-operation and Development) reminded the audience that the creation of the Union sprang from a deep reaction to war and dictatorship — with membership also helping democratic achievements in countries such as Spain, Portugal and Greece. The hope is that the adaptability that the EU has shown in the process can now be expanded to the Middle East. The rejection of the constitution was a set-back but one that should be interpreted as a vote of no confidence on the economic and political process, and motivated by a fear of globalization. As to the social model of Western Europe, it does need reform but remains an important model that helps assure people they will not be at the mercy of market forces. Countries without this kind of safety net revert to protectionism during economic downturns. Europe's social model represents a good way of smoothing globalization's impact on households.

What could Asia learn from European integration? **Mr. Haruhiko Kuroda** (President of the Asian Development Bank) noted that Asia's integration has been rapid and market driven, mostly through trade and investment: intra-regional trade, at 55%, is similar to that of the EU. Indeed, regional economic integration has been one of the successful factors of the region. ASEAN may now need to work on the institutional and political elements of this integration. The experience of the EU with small country bias and subsidiarity principles will be helpful. **BT**

Credit Expansion in Emerging Europe

Some countries have witnessed a true credit boom that has contributed to overheating of their economies

Eastern and Central European countries entered the EU with reformed and relatively modern banking systems. Despite the impressive progress, all of the NMS face the challenge of financial system deepening and remain far behind the eurozone in respect of financial depth of bank and non-bank financial institutions, and capital market development. In some countries, such as Latvia and Romania, the total assets of financial institutions still constitute less than 50% of GDP. In most NMS, foreign-owned banks dominate the banking system.

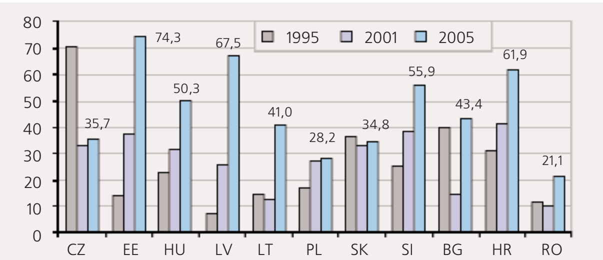
Rapid Credit Expansion

Over the last decade, bank credit to the private sector has expanded impressively in almost all countries, at an average annual compounded rate of 24%. The growth of bank lending was particularly strong and sustained in Southeastern Europe (SEE) — Romania and Bulgaria — and the Baltic countries. The credit expansion of the last two years is largely a result of increased loans to households, while growth in the corporate sector has remained modest. The latter has been due to an improvement in companies' earnings, accumulation of liquid funds and access to external lending. This raises questions about the productive impact of the observed credit growth.

Among loans to households, housing loans have been growing particularly fast. Between 2004 and 2005 alone, such loans increased 95% in Bulgaria and around 90% in Latvia and Lithuania. However, compared to the EU-15, the level of residential mortgage debt remains rather low, below 30% in the Baltic countries and Hungary and below 10% in other countries (compared to e.g. over 70% in UK).

The demand for credit has grown because of increases in disposable income and higher confidence related to EU accession, falling inflation and interest rates, stable or appreciating local currencies, and better investment opportunities. The increased supply of bank loans has been driven primarily by financial sector deregulation and deepening (due to large privatizations in the sector and increased competition from foreign banks).

Bank Credit to the Private Sector
(% of GDR, 1995/2001/2005)



Source: national Central Banks; World Development Indicators for 1995.

Large Macroeconomic Imbalances in Some Countries

An analysis of the current financial health of banks suggests that generally they are well-capitalized and profitable. They have also visibly improved the quality of credit portfolios. For example, in the Czech Republic the ratio of non-performing loans (NLP) to total loans decreased from around 13% in 2001 to 4.3% in 2005, and in Slovakia from almost 25% to 5.5%. Banking supervision has also improved significantly. Yet, the low ratios of NLP today are no guarantee of low levels in the future, and credit quality may be deteriorating. Besides, less sound banks are equally engaged in lending and may be taking even higher risks. Moreover, there is no guarantee that parent banks of foreign owned banks would come to the rescue in case of trouble.

The sharp increase in domestic demand, especially household consumption, has spurred real GDP growth in the region since 2000, but also contributed to the emergence of large macroeconomic imbalances in some countries. Output growth has been particularly rapid in the Baltic countries at around 10% in 2000-2005. In these countries, strong inflationary pressures have raised concern about overheating. The domestic demand boom has led to a surge in imports and large current account deficits, especially in the Baltic and SEE countries. External debt levels have increased sharply in some countries, with the external debt-to-GDP ratio in Estonia and Latvia reaching about 80% of GDP in 2005. Most countries have not taken adequate advantage of the strong growth to consolidate public finances and have been running pro-cyclical fiscal policies.

Thus, while credit expansion to a significant extent reflects a normal catching-up process by previously underdeveloped financial systems and credit to the private sector as a share of GDP remains in line with per capita incomes in the region, some countries, in particular the Baltic and the SEE countries, have witnessed a true credit boom that has contributed to surging consumption and the overheating of their economies. Slovenia, which joined the eurozone in January 2007, probably enjoys the best protection against any potential financial distress.

International experience suggests that prolonged, rapid credit growth coupled with macroeconomic imbalances can easily deteriorate into financial distress. Many countries have been concerned about excessive credit growth and have taken measures to control this. However, their effectiveness is unclear as credit continued growing rapidly and macroeconomic imbalances remained large.

Policy Advice

A proactive policy response is needed ranging from enhanced supervision and possibly regulation to more hard-hitting measures, including tightening of monetary policy (where possible) and fiscal policies aimed at discouraging household borrowing and stimulating private savings. Authorities should also prepare themselves for the unlikely, but not impossible scenario of a financial distress, and put in place adequate contingency plans. Given the lessons learned from previous experience, it is clear that prudence should dominate the "growth versus imbalance" policy dilemma that many of the NMS face today.

Source: World Bank EU8+2 Regular Economic Report, January 2007, www.worldbank.org/eu8-report. The report covers the NMS in Central and Eastern Europe. **BT**

The Economic Cost of Smoking in Russia

Russian male smokers earn 14.8% less then non-smokers

Michael Lokshin and Zurab Sajaia

Tobacco smoking is widely prevalent in Russia. About 50 million Russians between the ages of 18 to 65 smoke, and each year 375,000 Russians die of smoking-related illnesses. According to the World Health Organization, Russia has the world's fourth-highest rate of smoking. The last decade witnessed a sharp increase in the number of smokers, especially among the female and younger populations. Russia is the third-largest market for tobacco in the world, with smokers spending up to US$6 billion on tobacco products. Along with alcohol consumption, smoking is a leading public health problem, and together they contribute to Russia's declining life span.

In recent years, the Russian anti-smoking movement, assisted by the government in its effort to reverse or slow population decline, has made some progress in controlling tobacco commerce and consumption. As a result, the Russian Parliament has ratified several decrees and laws restricting smoking in public places and banning tobacco advertisements on television and radio. However, smoking is still on the margins of Russia's policy agenda. Russia has not joined the Framework Convention on Tobacco Control that 167 countries had signed and 57 national parliaments had endorsed by February 2005.

Economic Losses Ignored

The anti-smoking debate in Russia has focused mostly on the adverse effects of smoking on health, and not so much on the costs that smokers impose on the economy through the reduction in their productivity. But such costs could play an important role in the anti-smoking policy debate in Russia.

Our study provides the first empirical estimates of the economic losses stemming from the negative effect smoking has on wages in Russia. The analysis is based on data from the Living Standards Survey conducted in the Tomsk region of Russia in 2006. While the survey is not intended to represent the nation as a whole, it provides information on a typical Russian region. The Tomsk region has a population of about 1.1 million people, many of whom live in urban areas. Large industrial enterprises and research centers in the region provide employment for the majority of the workforce; the share of the public sector in total employment is high.

30 to 35-Year-olds Most Likely to Smoke

In our sample of over 2,500 respondents, 61% of males and 14% of females categorized themselves as smokers. The incidence of smoking is higher among the male rural population and female urban dwellers (see Table). The prevalence of smoking increases sharply with age, peaking at 30-35 years. The lower proportion of old-age smokers in the sample could be explained by higher attrition rates in that group. Accumulated over a lifetime, the negative effects of smoking could lead to earlier exit from the labor market or even death. For both genders the prevalence of smoking declines with education. More than two-thirds of men and about 25% of women with high school diplomas smoke. Those propotions drop significantly for individuals with university degrees or higher.

On average, non-smoking men earn more than smokers: 10,732 rubles per month (about US$400 at the exchange rate of RUR27/US$1) vs. 8,992 rubles (US$330), respectively, thus enjoying about a 19% unadjusted wage premium over smokers. The wage premium of non-smoking women was quite a bit lower at 6%, which translated to an approximately US$15 "bonus".

Why Lower Wages?

Several theories explain the lower wages associated with smoking. Health effects of smoking are arguably the most frequently noted link; smoking causes various morbidities, which could therefore result in lower labor productivity. A second, partially health-related explanation, is the higher costs to employers of hiring a smoker relative to a non-smoker (for example, due to healthcare costs induced by smoking). Even if smokers are equally productive or do not incur more costs in employment, discrimination against smokers in the workplace may result in lower earnings for those who smoke. Finally, smoking could be correlated with lower earnings because of the differences in preferences over present and future consumption between smokers and non-smokers.

Prevalence of Smoking and Simulated Wage Losses

	Prevalence of Smoking by Region, Age and Education Groups (Mean)			Simulated Wage Losses from Smoking (%) by Gender	
	Men	Women	Total	Men	Women
Tomsk	55.1	18.6	35.0	-19.7	-4.1
Other Urban	55.7	14.4	33.5	-23.2	12.1
Rural	65.6	11.9	38.0	-9.7	-6.0
Age groups					
25-30	60.3	17.7	39.2	-17.5	9.2
35-40	64.7	15.4	36.6	-11.9	-10.9
45-50	60.0	12.3	33.0	-14.9	0.4
55-60	51.2	9.4	29.9		
Education					
Secondary general or less	72.5	26.8	56.1	5.2	-16.4
University and higher	43.6	8.8	22.7	-19.3	3.6
Total	61.1	13.9	36.2	**–14.8**	**–0.6**

Losses up to 2% of GDP

Individuals who choose to smoke may be different from non-smokers in some unobserved dimensions that are negatively correlated with wages. The challenge for our empirical strategy is to estimate the effect of smoking on wages controlling for such unobserved factors. The results of our estimations demonstrate that smoking indeed has an adverse effect on the wages of smokers. Controlling for observed individual characteristics, such as age, level of education, health status, and household composition, we find that the smoking wage differential amounts to about 10.9% for males and about 3.8% for females. Taking into account differences in both observable and unobservable characteristics, our estimations show that men earn about 14.8% less if they smoke. No such effect of smoking on wages is found for women in this estimation. The estimates of the negative effect of smoking on wages in Russia are larger than the estimates for Germany and the U.S., where workers lose 4% to 8% of their wages because of smoking.

The deleterious impact of smoking on wages is greater for younger men: the wages of smoking men aged 25-35 are almost 18% lower than wages of non-smokers of the same age group. The negative impact of smoking on wages is also larger for men and women with higher educational attainment.

Aggregating the individual wage losses from smoking at the regional level, we can conclude that Tomsk region loses a considerable share of its revenue just from the reduction in productivity due to smoking. On average, a male smoker loses about 1,125 rubles per month due to smoking, and a loss in wages for a smoking woman is about 29 rubles per month. Taking into account that there are 154,000 men and 33,000 women in the total work force who smoke, the Tomsk region looses 2.1 billion rubles or 2.0% of the regional GDP per year.

Obviously, the state would lose taxes if people reduce their cigarette consumption. However, the tobacco duties existing in Russia are among the lowest in the world. Tobacco companies pay only 65 rubles per 1000 cigarettes plus 8% on the sale price of cigarettes. If an individual who smokes a pack of cigarettes per day quit smoking, the losses in taxes for the state would be at least 10 times lower than the individual's losses in earnings.

We can conclude that the economic cost of smoking represents an important component of the burden smokers impose on Russian society. The arguments presented here could be used in the anti-smoking debate because they show that Russia bears an immediate loss from smoking, as opposed to the long-term health-based losses that lie beyond the decision horizon of most policymakers.

Michael Lokshin is a Senior Economist and Zurab Sajaia is an economist at the Development Economics Research Group, the World Bank, Washington, DC. The findings and interpretation of this paper are those of the authors and should not be attributed to the World Bank Group, its Executive Directors, or the countries they represent. Full text of the paper "The economic cost of smoking: Differences in wages between smokers and non-smokers in Russia" is available from the authors. **BT**

Smoking in Albania

In Albania, 60% of adult males and 18% of females smoked in 2002 and the number of smokers has been increasing rapidly over the last decade. Anti-smoking policies are high on the country's agenda. In January 2006, the government submitted a new draft law on tobacco and smoking that outlawed sales of cigarettes to minors younger than 18, and presented stricter rules for the tobacco industry regarding the sale and advertising of tobacco products.

Data from the fourth round of the Albania Living Standard Monitoring Survey allowed us to estimate forgone earnings from smoking for working Albanian men (the proportion of female smokers in the sample was too small).We find that the incidence of smoking is similar among the urban and rural male populations in Albania. The prevalence of current smokers is close to 50% among the least educated males and declines for better-educated men. Only 25% of men with a university degree smoke. The propensity to smoke varies by religion: the highest proportion of smokers (36%) is among Albanian Muslims, including Bektashi. Albanian Christians smoke at a rate of about 30%.

The incidence of smoking increases with the age of the respondents. Less than 20% of 25 year old men classified themselves as current smokers. The proportion of smokers increases sharply for older age groups peaking at about 35% for men 38 years old and older.

On average, non-smokers earned about 26,300 lek per month relative to 24,290 lek per month for smokers (8.3% difference). Wages of non-smokers are higher than wages of smokers for all age groups with the largest gap in wages observed for workers between the ages of 35 and 50.

When controlling for productive human capital characteristics, such as education and knowledge of English, Italian and Greek, etc. we find a stronger dependence between wages and these characteristics for non-smokers than for smokers. This supports the idea that smokers and non-smokers have different preferences over present and future consumption.

For working Albanian men aged 25 to 60, our analysis shows that the wages of smokers are significantly lower than the wages of individuals who never smoked. Consistent with other studies for developed countries, the wage penalty differs depending on how the observed and unobserved traits of smokers and non-smokers are addressed. A simple comparison of mean wages produces the 8% difference, as shown above. When taking into account observable personal characteristics, we find that the negative wage effect of smoking is reduced to 4%. However, considering both the differences in observable and unobservable characteristics of smokers and nonsmokers, the wage penalty for smoking becomes much larger: smokers experience wage reductions of 21-28%. This indeed provides strong evidence for the potential policy relevance of tobacco control initiatives for developing countries such as Albania.

Source: "Forgone earnings from smoking: Evidence for a developing country" by Michael Lokshin and Kathleen Beegle, both from the Development Economics Research Group, the World Bank. **BT**

Deregulating Business in Russia

Better progress in regions with more transparent, less corrupt and more fiscally-motivated governments

Ekaterina Zhuravskaya, Evgeny Yakovlev

In recent years deregulation has been a popular topic on policymakers' agenda: in 2005 and 2006 alone, 55 countries undertook reforms that lowered the costs of doing business, the World Bank reports. How can the reform achieve the desired results at the local level if started by the central government? What results did deregulation of business activity bring to businesses and the population at large?

In addressing these questions, we use a unique combination of a deregulation policy experiment undertaken in Russia in the early 2000s and detailed panel data on the actual regulatory burden on firms across regions. The data come from regularly-repeated surveys of 2,000 firms in 20 regions of Russia about their actual levels of regulatory burden in each area of regulation affected by the reform.

Ambitious Reforms

Between 2001 and 2004, Russia passed laws that drastically simplified procedures and reduced red tape associated with entry regulation, and with the regulation of existing business. The laws introduced clear measurable limits to regulatory burden, for example, they established that registering a business requires a trip to just one government agency ('one-stop shop') and takes no more than a week; each inspecting agency, comes to inspect a business no more frequently than once in two years; licenses are valid for no less than five years. In addition, the reform foresaw a substantial amount of 'delicensing', i.e., the exemption from licensing of many business activities which previously had required licenses.

Prior to the reform, Russian firms suffered from excessive regulatory burden. It was argued that over-regulation was among the most important reasons for the country's poor economic performance during the first eight years of transition. The proclaimed goal of the reform was to induce the entry and growth of small business.

In our study we, first, examine whether the reform succeeded in bringing down administrative costs for firms. Second, we study which institutional factors affected the level of enforcement of deregulation laws in different regions. And third, we estimate the causal effect of deregulation on outcomes — firm entry, employment in small businesses, public health, and pollution.

Transparent and Accountable Governments Succeed

To begin with, we compare the actual regulatory burden with the official level established by the legislation and find that official regulations are poorly enforced and grossly understate the regulatory burden, as much of the actual regulation is in excess of the official levels. The difference in timing of the initial enactment of different deregulation laws allows us to estimate the effect of the enactment on regulatory burden. Controlling for all regional characteristics, macro-economic shocks, and region-specific trends we find that, on average, the enactment of a deregulation law has led to a significant reduction in regulatory burden for Russian firms in the area of regulation affected by that law.

At the same time, reform progress exhibited a large regional variation. Therefore, looking only at the largest cities may give a misleading picture about the state of regulation in the country as a whole. Moreover, the geographical variation of regulatory burden in each area of regulation prior to the reform's implementation had also been very large. So in examining what determines the success of a deregulation reform at the regional level, we take into account the pre-reform regional institutional environment. Based on our estimations we can conclude that four factors significantly boost enforcement of deregulation laws in a region:

- Government transparency;
- Low corruption;
- Presence of a strong industrial lobby, i.e. the extent to which regional authorities are under the influence of powerful industrial groups;
- Strong fiscal incentives, i.e. the extent to which regional budgets are comprised of local taxes rather than transfers from the federal center.

Effect Similar for All Firms

Interestingly, these institutional factors affect in the same way both the entry deregulation and the liberalization of regulations on established firms. This implies that industrial lobbies accelerate deregulation in all areas of regulation and do not use entry regulation to protect themselves from potential competitors.

According to our estimates, deregulation had a positive significant effect on firm entry and employment in small business. At the same time, no effect on either pollution or public health (morbidity from poor-quality products) has been recorded.

In concluding it is worth repeating that it is the regions with the least corrupt, transparent, accountable, and most fiscally-motivated governments that achieve most progress in deregulation.

The evidence allows us to evaluate the competing theories of the nature of regulation. Our findings are inconsistent with the public interest theory because regions with transparent and accountable governments are the ones that achieve progress in deregulation, and moreover, deregulation does not have an adverse effect on pollution or morbidity (two market failures that regulations are supposed to cure). The evidence is also hard to reconcile with the regulatory capture theory because the presence of a politically-powerful industrial lobby has the same effect on regulation of entry and existing business. Industrial lobbies accelerate deregulation in all areas and do not use entry regulation to protect themselves from potential competitors. But, in accordance with 'tollbooth' theory, the least corrupt and most fiscally-motivated governments promote deregulation the most.

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Land and Real Estate Transactions for Businesses in Russia

Businesses complain about little land privatization, non-transparency and favoritism in the process

Gregory Kisunko and Jacqueline Coolidge

Land privatization in the Russian Federation has a checkered history, with a clear favorable policy not firmly established until the enactment of the 2001 Land Code. Even after the enactment, many vital parameters of land privatization, including pricing parameters, have still not been settled.

The new Land Code explicitly calls for land to be privatized as follows:

- Land under buildings that were privatized earlier is supposed to be sold (or leased) to the owner of the building at an administered price within parameters set by federal legislation (this category accounts for the great majority of land transactions involving businesses).
- Vacant land intended for new construction is supposed to be privatized by transparent auction or tender procedures (there have so far been relatively few transactions of this type).

The privatization procedure for land under privatized buildings (the most common procedure for acquisition of land) involves an average of 11 stages, eight different agencies, 17 different documents, 220 days, and about 70,000 Rubles (about US$2,400) in official fees. The range, however, is quite large, from low figures of about 50 days in Rostov region and 10,000 Rubles in Novgorod region to high figures of over 400 days in Novosibirsk and 360,000 Rubles in Moscow region.

To date, most land of interest to businesses is still owned or controlled by municipal governments, which gives them strong "market power" as near-monopolist landlords, while greater legal flexibility over land rents (as opposed to buy-out prices and land taxes) provides a strong fiscal incentive to municipalities to try to maintain their ownership rights, and encourage businesses to apply for lease rights instead of ownership rights. In ten out of 15 regions in our survey, more than three-quarters of land is owned or is in the possession of the state or municipalities. Only in one region — Rostov — the share of state and municipal lands is much lower at 35%. The city of Moscow stands out with 100% of land still publicly owned. The remainder of the land is owned by legal entities and individuals, with individuals owning significantly more land parcels than businesses do.

In addition, there is still considerable evidence of municipalities abusing their market power through administrative barriers, not necessarily to keep rents high, but more often to favor some firms over others and/or exercise undue influence over local business development.

Limited Access to Land as an Obstacle to Business

Businesses continuously complain that there has been very little land privatization to date, and that the limited amount of privatization that has taken place has suffered from severe inconsistencies, non-transparency, and outright favoritism. While this problem is not unique to Russia, cross country comparisons suggest that businesses in Russia are even more likely to perceive "access to land" as an obstacle, relative to many other emerging markets.

In our study we investigate the problems faced by businesses in carrying out land and real estate transactions in Russia. The analysis is based on a survey carried out by the Foreign Investment Advisory Service, which covered 15 Russian regions and included information from 517 business intermediaries that helped clients with land and real estate transactions in 2004, as well as 1,188 legal entities and sole proprietors that attempted, underwent or completed land and real estate transactions in that year.

Our analysis demonstrates that the principal factor influencing the level of land privatization in a region (dominated by privatization of land under buildings) is the pricing policy pursued by local authorities. In those surveyed regions where the local government pricing policy is at the low end of the range stipulated by federal law, the rate of land privatization transactions is higher. A reduction of the official price from the higher to the lower end of the federally mandated range is associated with a significant increase in the rates of land privatization (more than doubling for some regions).

Excluding the pricing policy from consideration, the length of time required to complete the relevant procedures becomes the main factor influencing the level of land privatization; the longer the duration of the procedure, the lower the rate of land privatization in a region. A decrease in the average procedure duration by one month increases the overall number of land privatization transactions per 100,000 residents by about 11%.

If businesses are deterred from applying for ownership rights, their only other choice is to apply for lease rights. Delays associated with land privatization procedures lead to an increase in the proportion of transactions for long-term land leases as opposed to land ownership. If the delays are reduced by 25% from their mean length, the rate of land lease transactions would decrease by about 15 percentage points in favor of land privatizations.

A second factor influencing land privatization is the frequency of refusals by government agencies in the course of a procedure. The analysis demonstrates that while processing land privatization applications, government agencies tend to refuse the completion of such transactions twice as much, on average, as land lease procedures, even though the procedures and criteria are supposed to be the same.

More Corruption in Complex Procedures With Sunk Costs

Procedures in which applicants have significant sunk costs (e.g., they have already purchased their land and are now trying to register their ownership rights) take about 34% more time than "reversible" procedures. Procedures in which sunk costs are involved are also more prone to corruption: the share of stages involving unofficial payments is higher by 11% as compared to the "reversible" ones.

More complex land procedures are more prone to corruption. Each extra stage added to the procedure increases the percentage share of stages in which unofficial payments were reported by about 4 percentage points.

The procedure duration does not significantly affect the level of unofficial payments. However, the official cost of the procedures, along with the complexities associated with them, has a significant effect on the level of unofficial payments — the higher the official cost, the higher the level of unofficial payments.

Established relationships with government officials may help to reduce the duration of the process somewhat, although the effect is not significant. However, such connections cost money to maintain — intermediaries who have connections that they think can help in the facilitation of their work charge more for the completion of procedures.

The use of auctions or tenders is still not very common in many regions, and while use of such mechanisms is associated with higher rates of land privatization, there is not yet clear evidence that they are associated with other positive outcomes such as fewer delays or unofficial payments.

Policy Recommendations

- Unnecessary complexity should be reduced in administrative procedures for businesses' access to land. Regions with the simplest procedures should serve as a positive example for regions with more complex procedures.
- For privatization of land under privatized buildings, keeping administered land prices low helps to encourage land privatization transactions and helps to develop a competitive secondary market in land. At the same time, if municipalities cannot obtain revenues from land rents, they may need some compensating source of revenue (e.g. enhanced land taxes) to maintain their fiscal balances and to encourage their cooperation with land privatization.
- For many administrative procedures, a policy of "silent consent" with time limits should be introduced. Officials should be required to provide a written explanation, against established legal or administrative criteria, for any refusal of applications for land privatization, within a stipulated time limit. If no decision has been rendered by the time limit, it should be deemed approved, with enforcement available through the courts if necessary.
- Auctions and tenders for land privatization should be further encouraged, but need to be monitored closely for transparency and fairness.

Gregory Kisunko is Sr. Public Sector Specialist at the Public Sector Group of the Poverty Reduction and Economic Management Network of the World Bank; Jacqueline Coolidge is Lead Investment Policy Officer at the Foreign Investment Advisory Service (FIAS), which is a multi-donor facility of the World Bank Group. Full text of the paper "Survey of Land and Real Estate Transactions in the Russian Federation" can be viewed at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=958175#Paper Download (World Bank Policy Research Working Paper No. 4115). **BT**

Land Issues: Barriers for Small Businesses

Questions, connected with the acquisition and renting of land and premises, play an important role in the decision to create and expand small businesses. This is proved by the sixth round of monitoring the administrative barriers to small business development. The monitoring is carried out by CEFIR and comes in the form of yearly repeated surveys of 2,000 firms in 20 regions of Russia. CEFIR has been conducting the survey since 2002 in order to evaluate the results of the deregulation reform, started by the federal government in 2001.

The monitoring results show that about half the firms face problems with land, while the problem of acquisition and renting of land and premises was singled out as the most serious problem connected with the federal regulations.

- *The procedure duration*. Purchase of land and premises looks like a lottery: in some cases the procedure is relatively fast (one to three months), while in others it drags on and takes more than six months. In 2003, more than a third of the firms, trying to acquire premises, had to spend over six months on the procedure; around 90% of the firms, purchasing the land, could not finish the purchasing procedure within the six months. In 2006, the duration of such procedures did not change significantly.
- *Purchasing federal property.* The procedure for purchasing federal property was in 2003 — and still remains — the most expensive, time-consuming and the least transparent. In 2006, the procedure duration for an average firm was three months.
- *Costs connected with purchasing and renting land and premises*. The survey results from 2004 show that this was not influenced by who the partner is in the transactions: whether it be a private party or the federal authorities. However, there was more pressure to give bribes while conducting the transaction with government agencies.

Thus, the survey results show that small businesses face serious problems when trying to acquire premises and/or land plots. A significant number of entrepreneurs abandon plans to start or expand their business due to these difficulties. In order to decrease the arbitrariness of the local authorities, the appropriate procedures must be simplified; this will be a strong incentive for the development of small business in Russia's regions.

Duration (Days) for the Procedure of Acquiring Premises, Median Values

	Purchase of the Federal Property	Purchase of Private Property	Rent of the Federal Property	Rent of the Private Property
2004	22	60	30	7
2006	30	30	30	7

Source: Centre for Economic and Financial Research, Moscow, www.cefir.ru. Questions, related to the purchasing and renting land and premises, have been added to the monitoring survey on the initiative and with the financial help of the Foreign Investment Advisory Service (FIAS). **BT**

Foreign Bank Profitability in Central and Eastern Europe

Performance of greenfield banks is superior to the other types of banks

Olena Havrylchyk and Emilia Jurzyk

What determines bank profitability? What is the impact of ownership structure and mode of entry on bank performance? Clearly, compared to domestic banks, foreign banks may be differently affected by some common factors. For example, they may be less sensitive to the structure of liabilities and local economic conditions. At the same time, they may be influenced by additional factors compared to local banks, for example, home country economic conditions and the strategies of parent institutions.

Foreign banks are not a homogeneous group, and they differ according to the mode of entry: greenfield banks (foreign banks newly established in a country), and takeover banks (domestic banks sold to private foreign investors). Greenfield banks are closely integrated with parent institutions, depend on them for capital and apply approved risk and portfolio management techniques. In contrast, when taking over a bank, foreign investors inherit personnel, infrastructure and client portfolio, and have to spend time and money to modernize the target. Additionally, as domestic banks offered to foreign buyers are often illiquid and burdened with non-performing loans, cleaning up and restructuring costs fall, too, on the new owners.

We examine the sources of profitability using data on 419 commercial and savings banks from 11 Central and Eastern European countries (CEE), namely Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia, between 1993 and 2004. This region has the world's highest share — 71% — of foreign investors in the banking sector, with both greenfield and takeover banks operating in all countries.

We decompose banks' profits into net interest margin, net non-interest income, loan loss provisions and overhead costs and examine their relation to a set of domestic and international factors. This allows us to see whether being a part of a multinational financial institution matters for the foreign banks' performance and whether the performance of different types of banks converges over time.

Greenfield Banks More Profitable

First, our results clearly show that the mode of entry for foreign banks is an important determinant of their performance. Profitability of takeover banks is not different from that of domestic banks, whereas greenfield banks earn 0.95 percentage points higher return on assets than other banks. Higher profitability results from the lower costs of greenfield banks, and not from higher interest or non-interest margins. Loan loss provisions and costs in an average greenfield bank are lower by 6.43 and 1.23 percentage points, respectively, than in a domestic bank. Greenfield banks' better quality of loan portfolio might be due to their superior skills in screening potential borrowers and their subsequent monitoring. Alternatively, greenfield banks may also target different market segments, namely the largest and most transparent enterprises, leaving riskier clients to domestic banks.

Costs in a greenfield bank are lower by 1.23 percentage points

Second, we find that the mode of entry determines foreign banks' vulnerability to local and international conditions. Greenfield banks are not sensitive to domestic factors, such as the structure of their balance sheets, GDP growth and interest rates. At the same time, they are affected by the health of their parent institutions and interest rate changes in the EU. This reflects very tight links between greenfield institutions and parent banks, which support their subsidiaries in CEE. Interestingly, the profitability of takeover banks depends on their own level of capital, and is not sensitive to either the local macroeconomic environment or international factors.

Third, we find that the entry of foreign banks (both greenfield and takeover) has important spillover effects on the performance of domestic banks in CEE. As the participation of foreign banks increases, the costs of domestic banks rise. This can be viewed as a "negative" spillover effect, but is explained by the fact that in countries with a low level of economic development the costs of domestic banks rise in response to competition from foreign banks, because they have to invest in new technology and human capital to be able to compete.

Over time, however, a certain degree of convergence occurs between banks with different ownership structures. The profitability of greenfield banks decreases, as their costs rise. This is a sign of a positive spillover effect: with time, domestic banks become more competitive, and greenfield banks can no longer earn abnormal profits.

Conclusions

Thus, our analysis shows that the performance of greenfield banks is superior to the other types of bank, which is the result of their modern management and lending techniques, superior reputation, and support from parent institutions. None of these factors appears to improve the performance of takeover banks, but this could be due to the short time that has elapsed from the change of ownership and the significant burden of bad loans that these banks inherited.

Foreign banks' entry has a positive impact on banking sector stability, since they are less sensitive to the domestic economic environment compared to domestic banks. Moreover, greenfield banks enjoy support from parent institutions.

Olena Havrylchyk is economist at CEPII, Paris, France and Emilia Jurzyk is a PhD student at the Department of Economics and LICOS, KU Leuven. Full text of the paper is available at: http://ssrn.com/abstract=965 **BT**

Banking in Ukraine: Changes Looming?

Two main risks of the Ukrainian banking industry are liquidity and currency risks

Natalya Dushkevych and Valentin Zelenyuk

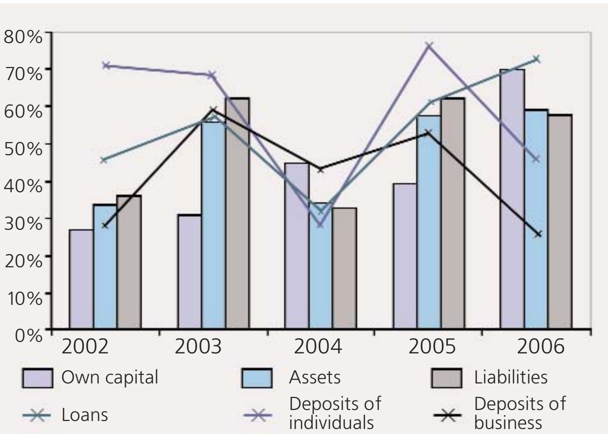
During the last decade, the banking industry in Ukraine has exhibited an enormous growth in assets (see Figure). The number of commercial banks went from 76 at the beginning of independence to a peak number of 230 banks in 1995 and to 193 banks in 2006. There remain only two state-owned banks with about 12% of the total assets — a much lower share than e.g. in the Czech Republic (24%) or Russia (35%). The industry is quite competitive with no one bank having a dominant position. The Herfindahl-Hirschman index of business concentration has stayed at around 400 points for many years, which is similar to the levels in the UK or France.

Big international players, such as Citibank, ING and HVB entered Ukraine before 2000 but did not make it into the top 20 banks in terms of assets. The last two years, however, showed a markedly increased interest from foreign investors in Ukrainian banking. The new wave of foreign acquisitions started in 2005 when Raiffeisen International purchased the second largest Ukrainian bank, Aval. Other big international players followed promptly, increasing the proportion of foreign ownership from about 15% in 2004 to about 30% by the end of 2006.

In 2006, about 65% of all FDI into Ukraine went to the banking industry. Not surprisingly, the prices skyrocketed: in early 2007, Swedbank agreed to pay about US$750 million for the 19th largest Ukrainian bank, which was equal to three quarters of what Raiffeisen International had paid for the second largest bank just 17 months earlier. At the same time, the stock market price for banks taken over by international players has increased dramatically, signalling a higher level of trust from investors.

However, it is also very likely that the proportion of domestic banks in Ukraine will remain much higher than in the above countries. This is because relative to other transition countries (except Russia) Ukraine has many more large domestically owned business groups, which own or control local banks. For example, the largest Ukrainian bank, Privatbank, is associated with one of the largest FIGs in Ukraine, the Privat Group.

Annual Growth of Main Banking Indicators



Industry Shakeout Likely

Thanks to increased competition, the Ukrainian banking industry is ranked higher by the World Bank than in most transition and even some developed countries. However, the weakness of many small banks, with some being on the verge of bankruptcy, is likely to lead to an a massive exit of banks and the consolidation of others. International experience shows that many industries go through a "shakeout" period around the 15th year of their development. The Ukrainian banking, which is already in its 17th year, also demonstrates a decent level of maturity in providing primary services — another factor considered critical for inducing an industry shakeout.

A large wave of bankruptcies — the worst-case scenario — could be prevented (or minimized) by encouraging mergers and acquisitions of small banks, many of which suffer from managerial and marketing deficiencies. Until recently, foreign investors have kept away from buying such banks, mainly because of their inadequate transparency. The recent legislative initiatives should help to increase transparency, yet the process has been going too slowly despite increasing threats.

What are the main risks to the Ukrainian banking industry? One is the increasing liquidity risk. Most of the bank liabilities are short-term deposits and current accounts, while most assets are mortgages and other long and medium-term loans. This threat is unlikely to materialize if trust in the banking system continues to increase, no large-scale negative economic shocks ensue, economic growth continues and incomes keep rising. Yet, the presence of so many uncertainties makes the system vulnerable.

The second is an increasing currency risk. While many loans are taken in US dollars, most deposits are made in the local currency (hryvnia). This is because the interest rate for dollar loans is 1.5 times lower than for the *hryvnia* ones, while the exchange rate has remained virtually unchanged in the past years. An external shock causing devaluation of *hryvnia* is likely to cause a credit crisis, as many borrowers with hryvnia-denominated incomes will find it hard to meet obligations.

The National Bank has considered various measures to discourage loans in hard currency. Yet, this is unlikely to solve the problem as the "remedies" are applied to the consequences rather than to the root of the problem. In our opinion, a more market-oriented solution would entail switching from the pegged to floating exchange rate regime, together with inflation targeting. This should stimulate convergence of interest rates in domestic and hard currencies.

Overall, the industry dynamics suggest that the Ukrainian banking is about to go through substantial changes and the result will depend on how well it addresses the risks and transparency issue.

Natalya Dushkevych is at EERC (Kyiv School of Economics) and Kyiv Economics Institute, KEI. Valentin Zelenyuk is at Kyiv Economics Institute, KEI, EERC and Millennium Capital. The views expressed in this article are those of the authors and do not represent the views of above organizations. **BT**

Knowledge Economy Forum: Adopt or Innovate?

The Sixth Annual Knowledge Economy Forum on "Technology Acquisition and Knowledge Networks" took place in Cambridge, England on April 17-19. Based on examples of international best practice, the forum discussed critical elements in enhancing the absorption of technology and knowledge by firms and explored the policy recommendations that support such processes in Europe and Central Asia (ECA). Cambridge's experience as one of the world's leading hubs for enterprise innovation provided important insights on the role of universities, private entrepreneurs, and government in facilitating technology and knowledge transfer to industry. The acquisition of technology and know-how from around the world offers greater potential for sustained economic growth in ECA in the short to medium term than innovation. While countries in ECA are striving to emulate Western European and Asian approaches as they face the challenges of competing in an increasingly integrated world, they cannot afford to ignore what is happening further east. China and India have vast, increasingly well-educated populations whose talents are being tapped by local and international firms flourishing in what are relentlessly competitive business environments, which have developed largely thanks to these economies' ability to acquire cutting edge technology and eventually innovate indigenously. Ongoing research by the World Bank suggests that governments in ECA must do their part in supporting the catch-up process by putting in place an incentive-compatible regulatory framework conducive to technology acquisition by the private sector and the creation of networks that can channel knowledge across countries. For more information, visit *http://www.worldbank.org/eca/ke*

Latvia and Hungary Graduate from World Bank Assistance

The governments of the Republics of Latvia and Hungary exchanged letters with ECA Vice-President Shigeo Katsu during the World Bank/IMF Spring Meetings April 14-15, signaling their "graduation" from World Bank borrower to donor status. Since Latvia became a member of the European Union, the partnership between Latvia and the World Bank has focused on measures to implement Latvia's convergence program, promote regional development, and strengthen governance. Hungary, which is the largest donor to the International Development Association among the eight Central European countries that joined the European Union in 2004, acknowledged its 25 years as a member of the World Bank and indicated its desire for a continued partnership with the Bank based on knowledge sharing. For more information, visit *http://www.worldbank.org/eca*

Roma Education Conference Calls for Scaling up from Donors, Governments

Continued progress in improving equal access to quality education for Roma will require strong commitments from donors and the backing of national governments, stressed the participants of the conference "Education Reforms and Roma Inclusion in Central and Eastern Europe," hosted by the Roma Education Fund (REF) and the Government of Hungary on April 2-3. The Roma Education Fund's first major conference in its two years of operations brought together government representatives, donors, and Roma civil society. REF Board member and World Bank Country Director Annette Dixon, as well as Open Society Institute chairman George Soros in a video message, called on donors to solidify their commitments to ensure that REF's successful projects can be scaled up, such as school integration and access to preschool education. Conference participants shared their experiences in panel discussions and roundtables, bringing to light best practice examples, such as the importance of involving parents and the Roma community in education reforms, and the improved educational outcomes for students in integrated classrooms. Several innovative examples of collaboration were shared, such as a program in Hungary that works with Roma secondary school students to prepare them for employment in the private sector. However, government cooperation is required to implement and enforce anti-discrimination and desegregation laws, and projects must be tailored to the specific situation, as no panacea exists for all cases. Donors, governments, and NGOs must also work together to optimize the use of the European Union's Structural Funds in the new member states. For more information, visit *http://www.romaeducationfund.hu*

New Country Partnership Strategy in Macedonia Focuses on EU Accession

The World Bank's Board of Executive Directors discussed on March 27 the new Country Partnership Strategy (CPS) for the Former Yugoslav Republic of Macedonia, which envisages a lending program of up to US$280 million for the period 2007-2010. Priorities of the new CPS are centered round the country's ambition to join the European Union and aim at supporting the government's program to accelerate economic growth and job creation. The CPS builds on the country's progress in firmly establishing macro-economic stability and will support important reforms to further improve the conditions for private sector investment. In addition, it presses forward with reforms in key sectors where weaknesses in governance continue to undermine the country's economic reforms. Improved transparency and accountability in service delivery are critical to meet the government's program on growth, foster human capital, and meet EU standards. The proposed activities envisaged under the CPS focus on two pillars: a) foster growth and job creation, increase living standards for all, and b) public service delivery and supporting good governance. For more information, visit *http://www.worldbank.org/mk*

World Bank Engages with Bulgaria in Key Sectors to Hasten EU Convergence

Bulgaria's economy has grown steadily since 2000, and this positive trend is expected to continue in the near future. However, raising productivity and employment to narrow the income gap and facilitate convergence with other member states in the European Union will remain Bulgaria's main challenge for the next few years. The World Bank Board of

Executive Directors approved three projects on March 21 that aim to strengthen the country's EU integration and convergence of living standards. The Social Sector Institutional Reform Development Policy Loan will support Bulgaria's reform agenda in the areas of health, education, and social protection. The Second Trade and Transport Facilitation in Southeast Europe will facilitate Bulgaria's national and international trade and transport by improving the capacity, efficiency, and quality of services at selected EU border crossings, with a particular focus on the Trans-European Transport Network. The board of directors also approved additional financing for the active Bulgaria Social Investment and Employment Promotion Project. The project aims to improve the standard of living in disadvantaged communities and make better use of the opportunities presented to Bulgaria by its accession to the European Union. For more information, visit *http://www.worldbank.org/bg*

Armenia's Poverty Reduction Agenda Stays on Track

The World Bank Board of Directors approved on March 8 a US$28 million Poverty Reduction Support Credit for Armenia. This is the third project under a four-year program that will assist the government with the implementation of its Poverty Reduction Strategy Program (PRSP). The credit will help sustain the country's economic growth and poverty reduction efforts by providing budget support and moving ahead with the high priority reform agenda identified by the PRSP. The Armenian authorities are currently completing a review of the PRSP in close consultation with civil society and donors. During the next phase of the PRSP process, the government will prepare an extensive analysis of the causes of poverty and identify the short and long term challenges on the road to greater economic growth. While growth has only recently begun lowering unemployment levels in the country, currently standing at nearly one-third of the labor force, the nascent rise in employment levels has had so far limited impact on the income of many households, particularly in the less productive sectors, such as agriculture. For more information, visit *http://www.worldbank.org/am*

Comprehensive Drought Strategies for Caucasus and Central Asia in New Report

Drought-susceptible countries in the Caucasus and Central Asia must establish National Drought Plans that are well integrated into other disaster-management plans, stresses a new World Bank report. *Drought Management and Mitigation Assessment for Central Asia and the Caucasus: Regional and Country Profiles and Strategies* is the result of research and consultations conducted in eight countries over the past two years. The report was prompted by a severe and prolonged drought in the region in 2000-2001, as well as the knowledge that exposure to drought will only increase in Central Asia, and with people in all eight countries vulnerable to drought conditions due to lack of careful planning and poverty. Thus far, disaster-management agencies have not adequately addressed the severity of long-term drought impacts, focusing instead on more immediate disasters. To access the materials in both English and Russian, visit *http://www.worldbank.org/eca/drought*

IDA Websites for Armenia and Bosnia Go Live

As part of the World Bank's focus on the results achieved through financing from the International Development Association (IDA) across the globe, IDA websites for Armenia and Bosnia have gone online. IDA is undergoing its 15th round of replenishment, known as IDA15. IDA lends money (known as credits) on concessional terms. This means that IDA credits have no interest charge and repayments are stretched over 35 to 40 years, including a 10-year grace period. Since its inception, IDA credits and grants have totaled US$161 billion, averaging US$7-9 billion a year in recent years. The Armenia and Bosnia IDA websites take a look at IDA's work in the country and its unique role in development and poverty reduction. The IDA story is told through a succinct country study, short project profiles, interviews with government officials, and photo slideshows. For more information, visit *http://www.worldbank.org/ida*

This section has been provided courtesy of Merrell Tuck and Christina Lakatos, Europe and Central Asia External Affairs

In Moldova, a 70 percent Decrease in AIDS Mortality

Moldova's health status markedly declined between 1990 and 2000. Life expectancy at birth is one of the lowest in Europe (68 years in 2003). From the mid-1990's onward, HIV/AIDS prevalence increased by more than 25 times among the 15-49 age group, reaching 0.90% in 2003. Service-wise, the country was trying to maintain extensive facilities inherited from Soviet times on a meager budget. Resources were skewed toward large hospitals, which represented 70% of health spending. The First Health Sector and HIV/AIDS Control Strategy, developed with assistance from IDA, the Dutch Government and other donors, helped the government set evidence-based policy directions and provide a framework for coordinating donor assistance in the sector. IDA's total contribution amounted to US$15.5 million. Collaboration between the Moldovan government, NGOs, and supporting donors has contributed to stabilizing life expectancy, a decrease in maternal and infant mortality, and 70 percent decrease in mortality due to AIDS. Health sector reforms created a new minimum benefits package and improved rural access to health care. For more information, visit *http://go.worldbank.org/IKYDS1WAN0.*

New Country Director in Russia

Mr. Klaus Rohland has assumed the position of the Country Director and Resident Representative of the World Bank in Russia. He first joined the World Bank in 1981 as an advisor to the German Executive Director and has since then held a number of key positions in the Bank. His most recent posting was as the Bank's Country Director for Vietnam. The previous Country Director for Russia, Mrs. Kristalina Georgieva returned to the Bank's headquarters in Washington, D.C. She was appointed as Deputy Vice-President, Sustainable Development, a recently established department that combines infrastructure development, agriculture, environment and social development. More information: *http://go.worldbank.org/XDF661E1P0* **BT**

World Bank Working Papers

http://econ.worldbank.org

Vojislav Maksimovic, Asli Demirguc-Kunt, Meghana Ayyagari

Firm Innovation in Emerging Markets: The Roles of Governance and Finance

March 2007, WPS 4157

The authors investigate the determinants of firm innovation in over 19,000 firms across 47 developing economies. They define the innovation process as including not only core innovation such as the introduction of new products and new technologies, but also other types of activities that promote knowledge transfers and adapt production processes. The authors find that more innovative firms are large exporting firms with private owners, highly educated managers with mid-level managerial experience, and access to external finance. In contrast, firms that do not innovate much are typically state-owned firms without foreign competitors. The identity of the controlling shareholder seems to be particularly important for core innovation, with private firms, whose controlling shareholder is a financial institution, being the least innovative. While the use of external finance is associated with greater innovation by all private firms, it does not make state-owned firms more innovative. Financing from foreign banks is associated with higher levels of innovation compared with financing from domestic banks.

Mona Haddad

Trade Integration in East Asia: the Role of China and Production Networks

March 2007, WPS4160

Production networks have been at the heart of the recent growth in trade among East Asian countries. Fragmentation trade, reflected mainly in the trade in parts and components, is expanding more rapidly than the conventional trade in final products. This is mainly due to the relatively more favorable policy setting for international production, agglomeration benefits arising from the early entry into this new form of specialization, considerable intercountry wage differentials in the region, lower trade and transport costs, and specialization in products exhibiting increasing returns to scale. The economic integration of China has deepened production fragmentation in East Asia, countering fears of crowding out other countries for international specialization. International production fragmentation in East Asia has intensified intraregional trade but has depended heavily on extraregional trade in final goods. While production networks centered on China have contributed significantly to growth in East Asia, they also breed vulnerabilities. They have not automatically led to technology spillovers but resulted in an extreme interdependence across East Asian countries.

Dragana Radevic, Irina Klytchnikova, and Patricia Silva

Poverty and Environmental Impacts of Electricity Price Reforms in Montenegro

February 2007, WPS 4127

The Government of Montenegro is preparing an electricity tariff reform due to recent developments in the national and regional electricity markets. Electricity tariffs for residential consumers in Montenegro are likely to gradually increase by 40% to over 100%. This significant price rise will impose a heavy burden on poor households and it may adversely affect the environment. In an ex-ante investigation of the welfare impact of this price increase on households in Montenegro, the authors show that the anticipated price increase will result in a significant increase in households' energy expenditures. A simulation of alternative policy measures analyzes the impact of different tariff levels and structures on the poor and vulnerable households in particular. Higher electricity prices could also significantly increase the proportion of households using fuel wood for heating.

Clifford Zinnes, Laura Bouriaud, Ioan Abrudan, Valy Marochko, Jeffrey R. Vincent, Jean-Daniel Saphores

Detecting Collusion in Timber Auctions: the Case of Romania

December 2006, WPS4105

Romania was one of the first transition countries in Europe to introduce auctions for allocating standing timber in public forests. In comparison with the former system of administrative allocation at set prices timber auctions offer several potential advantages: greater revenue generation for the government, a higher probability that tracts will be allocated to the firms that value them most highly, and stronger incentives for technological change within industry and efficiency gains in the public sector. Competition is the key to realizing these advantages. Unfortunately, collusion among bidders often limits competition in timber auctions. The result is that tracts sell below their fair market value, which undermines the advantages of auctions. The paper confirms that data from Romanian timber auctions can be used to determine the likelihood of collusion, and it suggests that collusion reduced winning bids in Suceava forest directorate in 2002 and perhaps also in Neamt forest directorate. The paper concludes with a discussion of actions that the government can take to reduce the incidence of collusion and minimize its impact on auction outcomes.

CASE

http://www.case.com.pl

Maria Cernobrovciuc, Joanna Konieczna, Mariana Puntea, Marcin Sowa, Alexandru Stratulat

Prospects for EU-Moldova Economic Relations

CASE Reports No. 67

In recent years, external links with the Republic of Moldova have been determined by the influence of two geopolitical blocks, the CIS and the EU. Despite the strong ties with the CIS, Moldova's relations with the EU are becoming increasingly important particularly with regard to the economic situation in the country. The report presents recent economic trends in Moldova, analyzes the effects of recently proposed and implemented macroeconomic policies, and discusses some of the structural changes that have taken place during the last five years. It also provides a background of EU-Moldova relations and describes the prospects of future economic relations.

Finally, it reports on the current attitudes towards integration with the EU, based on an expert opinion poll, and concludes with a set of recommendations for Moldovan policy-makers.

Malgorzata Jakubiak, Maryla Maliszewska, Irina Orlova, Vitaly Vavryschuk, .
Non-Tariff Barriers in Ukrainian Export to the EU
CASE Reports No. 68

Overall EU tariffs for Ukrainian products are rather low and traditional protection measures apply only to selective sectors. Moreover, the latter are expected to disappear within the next few years, following Ukraine's WTO entry and the establishment of the EU-Ukraine free trade area in manufacturing goods. However, the EU often resorts to non-tariff barriers to trade, such as certification of origin, customs procedures and technical standards, to protect its own market, which may prove prohibitive for Ukraine. The report explores whether and to what extent the non-tariff barriers impede Ukrainian exports to the EU. It reviews the Ukrainian trade policy and the evolution of bilateral trade flows with the EU, and discusses the experience of Central and Eastern European countries in relation to overcoming non-tariff barriers and the extent to which this can be applicable to Ukraine. Finally, the report presents the results of the survey on non-tariff barriers to trade faced by Ukrainian exporters and concludes with policy recommendations.

CEFIR

http://www.cefir.ru

Irina Denisova
Entry to and Exit from Poverty in Russia: Evidence from Longitudinal Data
March 2007, CEFIR/NES Working Paper 98

More than 25 million Russians have incomes that are lower than the subsistence level. The study investigates how entry to and exit from poverty are shaped using survival analysis and utilizing the Russian Longitudinal Monitoring Survey (RLMS) panel for 1994-2004. The study shows, among other things, that the presence of children increases the chances of moving into poverty and decreases the chances of leaving it, while a high share of adults with university degrees in the household and the urban residence have the opposite effect. Interestingly, economic upturns and downturns have an asymmetrical impact on poverty: economic growth lowers the chances of slipping into poverty but also reduces hazards from poverty. This implies that poor households during economic upturn are those with serious problems and are to be paid special attention to.

Ariane Lambert-Mogiliansky, Konstantin Sonin, Ekaterina Zhuravskaya
Are Russian Commercial Courts Biased? Evidence from a Bankruptcy Law Transplant
March 2007, CEFIR/NES Working Paper 99

The authors study the nature of judicial bias in bankruptcy proceedings following the enactment of the 1998 bankruptcy law in Russia. The two main findings are as follows. First, regional political characteristics affected judicial decisions about the number and types of bankruptcy proceedings initiated after the law took effect. Controlling for indicators of firms' insolvency and the quality of the regional judiciary, re-organization procedures were significantly more frequent in regions with politically popular governors and governors who had hostile relations with the federal center. Poor judicial quality was also associated with a higher incidence of re-organizations. Second, the quality of the regional judiciary affected the performance of firms under the re-organization procedure: in regions with low quality judges, firms that were re-organized according to the 1998 law had significantly lower growth in sales, labor productivity, and product variety compared to firms not subject to bankruptcy proceedings. In contrast, in regions with high quality judges, firms in re-organization outperformed firms not in bankruptcy proceedings. This effect of judicial quality on the performance of re-organized firms was stronger when governors were politically popular. These findings are consistent with the view that politically strong governors subverted the enforcement of the 1998 bankruptcy law.

Other Publications

Andrei V. Vernikov
Russia's Banking Sector Transition: Where to?
BOFIT Discussion Paper 5/ 2007
http://www.bof.fi/bofit_en/

This paper applies an analytical paradigm of institutional economics to the transition of the Russian banking sector, focusing on the interplay between ownership change and institutional change. It finds that the state's withdrawal from commercial banking has been inconsistent and limited in scope. To this day, core banks have yet to be privatized and the state has made a comeback as owner of the dominant market participants. The paper also looks at the new institutions imported into Russia to regulate banking and finance, including rule of law, competition, deposit insurance, bankruptcy, and corporate governance. The unfortunate combination of this new institutional overlay and traditional local norms of behavior have brought Russia to an impasse — the banking sector's ownership structure hinders further advancement of market institutions. Indeed, one may now be witnessing a retreat from the original market-based goals of transition.

Barry Bosworth, Susan M. Collins
Accounting for Growth: Comparing China and India
February 2007, NBER Working Paper 12943
http://www.nber.org/papers/w12943

The authors compare the recent economic performances of China and India using a simple growth accounting framework that produces estimates of the contribution of labor, capital, education, and total factor productivity (TPF) for the three sectors of agriculture, industry, and services as well as for the aggregate economy. The growth accounts show a roughly equal division in each country between the contributions of capital accumulation and TFP to growth in output per worker over the period 1978-2004, and an acceleration of growth when the period is divided at 1993. However, the magnitude of output growth in China is roughly double that of India at the aggregate level, and also higher in each of the three sectors in both sub-periods. In China the post-1993 acceleration was concentrated mostly in industry, which contributed nearly 60% of China's aggregate productivity growth. In contrast, 45% of the growth in India in the second sub-period came in services. Reallocation of workers from agriculture to industry and services has contributed 1.2 percentage points to productivity growth in each country.

Guido Friebel, Elena Panova
Insider Privatization and Careers — A Study of a Russian Firm in Transition
March 2007, NBER Working Paper 12998
http://www.nber.org/papers/w12998

The paper studies how transition has affected human resources policies of a Russian heavy industry firm. The data set contains personnel files of 1,538 white-collar workers over 17 years: from 1984 to 2000. The authors find that until 1991, still in Soviet times, the firm featured stable patterns of upward mobility that looked quite similar to career paths in western firms. From 1992 when liberalization reforms began, to 2000, no similar career paths were observed. The reason is that in all tiers of the firm's hierarchy except for the lowest one, more managers were hired from the outside, and fewer managers left the firm. As a result, the firm became "toploaded", and promotions were blocked. A possible reason is extremely weak outsider property rights enforcement in Russia.

Celine Allard
Inflation in Poland: How Much Can Globalization Explain?
IMF Working Paper WP/07/41
February 2007, IMF Working Paper 07/41

The paper analyzes how globalization has affected inflation in the EU's New Members States and Poland in particular since 1995. It finds prices have become less sensitive to domestic economic conditions as trade integration rose, possibly because monetary policy incentives increasingly shifted toward meeting price stability objectives. Quantitatively, globalization appears to have lowered Polish prices by 0.5-1 percentage point annually since 1995, substantially more than in advanced economies. However, future inflation-dampening effects in the NMS are likely to be smaller as the pace of increases in trade openness moderates.

Pasquale Tridico
Regional Human Development in Transition Economics: The Role of Institutions
Universite degli Studi Roma Tre, Working Paper 70
http://host.uniroma3.it/dipartimenti/economia/pdf/wp70.pdf

The aim of this paper is to analyze regional difference in human development in Poland. The author constructs Human Development Regional Indexes for 16 Polish regions and describes the income and non-income dimensions of human life. During transition, western Polish regions experienced higher growth of GDP per capita than eastern regions. Yet, this has not produced a higher level of non-income dimension indicators — education and life expectancy. On the contrary, eastern regions, although they have a lower level of GDP per capita, have a higher level of non-income indicators. The author finds that in the east, social norms and group preferences are more oriented towards social policies and public services, while in the west the norms and preferences are more oriented towards a market economy.

Markku Kotilainen
Free Trade between the EU and Russia — Sectoral Effects and Impacts on Northwest Russia
Working Paper No. 1087
The Research Institute of the Finnish Economy, http://www.etla.fi/eng/julkaisuhaku.php

The paper analyzes the implications of free trade between the EU-25 and Russia using a computable general equilibrium model, with a focus on the regions in Northwest Russia. Free trade on its own would have a negative terms-of-trade effect in Russia and cause a small decline in welfare. If coupled with an increase in productivity, welfare would increase. This emphasizes the importance of reforms in the Russian economy. Ferrous and non-ferrous metallurgy, machine-building and metal working, and wood and paper are the principal losers due to free trade. At the same time, production in capital goods, fuel industry, and services increases. Due to its production structure, the Northwest seems to benefit slightly less than Russia on average in terms of the volume of GDP.

Alexandra Ferreira Lopes
The Costs of EMU for Transition Countries
REPEC: http://repec.org/mmf2006/up.7815.1140017467.pdf

Should the Czech Republic, Hungary and Poland — the biggest economies that joined the EU in 2004 — adopt the euro? The author constructs a model to evaluate the economic costs of the loss of autonomy of the monetary policy as a result of joining the EMU. The findings suggest that EMU membership can be a costly decision to these countries. The decision of entering the EMU is more costly when technological shocks are stronger, when correlation of the monetary policy shocks is weaker, when consumers are more risk averse and when the import share between the countries studied and the EMU is lower.

Floro Ernesto Caroleo, Francesco Pastore
A New Regional Geography of Europe? The Labor Market Impact of the EU Enlargements
IZA Discussion Paper No. 2620
Available at SSRN: http://ssrn.com/abstract=969620

The aim of this paper is to summarize research ideas and outcomes on how the changing political and economic map of Europe affects labor markets in both the old and new EU member states. The specific focus of the discussion is on the microeconomic foundations of structural change and its spatially asymmetric impact on local labor markets. The issues discussed include: regional job and worker turnover; the impact of migration on regional unemployment differences; a regional dimension of gender differences; human capital as a factor of regional convergence; the impact of trade and FDI on regional labor markets; hidden economy and hidden employment; national and EU regional policy. **BT**

2nd annual Emerging Markets Private Equity Conference (EMPEC 2007)

June 4-5, 2007, Moscow, Russia

The conference titled “Russia and Other Emerging Markets: Investors Knocking at the Gates” is organized by the International Council of Institutional Investors. EMPEC 2007 provides insights and opportunities with respect to private equity, venture capital and real estate investments in emerging markets of Russia and CIS republics. The list of speakers includes representatives of the Russian governments, foreign and Russian investment banks, venture funds, and international organizations.

Information: http://www.empec.org/2007/index.php?lang=ru

Globalization, EMU and the Reshaping of European Economies

June 22, 2007, Florence, Italy

While European economies have become increasingly integrated over the last 15-20 years, there are striking differences in the degree of product and labor market liberalization, the organization and reform of the welfare and public finance systems, and the degree of openness to international capital markets. Rates of R&D expenditures and investment in new technologies are far from converging. The workshop organizers welcome submission of theoretical, empirical and policy contributions addressing these issues. The main goal of the workshop is to shed light on the roots of the differences in European countries ability to reap the benefits of regional and global economic integration.

More information: www.cepr.org

European Summer School on Industrial Dynamics

September 3-9, 2007, Dubrovnik, Croatia

The 2007 edition will be dedicated to the special topic of the "Economics of Science". Applications are invited from PhD students and young scholars on the following topics:

- The economics of public research (university funding, science policy)
- The labor market for scientists
- Scientists' careers, networks, and productivity
- The commercialization of academic research
- Any other topic related to economic aspects of scientific enquiry.

More information: http://www.unibocconi.it/essid2007

WIDER Conference: Southern Engines of Global Growth: China, India, Brazil, and South Africa (CIBS)

September 7-8, 2007, Helsinki, Finland

This conference focuses on the inter-linkages between CIBS and the global economy, including the impact of these economies on their respective regions. The main themes are growth, trade, international finance, global governance and geopolitics. The conference is expected to cover the following (non-exhaustive) topics:

- Implications of CIBS growth for other economies: opportunities, challenges and threats;
- Growth paths and development prospects of CIBS, including possible setbacks, and lessons for other countries;
- Commodity and services trade: the changing patterns of trade, competitive and complementary trade relationships, and volatility in commodity prices;
- Capital flows and financial markets: the role, determinants and spillover effects of FDI, government strategies in attracting FDI, prevention of financial crisis, exchange rate regimes, capital account control;
- CIBS’ role in WTO negotiations, regional trade arrangements and the implications for Southern economies;
- Possible consequence for energy demand, climate change and regional tensions;
- Technology transfer, intellectual property rights, and national research policies;
- Political economy and international governance issues, including implications for foreign policies.

More information: http://www.wider.unu.edu/conference/conference-2007-2/conference-2007-2.htm

First Summer School on “Transnationality of Migrants”

September 9, 2007, Lake Garda, Italy

The school intends to provide an intensive training course for PhD students and young researchers who are working in the fields of international economics and development. This year it will focus on the main analytical and empirical approaches to the study of the impact of international migration on the host country. The school is open to 40 students from all countries. Students are expected to attend the school full time. The school is organized as part of the Marie Curie Research Training Network on “Transnationality of Migrants”.

More information: www.cepr.org

CEPR/ESI 11th Annual Conference on Global Imbalances, Competitiveness and Emerging Markets

September 28, 2007, Pretoria, South Africa

The topic of the conference will cover the following areas:

- Implications of global imbalances for banking, financial markets and financial stability in mature and emerging markets;
- Impact of global imbalances on monetary policy in emerging markets (with special emphasis on the following channels: carry trades, capital flows, liquidity, asset inflation and exchange rates);
- Modeling competitiveness and balance of payments issues associated with mature and emerging markets. The intention is to have three policy lectures by senior central bankers.

The organizers will select the three best papers for presentation at the conference in a special session of central bank research papers and will award the best of these three papers with the CEPR/ESI Prize 2007 for the Best Central Bank Research Paper.

More information: www.cepr.org **BT**

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