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THE NEWSLETTER ABOUT REFORMING ECONOMIES

TRANSITION

Volume 10, Number 5 The World Bank in collaboration with The William Davidson Institute October 1999

New Corruption Indexes of Transparency International: Wide Range of Scores

At the end of October, Transparency International (TI), the global anticorruption organization, released its first ***Bribe Payers Perceptions Index (BPI)****. TI also published the fifth annual* ***Corruption Perceptions Index (CPI)****, which this year ranks a record 99 countries, up from 85 in 1998. The CPI is a "poll of polls," based this year on 17 surveys from 10 more independent organizations than before.*

The "bribe index" ranks 19 leading exporting countries by the degree to which their corporations are perceived to be paying bribes abroad to senior public officials. The survey was undertaken by Gallup International in 14 emerging market economies, including Hungary, Poland, and Russia. The survey involved detailed questions to more than 770 senior executives at major companies, chartered accountancies, chambers of commerce, major commercial banks, and law firms. Respondents included foreign nationals and executives at international firms. The questions concerned the propensity of corporations to use bribes.

The survey shows that companies from many leading exporting nations are widely seen as using bribes to win business. This despite the fact that in February 34 countries, including all leading exporting countries, agreed to an OECD convention to make the bribery of foreign officials a criminal offence. Ranking 19 leading exporting countries according to the "bribe index" (where, on a scale from 0 to 10, 10 represents a corrupt-free exporting country), Sweden got the best score with 8.3, while China (including Hong Kong) received a score of only 3.1.

The 1999 TICP Index

The **CPI** and the **BPI** are two sides of the same coin: CPI ranks the home countries of the payers of international bribes; BPI ranks countries in terms of the degree to which they are perceived to be the homes of bribe-takers—public officials who abuse their office for personal gain.

As in 1998, this year Denmark heads the CPI ranking with an essentially corrupt-free score of 10.0 (see table). "We are seeing many very poor countries in the lowest positions on the CPI. We would caution that it

Help save our Russian language edition!

Our Russian edition has fallen victim to across the board budget cuts. We are short the $35,000 annual support that helped finance the Russian edition of **Transition**, which is now two issues behind. Intensive efforts to find in-house solutions have been unsuccessful. We are concerned that our partner in Kyiv, the International Centre for Policy Studies, which provides matching funds to translate, print, and distribute ***Tranformatsia***, won't be able to meet the demands of the 3,000 readers of the Russian language edition (and the many more trying unsuccessfully to access the Russian version on the Web).

To keep this important information source and free discussion forum accessible to our Russian speaking readers across the CIS, we are turning to our readers for help. **Businesses, foundations, and individuals: Consider co-sponsoring the Russian edition of our newsletter. Transition** has wide distribution. Beside our recently launched Chinese edition,our English edition has a circulation of 11,000 for the printed version and 2,000 for the electronic version. We have had nearly 38,000 hits on our Web site as of September, 1999. For details, contact Richard Hirschler (rhirschler@worldbank.org or 202-473-6982) or Jennifer Prochnow (jprochnow@worldbank.org or 202-473-7466).

Public Disclosure Authorized

would be wrong to call these countries the most corrupt in the world. Our Index covers more countries than ever before, but we just do not have sufficient credible data to include over 80 other countries," warned Peter Eigen, Chairman of TI. He added: "Governments of countries with low CPI scores need to do far more to publicly acknowledge the problems, to confront the issues, to subject the corrupt companies and the corrupt officials to prosecution, and to earn public confidence by their antibribery policies.

The 1999 CPI score relates to perceptions of the degree of corruption as seen by business people, risk analysts, and the general public, and ranges between 10 (highly clean) and 0 (highly corrupt).

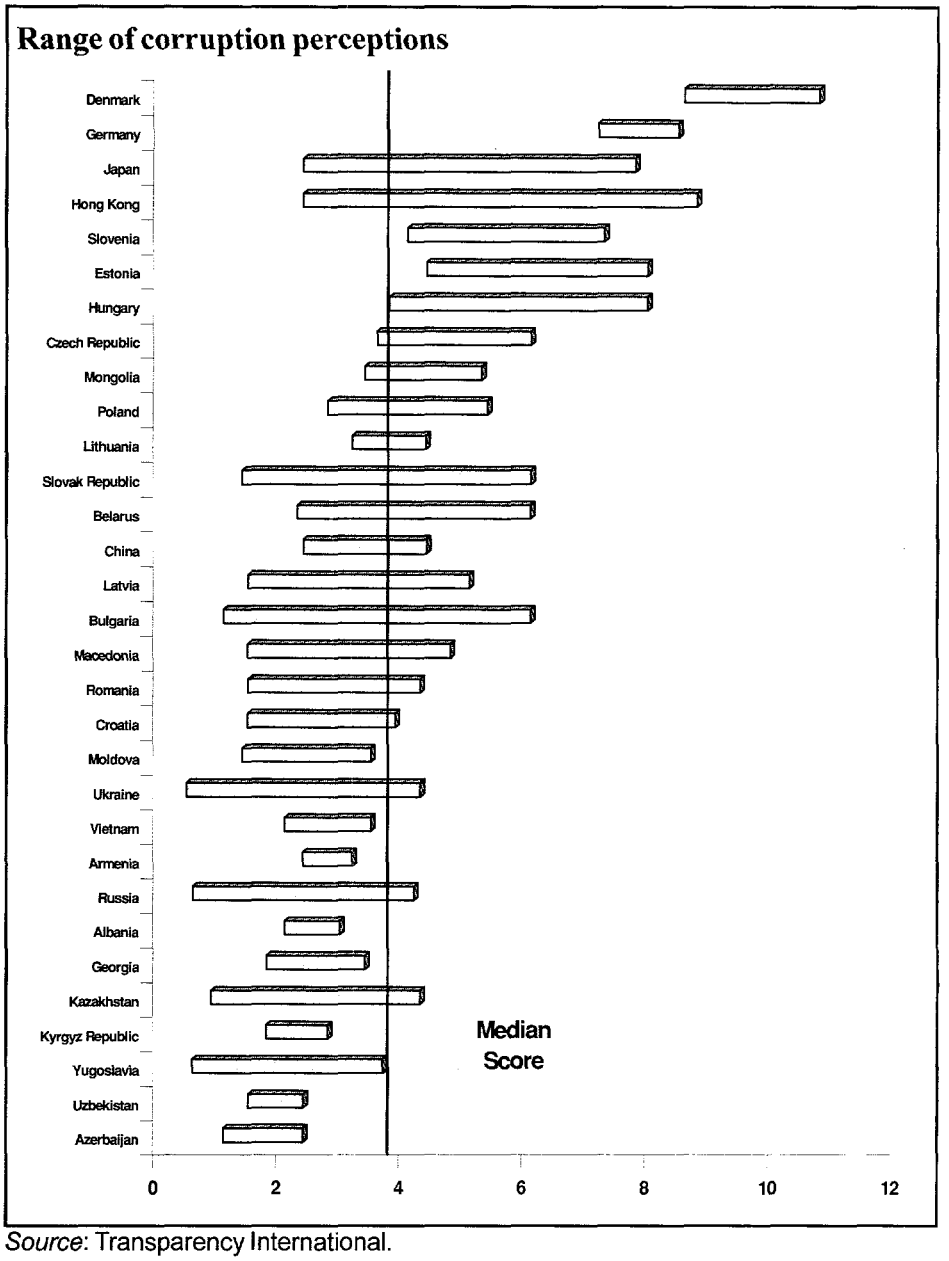
Many experts suggest using caution when interpreting TI data and point out that composite corruption ratings are inherently imprecise. Since the CPI is an average of various sources' perceptions about corruption, it hides the wide diversity of opinion among these sources for a given country. This point has been emphasized by the Latin American chapters of Transparency International. They have published an alternative presentation of the CPI data that shows the minimum and maximum scores for each country as a tool to highlight the diver-

1999 Transparency International Corruption Perceptions Index (CPI)
Maximum and Minimum scores widely deviate.

Rank	Country	CPI Score	Max. Score[a]	Min. Score[b]
1	Denmark	10.0	10.8	8.6
2	Finland	9.8	10.3	8.8
15	Hong Kong (China)	7.7	8.8	2.4
25	Slovenia	6.0	6.3	4.1
27	Estonia	5.7	8.0	4.4
31	Hungary	5.2	8.0	3.8
39	Czech R.	4.6	6.1	3.6
43	Mongolia	4.3	5.3	3.4
44	Poland	4.2	5.4	2.8
50	Lithuania	3.8	4.4	3.2
53	Slovakia	3.7	6.1	1.4
58	Belarus	3.4	6.1	2.3
	China	3.4	4.4	2.4
	Latvia	3.4	5.1	1.5
63	Bulgaria	3.3	6.1	1.1
	Macedonia	3.3	4.8	1.5
	Romania	3.3	4.3	1.5
74	Croatia	2.7	3.9	1.5
75	Moldova	2.6	3.5	1.4
	Ukraine	2.6	4.3	0.5
	Vietnam	2.6	3.5	2.1
80	Armenia	2.5	3.2	2.4
82	Russia	2.4	4.2	0.6
84	Albania	2.3	3.0	2.1
	Georgia	2.3	3.4	1.8
	Kazakhstan	2.3	4.3	0.9
87	Kyrgyz R.	2.2	2.8	1.8
	Yugoslavia	2.0	3.7	0.6
	Uzbekistan	1.8	2.4	1.5
96	Azerbaijan	1.7	2.4	1.1
	Indonesia	1.7	3.3	0.4
98	Nigeria	1.6	2.6	0.6
99	Cameroon	1.5	2.4	1.3

(a) indicates the maximum standardized value given to a country by a source; in some cases it can exceed 10.
(b) indicates the minimum value given to a country by a source.

99 countries ranked, 14 more than in 1998. Of the newly surveyed countries, 13 are transition economies: Albania, Armenia, Azerbaijan, Croatia, Georgia, Kazakhstan, Kyrgyz Republic, Lithuania, Macedonia, Moldava, Mongolia, Slovenia, Uzbekistan.



Source: Transparency International.

sity of opinion regarding each country. The accompanying graph show the same presentation for the transition economies as well as Denmark, Germany and Japan.

A simple way to see the diversity of opinion in these corruption surveys is to look at the range of scores reported by different sources for each country. Take Russia, for example, which receives a very low average score of 2.4, placing it 82nd out of 99 countries in the CPI. However, at least one source rates Russia as high as 4.2, which would place Russia in the middle of the pack and comparable to Poland, whereas another source rates it as low as 0.6, which would place Russia on the bottom of the list.

In this Issue

Development Dividend of Good Governance

There is a growing consensus among academics and practitioners that good governance is a key ingredient for economic development. Recent research at the World Bank by Daniel Kaufmann, Aart Kraay, and Pablo Zoido-Lobatón provides new empirical evidence on the causal impact of better governance on better development outcomes—the "development dividend" of good governance.

Kaufmann, Kraay, and Zoido-Lobatón define governance as the traditions and institutions by which authority in a country is exercised for the common good. This includes the process by which governments are selected and replaced, the capacity of the government to effectively formulate and implement sound policies, and the respect of citizens and the state for the institutions that govern economic and social interactions among them. Using this definition as a guide, the authors:

- Gathered several hundred indicators of governance produced by 13 different organizations, including commercial risk rating agencies, think tanks and other NGOs, and multilateral organizations including the World Bank, covering more than 170 countries.
- Developed and implemented a new methodology to combine related governance measures from these many sources into six composite governance indicators that measure fundamental aspects of governance, namely *voice and accountability*, *political instability and violence*, *government effectiveness*, *regulatory burden*, *rule of law*, and *corruption*.
- Provided new empirical evidence of a strong causal link from better governance to better development outcomes

Their research points to three broad conclusions: governance matters for development outcomes, existing governance indicators are not very precise, and there is a need to focus on real reform and better measures of governance.

Good Governance Fosters Development

An improvement in governance—such as an improvement in rule of law from that in Russia to that in the Czech Republic, or a reduction in corruption from that in Indonesia to that in the Republic of Korea—leads to a two- to four-fold improvement in per capita incomes, a comparable decrease in infant mortality, and about a 20 percent improvement in literacy. Figure 1 illustrates the "development dividend" of better governance, using several measures of governance and several development outcomes. It is worth stressing that these results are not just simple correlations between better governance and better development outcomes. Rather, their techniques allow them to identify a causal effect *from* better governance *to* better development outcomes.

Ranking and Precision

While the composite governance indicators developed for this research are very useful for understanding the broad cross-country relationships between governance and development, not being very precise, they are less informative about the quality of governance in individual countries. Yet, a novelty of their methodology for constructing aggregate governance indicators is that it produces statistically sound margins of error around the estimates of governance for individual countries. In other words, there is some precision about the inprecision of the country estimate. This allows users of the indices to be relatively certain about the substantial uncertainty associated with

estimates of governance for individual countries. In light of these margins of error, it is misleading to offer precise rankings of countries according to their level of governance. Small differences in country rankings are unlikely to be statistically—let alone practically—significant.

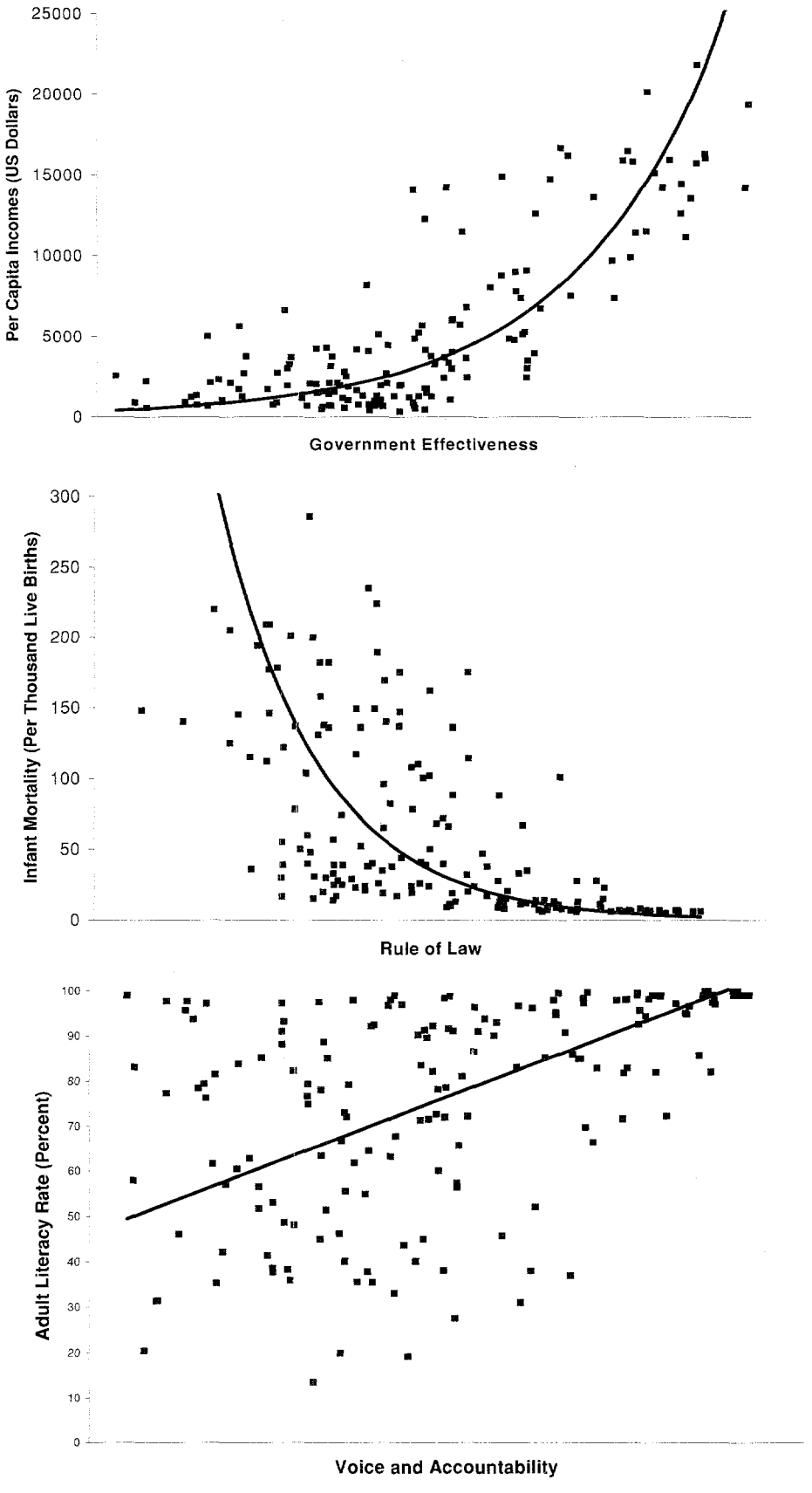
Diagnosing Causes of Misgovernance and Focusing on Real Reform

Composite governance indicators based on existing sources of governance data are powerful tools for drawing attention to governance issues. They are also indispensable for cross-country research into the causes and consequences of misgovernance. But they are a blunt tool for providing the basis for policy advice: they only provide an initial benchmark of where countries stand relative to each other on governance issues. Most countries, for any of the six previously mentioned governance indicators, could be placed into *crisis*, *high risk*, or *low risk* categories depending on the extent of systemic misgovernance risks. No further fine-tuning in rankings is warranted.

To help countries improve their governance, much more needs to be known about the country-specific policy and institutional failures that are reflected in perceptions of misgovernance in the existing data. Indepth country governance diagnostics are an essential tool to helping countries understand and design their own solutions to improve governance. Monitoring progress should focus on real institutional reform and rigorous, indepth, country-specific, and locally owned diagnostics.

This article is based on two recent World Bank Policy Research Working Papers of Daniel Kaufmann, Aart Kraay, and Pablo Zoido-Lobaton : "Aggregating Governance Indicators" (no. 2195), and "Governance Matters" (no. 2196). Both papers are available electronically at www.worldbank.org/wbi/gac.

Figure 1. Governance dividend



Source: Kaufmann, Kraay and Zoido-Lobatón (1999).

The Art of Attracting Foreign Direct Investment in Transition Economies

by Jacqueline Coolidge

Before the fall of the Berlin Wall in 1989, foreign direct investment (FDI) in Central and Eastern Europe was limited to a handful of joint ventures with state-owned enterprises. Early in the liberalization process, some of the most rapid reformers (such as Hungary and Estonia) opened their doors to FDI, while others maintained restrictions for many years.

Many countries in the region have experienced a hump or spike in their FDI inflows associated with privatization (notably the Czech Republic, Estonia, and Hungary, all strong performers in attracting FDI; see table), followed by a fall as they ran out of assets to sell to foreign investors. The key issue of the post-privatization era is how to attract FDI into greenfield ventures and into privately owned assets. While selling pre-existing industrial and commercial assets is usually possible if the price is low enough, foreign investors who might make greenfield investments are sensitive to the business environment and to market potential.

Transition Economies' Comparative Advantages

In the eyes of foreign investors, the Eastern European region has three especially attractive features:

- Low-cost but qualified labor.
- Long-term market potential.
- Access to rich natural resources.

The labor force in Eastern Europe is viewed as literate and skilled, but still rela-

Foreign Direct Investment Inflows in Central and Eastern Europe and Central Asia *(US$ millions)*

Country	1997 Population (millions)	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Albania	3			17.0	20.0	58.0	53.0	70.0	90.1	47.5	45.0
Armenia	4					0.8	8.0	25.3	17.6	51.1	70.0
Azerbaijan	8							330.1	627.3	1,114.8	1,023.0
Belarus	10				7.0	17.6	10.5	14.7	72.6	200.0	120.0
Bulgaria	8		4.0	56.0	41.5	55.4	105.4	90.4	109.0	505.0	200.0
Croatia	4				13.0	96.3	113.1	101.2	533.3	388.3	854.0
Czech Republic	10					654.3	878.2	2,567.6	1,435.3	1,286.0	1,400.0
Czechoslovakia, former	15	257.3	207.1	599.9	1,102.6						
Estonia	1.5				82.3	162.2	214.4	201.5	150.2	266.2	300.0
Georgia	5						8.0	6.0	40.0	50.0	50.0
Hungary	10	187.0	311.0	1,462.1	1,479.2	2,349.7	1,144.1	4,518.6	1,982.4	2,079.0	1,936.0
Kazakhstan	16				100.0	150.0	185.0	964.3	1,136.9	1,321.3	750.0
Kyrgyz Republic	5					10.0	38.2	96.1	47.2	83.8	55.0
Latvia	2.5				29.4	45.1	214.5	179.6	382.0	521.0	274.0
Lithuania	3.5				10.0	30.2	31.3	72.6	152.4	354.5	925.5
FYR Macedonia	2						24.0	25.0	11.2	15.7	18.0
Moldova	4			25.0	17.0	14.0	11.6	25.9	23.7	71.9	70.0
Poland	39	11.0	89.0	291.0	678.0	1,715.0	1,875.0	3,659.0	4,498.0	4,908.0	5,500.0
Romania	23		(18.0)	40.0	77.0	94.0	341.0	419.0	263.0	1,215.0	950.0
Russia	147				700.0	700.0	638.0	2,016.0	2,478.0	6,243.0	2,183.0
Slovak Republic	5					198.8	203.4	182.6	280.5	165.0	350.0
Slovenia	2				111.0	113.4	128.1	175.9	185.4	320.8	165.4
Tajikistan	6						10.0	15.0	16.0	20.0	18.0
Turkmenistan	5								108.1	85.0	130.0
Ukraine	50				170.0	50.0	159.0	267.0	521.0	623.0	640.0
Uzbekistan	24				40.0	30.0	50.0	115.0	55.0	285.0	200.0
Total	397.5	455.3	593.1	2,491.0	4,678.0	6,544.8	6,443.8	16,138.4	15,216.2	22,220.9	18,226.9

Source: FIAS

tively low cost. There are, however, long-term fears about the "brain drain" of technical professionals and the strong upward trend of real wages for skilled workers. Labor costs also are pushed up by high payroll taxes, needed to fund the high pension bills of a demographically mature population.

Central European markets benefit from their proximity to the mature EU market. Many producers in the global economy find it efficient to source some of their production in high-skilled, low-wage Central European countries and to export to Western Europe. The Baltic countries are similarly well placed for the Nordic market. Russia is a huge and lucrative potential market that excites many consumer-goods producers. But the Russian business environment is still considered poor detering all but investors who feel the Russian market is a "must."

Natural resources have been Central Asia's chief attraction for FDI, which has focused almost exclusively on the extractive sectors. Azerbaijan and Kazakhstan have attracted significant volumes of FDI into oil and gas, while the bulk of FDI in the Kyrgyz Republic has gone into gold mining. The business environment in these countries, however, is considered too poor to attract much manufacturing or service investment.

What Makes a Favorable Environment?

The Czech Republic, Estonia, Hungary, Poland, and Slovenia—countries selected for the "first wave" of EU accession—tend to have the most advantageous business environment and have attracted the most FDI (per capita or relative to GNP). These countries place few restrictions on FDI, offer "national treatment," have a relatively sound company law or commercial code, and impose no restrictions on current account transactions and few restrictions on capital account transactions.

Nonetheless, restrictions continue in some areas. For instance, several countries block foreign investors from acquiring full ownership of land, especially in agricultural areas, border areas, and other sites deemed sensitive or strategic. Poland and Slovenia have the most restrictive regimes for foreign land ownership, which may have deterred foreign investments in agribusiness. Other countries, like Lithuania, are ready to allow foreigners to own land, but foreign investments are put off by the uncertainties and lengthy delays involved in land acquisition. These concerns include the difficulties of restitution and land reform and the slow development of cadastral registries.

Investment incentives are becoming more sophisticated. In the early 1990s, most Central and Eastern European countries (with the notable exception of the Czech Republic) offered tax holidays. In the mid-1990s, several countries dropped these holidays, including Estonia and Hungary. Estonia maintained a flat income tax rate of 26 percent on most sources of income, while Hungary introduced a lower corporate tax of 18 percent. Both countries attracted high FDI inflows.

Some governments, including the Czech Republic and Hungary, concerned with the winding down of privatization programs and an expected dip in FDI inflows, introduced new tax holidays and other investment incentives. Some Baltic countries are now flirting with the idea of abolishing corporate income tax, although they would continue taxing dividends distributed to shareholders. Most tax experts advise against this approach; they find it distortionary and more difficult to administer than it might seem. Why? Because many employees would try to turn themselves into companies and contract their services back to their original employer—and almost all companies would disguise dividends.

Many Central and Eastern European countries severely restrict deductions for expenses that are routinely allowed in the EU and North America, including advertising expenses, business travel, inventory losses, and bad debts. Loss carry forward is usually very limited, and depreciation rates are unrealistically long. Progress is being made in this area, but it is slow and requires extensive technical assistance and training for the tax administration.

Several countries are introducing or considering more transparent and automatic forms of investment incentives, such as accelerated depreciation, more generous loss carry-forward, and investment tax credits or investment tax allowances that operate automatically through the tax code without need for prior screening and approval.

Another important aspect of the business environment is business regulation, including investment procedures. While many countries have a sound legal framework on paper, investors, in general, and foreign investors, in particular, complain that implementation is inconsistent, unfair, rigid, or corrupt. For example, company registration can take place within three days in Latvia, while it usually takes more than three months in Slovakia (that is, without a bribe).

Customs procedures can vary widely from one border post to another in Bulgaria. Running the gauntlet of the construction permit process takes about 18 months in Latvia. Romania has been plagued by a rapid proliferation of new fees and levies on producers—with accompanying regulatory procedures—over the past year. The list of problems can appear endless and often deters foreign investors, especially prominent multinational corporations that cannot risk being seen bending the rules, even if such behavior is the norm.

Several governments in Central and Eastern Europe—Bulgaria, Latvia, Lithuania, and Romania—have begun documenting investment procedures and business regulations, soliciting feedback from the private sector, and seeking advice on removing administrative barriers to investment. The Latvian government, for instance, is devel-

oping guidelines to improve the transparency and accountability of the various government inspectorates that enforce regulations in the workplace (for example, fire, safety, sanitation, and language inspection) and to remove opportunities for corruption by active input from the private sector—including foreign investors.

Corporate governance has proven to be a significant factor in FDI flows associated with mergers and acquisitions. Most Central and Eastern European countries are still relatively weak in protecting minority shareholders. In the Czech Republic and Slovakia, severe backlogs in bankruptcy proceedings are keeping otherwise interested foreign investors from acquiring and restructuring industrial and commercial assets that will get them back into production.

The New Frontier: Infrastructure

As private participation in infrastructure becomes more commonplace, there are many new opportunities for FDI. The country benefits from imported new technology and management techniques, in addition to the basic inflow of capital. However, many governments find themselves at a disadvantage in negotiating with foreign investors. These governments are new to the game, while foreign investors are very knowledgeable and experienced. This difference in experience points to a continuing need for advisory assistance.

Some governments that rushed to privatization, agreeing to many years of broad monopoly protection, are now being required by the World Trade Organization or the EU to renegotiate the deals and allow more competition. Even countries not required to renegotiate often feel a desire to do so in order to bring down excessively high tariff rates that are pricing communications-intensive service industries out of the market. Countries like Slovenia are developing a sound legal framework for private participation in infrastructure before moving ahead with privatization deals.

Linkages to Local Companies

Some CEE countries that have already attracted many multinational corporations to their shores are now keen to enhance the links between multinationals and local suppliers. In fact, a strong supplier base is considered desirable by those foreign investors with globalized production bases.

Multinationals often are willing to devote time, effort, and resources to work with some of the most promising of the local suppliers, helping to improve quality control, reliability, and responsiveness. Domestic firms that are competitive enough to supply multinationals are also the most likely to break into global markets on their own.

Jacqueline Coolidge is program manager for Europe and Central Asia at the Bank Group's Foreign Investment Advisory Service (FIAS).

Foreign Direct Investment: New Trends in Transition Countries

In 1998 the flow of foreign direct investment (FDI) into Central and Eastern Europe reached $23.7 billion, 5.9 percent higher than the previous year. Portfolio investments in the region declined after the Asian financial crisis—and declined further still after the Russian and Brazilian crises. However, flows of FDI capital, which tend to aim for longer-term opportunities and make more careful distinctions between regions and countries, increased in Central Europe and Ukraine in 1998, declining only in Russia and Belarus. As the **Report of the Economic Intelligence Unit (EIU)** points out, the region's share of global FDI fell from 4 percent to 2.7 percent; the lion's share of last year's rise was absorbed by the United States and the EU. FDI to Asia's developing economies fell by 11.5 percent, to African countries by 12 percent.

General Trends

Keeping track of FDI is no simple matter. The latest analysis from UNCTAD differs considerably from other assessments, including that of FIAS (see table page 5). For Poland, for example, UNCTAD calculates that FDI last year was a mere $5.1 billion, whereas the EIU puts the total at $8 billion and Oxford Analytica puts it at $7 billion. Poland's own foreign investment agency estimates the total at $11 billion. Despite the differing numbers, there is little dispute that Poland leads the region in absolute numbers. Several other trends can also be seen:

- The inflow of FDI to the 10 Eastern Europe countries that have applied for EU membership was $16.5 billion, $5 billion higher than in 1997.

- FDI inflows increased significantly over the previous year.

- Hungary is making the region's first successful shift to post-privatization FDI; 94 percent of investment went into greenfield projects last year, against 34 percent in 1995. Such investments support restructuring and economic growth more directly than takeovers.

- The region's prospects are becoming increasingly dependent on the longer-term development of demand in Western Europe, primarily Germany. The motivation for new FDI in Hungary has shifted from local-market activity to export-oriented ventures. In Poland, too—although the large and expanding domestic market attracts an increasing amount of investments—many new projects aim to export to the European Union.

• Southeast Asia is not a serious competitor of Eastern Europe in attracting FDI. While the main foreign market for Eastern Europe is Western Europe, multinationals settled in Southeast Asia concentrate their export activities on the U.S. and Japanese markets. Competition between European and Asian production sites is confined to Europe-oriented activities. However, this competition has intensified with the emergence of some Eastern European producers as viable alternatives to Asian firms—in the electronics industry, for instance.

The highest per capita inflow of FDI was registered in Estonia ($401) followed by the Czech Republic and Lithuania (around $250). Croatia, Hungary, and Poland came next with sums below $200 per capita. In Bulgaria, Romania, and Slovakia per capita FDI was below $100, and in Russia and Ukraine that number remained at around $15.

1999 Trends

Investment volumes in the first half of 1999 were generally higher than a year earlier, although this may reflect significant one-off privatization deals rather than a continuous trend:

• First-quarter Czech data show a boom in FDI with $608 million—almost three times more than in the first quarter of 1998.

• The Polish balance of payments registered an inflow of $1.14 billion in the first quarter, 13 percent more than last year.

• In Hungary $853 million was invested in the first six months, 23 percent more than in the same period of 1998.

• In Slovenia five-month data show a doubling of FDI to $45 million.

• Bulgaria reported some decrease and Romania an increase of FDI in the first four months of 1999, although these figures do not reflect the negative impact of the Yugoslav crisis. Several investment projects in Bulgaria and Croatia were delayed in May and June. However, a recovery of foreign investment activity in the Balkans might be expected in connection with increasing political stability since June and the progress of reconstruction plans. If Western European economies recover in the second half of this year, FDI in Eastern Europe may surpass the level of 1998.

FDI Stocks

As a result of an inflow of new capital, methodological changes, and exchange rate fluctuations, the stock of FDI in the region increased by 33 percent in 1998. Methodological differences make stock data less comparable across countries and years than flow data. FDI stocks in countries of Eastern Europe and the former Soviet Union reached $104.4 billion, $14.8 billion of it invested in Russia and $72.1 billion in the 10 EU-associated countries. Poland has the highest amount of FDI: $24.8 billion, if the estimation for the 1998 inflow of $7 billion proves to be correct. Hungary comes second with $18.3 billion. For the Czech Republic, revised data include not only equity capital but reinvested profits and inter-company loans, leading to a jump in FDI stocks to $13.5 billion.

The size of the FDI stock relative to GDP is generally used to assess the comparative attractiveness of countries to foreign investors. In this respect, Hungary, with FDI stocks at 38.5 percent of GDP, and Estonia, at 35.0 percent of GDP, are far ahead of other Eastern European countries. Indeed, they are among the leading FDI recipients worldwide. The Czech Republic and Latvia have more than the world average of 15 percent of GDP, while Lithuania and Slovenia are near the world average. In the western Balkans the stock of FDI is about 5–6 percent of GDP.

These data broadly reflect the progress of each country in terms of transformation, pace of economic development, and progress of privatization. The lack of basic economic stability in most of the western Balkans has been a major obstacle to investment. Countries bordering the EU are more attractive, owing to their stronger economies and faster transformation, as well as their geographic and cultural proximity. In the more stable Central European region, the choice of privatization method and speed of privatization sales have also been important. Fast sales of state-owned enterprises to the highest bidder allowed foreign investors to take a controlling position over most of the Hungarian manufacturing, financial, and retail sectors. Sales to foreigners were more selective in other countries, where voucher methods and leveraged sales to management dominated.

FDI Sources

Germany is the largest investor in Central Europe, followed by the United States. The stronger European capital-exporting countries—such as France, Italy, the Netherlands, Switzerland, and the United Kingdom—have a significant presence in almost all Eastern Europe states. Japan shows weak interest in the region. Like the Republic of Korea, Japan is involved in a small number of large projects. U.S. investors prefer larger than average-size investments, with Poland the number one target. Austria has a prominent role in this region, with its proximity compensating for the country's small size. In tiny Slovenia, for instance, Austrian investors rank number one, surpassing U.S. and German investors. Austria also plays a major role in Slovakia. Neighborly ties to Bulgaria and Romania lead to high levels of FDI support from Turkey and Greece. Russia is not a significant direct investor in the region, except in Poland.

FDI in manufacturing is concentrated in car production, electronics, and construction materials. In countries where telecommunications or banking privatization lags behind, manufacturing accounts for more than 50 percent of FDI. Only in Hungary is the manufacturing sector less than a 40 percent share, owing to the progress of privatization in all sectors of the economy, including utilities.

Information for this article was excerpted from Oxford Analytica, the Oxford (UK)-based International Research Group.

The Hidden Growth Potential of EU Candidates

by Tsuneo Morita

Central European countries have every opportunity to enjoy large-scale and steady economic growth in the first decades of the 21st century, assuming their economic integration with the European Union and a steady flow of foreign direct investment (FDI). Once the process of growth begins, continued growth and currency appreciation can be expected for at least 10 years, much like the experience of Spain and Portugal after joining the European Union.

Miscalculating Convergence

Economists who focus on EU enlargement are intensely debating when and how the per capita GDP of the highest income candidate countries (primarily the Czech Republic, Hungary, Poland, and Slovenia) will reach the lowest income membership countries in the European Union—Greece, Portugal, and Spain. According to some economists, there will be no convergence at all; what's more, the income gap is predicted to widen over time. Others believe it will take at least a generation for the East to catch up to the West.

There are some common defects in these calculations (tables 1 and 2):

- Central and Eastern European countries often are treated as one homogenous group, although some countries are converging while others are diverging.
- GDP, calculated as purchasing power parity (PPP), can lead to misplaced conclusions. (PPP means that the same goods sell for the same price in different countries if measured in a common currency—such as in dollars). For example, based on PPP, the 1995 GDP of the Czech Republic and Slovakia seemed extremely high because the currency of both countries was highly undervalued at the time.
- Post-socialist countries were hit by the transformation recession during the early 1990s, making it meaningless to discuss convergence based on data of that period.
- The applied growth models consider growth determinants such as the school enrollment rate, the population growth rate, and the rate of public investment compared to annual GDP. These rates are more or less similar in all European countries, including Central and Eastern Europe. But if the traditional growth models for convergence calculations ignore specific regional characteristics and factors that might accelerate economic growth during the transformation process, the result can be misleading.

Table 1. Calculations Based on Barro and Levine-Renelt Models

		Barro model government consumption = 10 percent (in percent of GDP)		*Levine-Renelt model investment = 30 percent (in percent of GDP)*	
Country	*Per Capita income in US$ (PPP based)*	*Projected per captia growth (%)*	*Number of years to converge to low-income EU levels*	*Projected per capita growth (%)*	*Number of years to converge to low-income EU levels*
Albania	538	7.10	63	6.28	75
Bulgaria	5,132	4.92	29	5.01	28
Croatia	4,142	5.38	32	5.48	31
Czech Rep.	8,173	5.44	11	4.40	15
Estonia	7,203	5.23	16	4.93	17
Hungary	6,211	5.28	20	5.02	22
Latvia	5,002	5.50	25	5.79	23
Lithuania	3,035	6.10	34	6.22	33
Macedonia, FYR	1,628	6.08	50	5.96	52
Poland	6,364	5.42	18	4.75	23
Romania	3,542	5.47	36	5.64	34
Slovakia	6,671	5.86	15	5.00	19
Slovenia	6,342	5.31	19	4.58	24
Average	4,922	5.62	28	5.31	31

Revalued Economy and Currency

System transformation—if carried out correctly—mobilizes the huge economic potential of the people that couldnot surface under the political oppression of old regimes. Transformation brings about qualitative changes to economic activities and induces gradual appreciation of production factors—land, labor, and capital. Once the labor force is properly combined with capital, technologies, and business opportunities, production surges. The inflow of FDI plays an important role in revaluing production factors in transition economies. In the long run, FDI helps to close the income gap between transition economies and Western economies. Traditional approaches to convergence usually neglect the appreciation component, although it is one of the major sources of high economic growth in transition economies.

Table 2. Convergence calculation based on neoclassical growth model

Per Capita GD	Countries included	No. of years to converge to half-way
Market rate		
1992-1995	24	∞
1992-1997	19	73
1993-1997	24	∞
1993-1997	19	69
PPP rate		
1993-1997	24	∞
1993-1997	19	44

Another potential growth factor ignored by traditional convergence calculations is the possible future revaluation of postsocialist currencies. Since the communist era most of those currencies—never exposed to a market valuation system—have remained undervalued. Almost all post-socialist countries have recorded two- or even three-digit inflation rates during the past 10 years of transformation; accordingly, they have continuously devalued their currencies.

Thus devaluation in nominal terms and appreciation in real terms were typical in Central and Eastern European countries in the past decade. The rate of devaluation usually lagged behind the inflation rate so the real exchange rate appreciated in dollar terms—but most transition currencies remained undervalued. It seems certain that during the ongoing integration process, Central and Eastern European currencies will gradually further appreciate.

Compared to other emerging markets, real GDP growth rates of Central and Eastern European countries proved modest over the first 10 years of transformation. However, growth rates in dollar terms at market exchange rates (domestic currency converted into dollars at market exchange rates) show an entirely different picture. These growth rates have been surprisingly high in almost every year of the transformation period.

The discrepancy between the two growth rates—real GDP and dollar-denominated GDP—can be explained by the continuous appreciation of currencies in real terms. This, in turn, reflects the steady revaluation of production factors in Central and Eastern Europe. The high GDP growth rate in dollar terms rapidly reduces the GDP gap between the relatively low income EU countries and the relatively high-income Central and Eastern European countries. This tendency will accelerate once the candidates join the European Union. Thus the convergence period may be much shorter than suggested by traditional calculations.

Table 2 shows that convergence for the Czech Republic, Hungary, and Poland ("high East")—with 1998 as the start off year—would be accomplished around 2010–2015, assuming that the growth rate of these countries outperforms that of Greece, Portugal, and Spain ("low West") by 7 percent every year. That seems an ambitious target. But convergence can be examined in another way: GDP, on the production side, consists of compensation to employees, operating surpluses, net indirect taxes, and depreciation. For simplification, we assume that GDP consists of wages and profits and that wages increase in proportion to profits.

Subsequently, we can consider convergence in terms of the number of years necessary to close the wage difference between the "high East" and the "low West" countries. Even if wages rise 10

Table 2A. Convergence time to the GDP level of Spain
(per capita GDP of 1998=US$13,950)

	Per Capita GDP in 1998 US$	Gap in GDP growth rate 3% years	4% years	5% years	6% years	7% years	8% years	9% years	10% years
Hungary	4710	38	28	23	19	17	15	13	12
Czech Rep.	5260	34	26	21	17	15	13	12	11
Poland	4075	43	32	26	22	19	16	15	13

Table 2B. Convergence time to the GDP level of Portugal
(per capita GDP of 1998=US$11,174)

	Per Capita GDP in 1998 US$	Gap in GDP growth rate 3% years	4% years	5% years	6% years	7% years	8% years	9% years	10% years
Hungary	4710	30	23	18	15	13	12	10	9
Czech Rep.	5260	26	20	16	13	11	10	9	8
Poland	4075	35	26	21	18	15	13	12	11

Table 2C. Convergence time to the GDP level of Greece
(per capita GDP of 1998=US$11,475)

	Per Capita GDP in 1998 US$	Gap in GDP growth rate 3% years	4% years	5% years	6% years	7% years	8% years	9% years	10% years
Hungary	4710	31	23	19	16	14	12	11	10
Czech Rep.	5260	27	20	16	14	12	10	9	8
Poland	4075	36	27	22	18	16	14	12	11

percent a year faster in the "high East" than in the "low West," it would take the three Central European countries about 15 years to catch up with the Western wage level. Thus the "low West" countries can maintain their competitive edge over this period, assuming a steady flow of FDI.

FDI Stimulates Growth

Data in most countries show that per capita GDP growth is closely related to per capita cumulative FDI. Hungary was once an exception. Until recently, Hungary received the most FDI among post-socialist countries (only lately has Poland overtaken it), but its GDP growth rate has hardly reflected the large FDI inflow. And despite the large inflow, the Hungarian forint barely appreciated in real terms. Several factors explain this unusual trend:

- Hungary inherited a heavy burden of external debt, and repayment of that debt has absorbed a large amount of external capital without causing appreciation of the currency.
- FDI has targeted privatized state companies, and so far much foreign capital has flown into infrastructure activities—such as banking and utilities—that have not yet contributed to expansion of production and increased value added.
- The level of capital accumulation is still low in Hungary. The domestic market is relatively small (with a population of 10 million people), and demand is limited due to the low income level (the wage level has not increased for 7–8 years in dollar terms, and the monthly average gross wage remains within the $300–350 range). FDI has contributed little to a deepening of the domestic market, which would boost the GDP growth rate.

These are the main reasons for the small real appreciation of the forint despite the large inflow of FDI. These same factors suggest that Hungary will experience a large takeoff in terms of real appreciation and GDP growth once the burden of external debt lessens and the leveling of the wage rate starts.

If History Repeats Itself . . .

How has convergence progressed for the current "low West" countries once they joined the European Union in the mid-1970s? A decade of slow growth pre-accession was followed by a decade of dynamic GDP growth in dollar terms at market exchange rates. This change can be attributed to the real appreciation of their currencies, which accounted for almost 80 percent of the GDP increase.

If history repeats itself, the emerging Central and Eastern European economies can look forward to 10 percent annual economic growth, measured in dollars at market rates, for at least 10 years after entry into the EU. If these assumptions are correct, the annual growth differential between the "low West" and the "high East" could be more than 7 percent, leading to rapid income convergence.

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Convergence? A Skeptical View from the East

by Joze Mencinger

When everybody is enthusiastic, when only benefits are seen and costs overlooked, and when doubts become annoying, economists should become concerned. They should be particularly concerned if they come from Central and Eastern Europe, where illusions nurtured over decades continue during transition with the added expectation that a capitalist market mechanism can instantly deliver welfare while political change can straightaway bring countries "back to Europe." In fact, transition has been slow and painful, with many setbacks. The aspirations of Central and Eastern European countries to join the European Union have encountered some reluctance on the part of EU members, who can easily visualize a future without them.

Both the enthusiasm on one side and the reluctance on the other are well founded. These emotions reflect an enormous asymmetry: the GDP of EU members is 40 times that of the 10 Central and Eastern European applicants; GDP per capita is 7.5 times higher. This asymmetry extends to the benefit side. The costs and benefits of expansion differ drastically for incumbents and potential newcomers. For newcomers, the EU market is just about the only market they have and therefore one they cannot afford to lose. They expect this market to bring them capital, well-paid jobs, and fiscal transfers. For incumbents, the potential benefits of expansion are meager and the costs could exceed the benefits for some time. Trade with Central and Eastern Europe represents only 3 percent of EU trade. Entry into the EU would not transform those small markets into large ones. EU countries can already reap the benefits of cheaper labor in Central and Eastern Europe under existing arrangements.

Expansion would enlarge the EU budget, so shouldn't present benefactors be willing to pay more or at least agree on sharing existing subsidies with the newcomers? The economic moral appears to be clear: EU expansion toward what the Central and Eastern European countries proclaim "a

State of Central and Eastern European Economies in 1997

Country	GDP growth	Current account balance as % of GDP	Inflation rate in %	General gov't balance as % of GDP	Foreign direct investment inflows as % of GDP	Unemployment rate, ILO definition	Exports of goods and services as % of GDP
Bulgaria	-6.9	4.1	1084.0	-2.6	4.8	15.0	61.3
Czech Rep.	1.0	-6.1	8.4	-2.2	2.5	4.7	57.6
Estonia	11.4	-12.0	11.2	2.1	2.7	10.5	77.2
Hungary	4.4	-2.2	18.3	-4.8	4.6	8.1	46.4
Latvia	6.5	-6.3	8.4	1.8	6.3	14.4	56.2
Lithuania	5.7	-10.3	8.8	-0.5	3.4	14.1	54.6
Poland	6.9	-3.2	15.0	-3.1	2.2	11.2	22.8
Rumania	-6.6	-6.7	155.0	-3.6	3.5	6.0	28.3
Slovak Rep.	6.5	-6.9	6.1	–	0.3	11.6	56.4
Slovenia	3.8	0.2	8.4	-1.1	1.8	7.1	54.3

Source: Compiled by the author.

political necessity and a historic opportunity" will most likely be overdue, and decisions will be based on political grounds only. Whether Central and Eastern European countries can fulfill the requirements is less relevant than whether the EU can afford the expansion. To preserve a facade created by promises, the EU could shift the blame to applicants and slow the entry process by inventing new hurdles until expansion becomes affordable or until current members can reorient subsidies and make changes in their own existing arrangements.

The institutional and administrative ability of the countries not only to formally accept the *acquis communautaires* of the EU but also to apply them in reality might be the real hurdle for accession. Formally, the institutions and know-how of a market economy can be reestablished by decrees, and most Central and Eastern European countries have been more than willing to copy them from the West. However, the gap in social behavior created by 40 years of socialism cannot be simply willed away. It is unlikely that market institutions borrowed from the West would actually operate in the East as they do in the West, where their creation was a gradual process over centuries of interactions between economic development, politics, and institutions of civil society. The "coming back" to a "normal" market economy can therefore only be a slow process; it may take decades before all Central and Eastern European countries have the proper institutional structures.

This brings us back to economic issues. Gradual convergence of Central and Eastern European countries with EU members is assumed—or pretended. Can convergence be confirmed by actual development? It appears that the initial positive effects of institutional changes on the economic performance of Central and Eastern European countries have been waning rapidly and that catch-up effects might end soon. The gap between EU and Central and Eastern European countries might expand rather than shrink.

The economic performance of the former socialist countries is typically measured using changes in inflation rates and interest rates, exchange rate regimes, existence of financial institutions and financial deepening, liberalization of capital flows, and the state of privatization. That the use of these criteria has been at least questionable was most dramatically shown by events in Russia. Perhaps these criteria should be replaced by sustainability of growth indicators linked to the current and capital account. This might be called the criterion of intrinsic or inherent economic growth, defined as growth of GDP combined with share of current account surplus in GDP. This is growth that is attained by an economy without reliance on foreign assistance, foreign loans, or the sale of assets to foreigners. The usefulness of foreign assistance in form of loans, acquisitions, or portfolio or direct investments by which a country might finance its current account deficit and development is thus not discussed at all, while methodological problems related to double counting are neglected.

The performance of the 10 Central and Eastern European applicant countries in 1997 indicates that high growth was accompanied by enormous current account deficits or a large share of foreign direct investments in GDP, particularly in the three Baltic countries (see table). Budget deficits were much lower, except in Hungary and two larger countries (Poland and Romania) with modest shares of foreign trade in GDP.

In 1993, which marked the end of Kornai's "transformational depression," four countries had a combination of GDP decline and current account deficit, two had decline and surplus, two had growth and deficit, and two had growth and surplus. In 1994 four countries combined growth with surplus, while in 1997 only Slovenia had growth without current account deficit. Since 1995 applicant countries have relied more and more on foreign savings to finance their current account deficits.

Thus the rather modest growth of GDP in applicant countries that followed the recovery from transformational depression has been accompanied by a constant worsening of the current account since 1995; intrinsic or inherent growth turned into decline by 1996. This might be a warning that the vitality of Central and Eastern European countries—specifically their ability to grow without reliance on foreign savings—is weak and fading. It also casts doubts on the assumption of convergence. In fact, the gap between EU and Central and Eastern European countries could grow rather than diminish, making delayed accession even more difficult than "premature" accession.

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EU Enlargement Process Keeps Rolling

The European Commission has proposed two major changes in the accession process for approval by the European Council, which will convene in Helsinki in December:

1. All 10 Central and Eastern European candidates—Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic, and Slovenia—as well as Cyprus and Malta should be included in negotiations. In 1997 the European Union opened negotiations with only five countries—the Czech Republic, Estonia, Hungary, Poland, and Slovenia.

2. The EU should set 2002 as the deadline for completing internal preparations for expansion. Such a scenario would require resolution of several complex and sensitive issues within the EU, including:

- Agreement on major internal reforms by the end of 2000, including the introduction of qualified majority voting in the European Council, giving more power to the European Parliament, and reassessment of the relative weight of member states' votes.

- Agreement on a further restructuring of the EU budget.

- Acceptance that even front-runner applicants must be allowed more than the minimal transitional period in expensive areas such as the environment, energy, and infrastructure.

Accession Negotiations

The latest of the Commission's regular progress reports envisages an overall acceleration in the expansion process, with the first occurring by 2004. Each country will move at a very different speed of negotiation. No longer will all candidates negotiate on the same chapters at the same time, but chapters will be opened only after the Commission has judged a particular country's preparations to be sufficient. This new approach essentially means that Bulgaria and Romania might join the negotiating process without actually negotiating for several years. Moreover, the Commission proposes reopening chapters that have been provisionally closed to include newly adopted legislation, suggesting that the conditions will be a perpetually moving target. Applicants will need to continue moving to align with an ever-growing body of EU law.

The EU has set additional conditions for starting negotiations with applicants that are behind in meeting accession requirements. Bulgaria has to close down the Kozludoi nuclear power plant, while Romania has to reform its state childcare institutions. Both countries are also required to implement specific economic measures.

Review of Accession Strategy

The original key criteria for membership to the EU, as defined at the Copenhagen summit of 1993, were:

- Stability of institutions guaranteeing democracy, the rule of law, human rights, and respect for minorities.

- The existence of a functioning market economy with the ability to compete within the single market.

- The ability to take on the obligations of membership, including support for the aims of the European Monetary Union.

Several new elements in the accession strategy will be activated over the next year, including:

- Revised Accession Partnerships, the documents that set out the EU's detailed short and medium-term priorities for each applicant, will be finalized.

- The EU's PHARE aid program will focus on institution building and investment in regulatory infrastructure, at 1.5 billion euros ($1.6 billion) a year. Further aid will come on-line from 2000 through two new instruments: ISPA (co-financing for investment in environmental and transport infrastructure, of 1 billion euros a year) and SAPARD (support for agriculture and rural development, of 500 million euros a year).

For the countries of the former Yugoslavia (except Slovenia, which is already in negotiations) and Albania, a new Strategy for Neighboring Countries offers the prospect of membership, but only under very strict conditions. In addition to the Copenhagen criteria, these countries would need to attain mutual recognition of borders, settlement of minority issues, and a regional framework for economic integration. The prospect of such a membership is not open to Russia, Ukraine, the Caucasus, and the Maghreb countries of North Africa, but the Commission proposes developing new cooperation initiatives that go beyond the trade and assistance programs so far on offer.

The Commission's assessment of candidates' progress is divided into sections on the political and economic conditions and other obligations of membership—taking on EU legislation and preparing to join EU structures such as the European Monetary Union and the Schengen agreement (which stipulated the free movement of persons and goods within the Union). There are two broad groups of Central and Eastern European candidates: the front-runners and new candidates (see details of the "report card" on the next two pages).

Information for this article was excerpted from reports of Oxford Analytica, the Oxford (UK)-based international research group.

EU expansion: European Commission assessments

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia
Relations with the EU	EU takes 50.6% of Bulgaria's exports, and provides 49% of its imports (rising to 60.3% and 49.3%, respectively, in first quarter of '99). Implementation of Europe Agreement is correct and smooth.	EU posts €2.4bn surplus in '98; EU accounts for 60% of Czech trade. Europe Agreement implementation "uneven", though problems solved by joint bodies. Czechs take anti-dumping steps against EU baby food.	Exports to EU were 70% of total in '98, imports from EU, 74.3%. Europe Agreement functioning correctly and smoothly, no trade problems. EU anti-dumping procedure against hardboard was closed.	EU posts €2.2bn trade surplus in '98. Europe Agreement functioning smoothly. Concessions to Israel will be dropped upon accession. EU anti-dumping hit polypropylene twine and some steel products.	Exports to EU were 56.6% of total in '98, imports from EU, 55.3%. Some hitches in relations, including Latvian duties on pork and restrictions on FDI in media, and EU anti-dumping against hardboard exports.
EU funding: [a] Phare funds, 1990-99 [b] Pre-accession aid, 2000-02	[a] €865.8m to date, €50.5m for '99 plus €14m catch-up facility. [b] Total for period: €390m Phare, €158.3m Sapard, €249m-375m ispa.	[a] €629.1m to date, €21m for '99 plus cross-border project funds. [b] Per year: €79m Phare, €22.1m Sapard, €55m-80m ispa.	[a] €187m to date, €8m for 1999 plus €3m for Baltic co-operation. [b] Total for period: €72m Phare, €36m Sapard, €60m-105m ispa.	[a] €1,303m to date, €102.9m for '99 plus €17m for crossborder. [b] Per year: €96m Phare, €38.1m Sapard, €70m-100m ispa.	[a] €248m to date, €16.1m for '99 plus €11m for crossborder. [b] Total for period: €90m Phare, €66m Sapard, €105m-165m ispa.
Stability of institutions guaranteeing democracy, rule of law, human rights and respect for and protection of minorities	Fulfils Copenhagen political criteria, but efforts needed to strengthen rule of law and protect human and minority rights, particularly Roma. Fighting corruption and improving judicial system merit special attention.	Fulfils Copenhagen political criteria, but further efforts needed to reform judiciary and improve situation of Roma, combat discriminatory attitudes. Needs effective policy against white-collar crime and corruption.	Fulfils Copenhagen political criteria, but needs to amend language law to integrate non-Estonian speakers into political and economic life. Fight against corruption also needs greater attention.	Fulfils Copenhagen political criteria, but faces criticism for failing to end discrimination against 600,000-strong Roma minority. Corruption needs more attention. Government role in public media criticised.	Fulfils Copenhagen political criteria, progress made integrating non-citizens, but needs to ensure that language law respects world standards. Work needed on judiciary, corruption and Latvian language instruction.
Existence of a functioning market economy as well as the capacity to cope with competitive pressures and market forces within the Union	Does not qualify as "functioning market economy", but is making sustained reform efforts. Hampered by adverse external environment and low starting point. Praised for macroeconomic stability. Urged to complete privatisation, speed up restructuring of enterprise and banking sectors, with special attention to liquidation and bankruptcy procedures. Impose financial discipline, particularly on state firms. Need for more work on stable and transparent legal framework for business.	Functioning market economy. But, alone among front-runners, "needs to make serious progress" to cope with single-market competition. About to be overtaken by Latvia in fast-track, and ranked after Poland, Hungary, Estonia and Slovenia. Deepening economic recession, but positive narrowing of external imbalance, reduced inflation. Progress made in bank privatisation and with bad loans. Needs speedy restructuring and privatisation, improved corporate governance.	Functioning market economy "where market forces play their full role". Should cope well with single-market competition provided structural reforms are finished. Ranked with Slovenia but after Poland and Hungary. Praised for macroeconomic stabilisation, high FDI, curbing external imbalances. Further reforms needed in oil-shale sector, in healthcare and pension reforms and in enacting better supervision of financial sector. Land privatisation should be accelerated.	Functioning market economy, and legal and institutional structures have been strengthened. With Poland, the region's top performer. Praised for macroeconomic stabilisation, lower inflation and sustained economic growth. Progress noted in pension reform (though recent reversals raise concern) and privatisation. But government needs to watch budget and current-account deficits, and enact healthcare reform in order to trim government spending.	Functioning market economy, needs to sustain macroeconomic stability and complete structural reform. Elevated to fast-track group, after Poland, Hungary, Estonia and Slovenia, and rivalling Czech Republic. Russia crisis wisely seized as opportunity to strengthen financial sector. Fiscal vigilance and privatisation of few remaining large firms needed, along with investment in infrastructure and labour force to improve productivity.
Adoption of the *acquis*: ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary Union	Praised, along with Hungary and Latvia, for "determined efforts" and steady rhythm of legal approximation. Progress on public procurement, standardisation, piracy, audiovisual legislation and liberalisation of telecoms. New VAT and excise laws closer to alignment. Particular problems with state aids, enforcement in agriculture, slow land restitution. Need to set timetable for closing Kozloduy nuclear plant. Shortage of people and funds hampers administrative enforcement.	Ranked at bottom with Poland owing to "sluggish" pace of work. Legislative change stalled by power-sharing agreement. Uneven progress. Advances in standards and certification, liberalisation of capital markets, and customs and borders. But other key internal market areas, such as intellectual property, public procurement, data protection, insurance, anti-trust, state aids and VAT/excise, reflect little or no movement. Risk of piecemeal approach. Unsatisfactory record in meeting short-term goals.	Steady but slow alignment with single market legislation. Progress good in intellectual property and data protection, free movement of goods and state aid monitoring. Further work needed on state aids, certification and standardisation, and customs code, tariffs and staffing. Institutional structures and human resources insufficient to implement and enforce the *acquis*, particularly in environment, agriculture, fisheries and regional development. "Capacity building" should be a budgetary priority.	Praised, along with Bulgaria and Latvia, for steady rhythm of legal approximation. Progress in most sectors, especially in public procurement and intellectual property, self-employment, standards and certification, and state aids. Pace of alignment in agriculture is slow. More effort needed in border management and health and safety at work. No progress in customs. Hungary is only applicant credited with "a reasonably consistent track record" in building institutions to implement and enforce EU laws.	Praised, along with Bulgaria and Hungary, for steady rhythm of legal approximation. Progress noted in free movement of goods and services, competition and state aids. Steady improvement in taxation, energy and rail transport, as well as environment. Work still needed in intellectual property, data protection and company law. Major effort required in telecoms, agriculture, fisheries, regional policy and financial control. Delays in public administration reform weaken enforcement capacity.

EU expansion: European Commission assessments

	Lithuania	Poland	Romania	Slovakia	Slovenia
Relations with the EU	EU posts €1bn trade surplus in '98, with exports to EU at 37.4% of total, *imports from EU*, 46.2%. Europe Agreement functioning smoothly. EU anti-dumpting hits urea, ammonium nitrate and cathode-ray TV tubes.	EU posts €12bn trade surplus in '98. Poland needs to remove *market access barriers* quickly. Poland raised farm tariffs without consulting *EU*. *EU anti-dumping* against hardboard, twine and steel wire.	EU posts €1.3bn trade surplus in '98. Europe Agreement functioning *correctly* and smoothly. Import surcharge imposed in Oct '98 was reduced from 6% to 4% in Jan '99 and will be lifted by end-2001.	EU posts €310m trade surplus in '98. Europe Agreement functioning smoothly. Slovak import surcharge imposed in Jun '99 in line with obligations. *EU anti-dumping* against urea and ammonium nitrate.	EU posts €1.5bn trade surplus in '98. Europe Agreement functioning smoothly. No anti-dumping measures in force, though complaint against stainless steel heavy plates was launched and withdrawn.
EU funding: [a] Phare funds, 1990-99 [b] Pre-accession aid, 2000-02	[a] €328m to date, €30m for '99 plus €10.5m for crossborder and catch-up. [b] Total for period: €126m Phare, €90m Sapard, €120m-180m Ispa.	[a] €2,050m to date, €230.5m for '99 plus €38m crossborder funds. [b] Per year: €398m Phare, €168m Sapard, €300m-370m Ispa.	[a] €1,203m to date, €166.9m for '98 plus €10m crossborder funds. [b] Per year: €242m Phare, €150m Sapard, €208m-270m Ispa.	[a] €415m to date, €69.5m for '99 plus €11.7m for crossborder. [b] Per year: €49m Phare, €18.3m Sapard, €35m-55m Ispa.	[a] €192m to date, €31m for '99 plus €7m for crossborder projects. [b] Per year: €25m Phare, €6.6m Sapard, €10m-20m Ispa.
Stability of institutions guaranteeing democracy, rule of law, human rights and respect for and protection of minorities	Fulfils Copenhagen political criteria, though work still needed in fight against corruption and reform of judiciary.	Fulfils Copenhagen criteria. Judiciary is independent, but court cases still take too long. Need for better fight against corruption, in part by reducing bureaucratic controls. Civil service law needs to guarantee open nature.	Fulfils Copenhagen criteria, but failure to act on needs of 100,000 institutionalised children could prompt downgrade. Independence of judiciary needs buttressing, corruption and anti-Roma prejudice need addressing.	Thanks to changes since Sep '98, Slovakia fulfils Copenhagen criteria. Praised for significant progress, but *de facto* independence of judiciary needs to be made *de jure*. Corruption and Roma need more attention.	Fulfils the Copenhagen political criteria. Two areas still needing attention are the streamlining and speeding up of the judicial and parliamentary processes.
Existence of a functioning market economy as well as the capacity to cope with competitive pressures and market forces within the Union	Does not yet qualify as "functioning market economy", but comes close. Completing reform agenda is precondition to being able to cope with EU competition. Macroeconomic shock from Russia has hurt fiscal and external balances. Budget deficit too high. Privatisation essential for financial sector, energy industry needs restructuring. More trade needs to go to EU and other developed markets. Investment in infrastructure and labour force needed to boost productivity.	Functioning market economy "with increasingly thriving private sector" and "appropriate legal and institutional environment for economic activity". Ranked tops with Hungary. Praise for macroeconomic stability, but concern about current-account and fiscal deficits, and lack of progress on reform of farming, fisheries and steel. Needs agricultural reform, restructuring, privatisation and further trade liberalisation to cope with EU competition in medium term.	Does not qualify as "functioning market economy": can't cope with EU competition. Situation is "worrying", and much effort needed to create suitable market economy. Macroeconomic instability and legal uncertainty deter FDI. Progress in privatisation but at high cost to budget. Exports falling despite depreciation. Financial discipline and restructuring loss-making firms should have priority. Need for medium-term strategy, more transparent and business-friendly legal environment.	Comes close to being a "functioning market economy", thanks to "courageous" policy decisions and new government's reform agenda. Efforts to rein in internal and external imbalances are bearing fruit. Plans under way for privatisation and restructuring. Capacity of banking sector to perform financial intermediation needs development, and bankruptcy legislation needs improvement and proper application. Fiscal reform necessary over the medium term.	Functioning market economy, ranked with Estonia but after Poland and Hungary in terms of ability to cope with single-market competition. Macroeconomic stability well rooted, and reforms given new impetus thanks to laws on banking and foreign exchange, the introduction of VAT, and agreement on pension reform. Structural reform needs to speed up, particularly privatisation of two state banks. Better corporate governance needed along with the restructuring of public utilities.
Adoption of the *acquis*: ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary Union	Progress noted in most areas of internal market, *particularly public procurement*, intellectual property, conformity assessment, free movement of capital and services, and anti-trust law. But enforcement needs strengthening, particularly in fighting piracy. Major effort needed on audiovisual law and taxation. Progress in environment, though level of compliance is uneven. Praise for decision to close *Ignalina nuclear power* plant. Much work awaits in customs, regional policy and financial control.	Ranked at bottom with Czech Republic owing to "sluggish" pace *in transposing* legislation and "sketchy" progress in areas covered by *acquis*. Good alignment in free movement of capital and services and financial control, but lagging on adoption of key internal market legislation (industrial and intellectual property, data protection, conformity assessment, and certification), free movement of people and *state aids*. "*Inertia*" and short-term measures in agriculture will hinder adaptation to CAP.	Alignment with internal market laws only partial. *Some progress on public* procurement, banking and standards but overall framework legislation is lacking. Bankruptcy rules still out of sync. Romania gives low priority to the environment, and serious problems in air, water and waste need urgent political attention. Lack of funds and weak administrative capacity impede enforcement. Public administration reform has *not yet started in earnest*. Independence of regulatory bodies, including central bank, not assured.	Important progress made on internal market alignment, *particularly in public* procurement, standards and certification, competition, and state aids. Transparency and shareholder protection improved in banking. Social dialogue enhanced. Praise for pledge to close Bohunice nuclear reactor. But much needs doing, especially in environment, regional policy, and health and safety at work, to make up for past inertia. *Civil service reform* is crucial, and regulatory bodies need guaranteed independence.	Significant acceleration in legal adaptation and "*impressive progress*" *in* most areas of *acquis*, including standards and certification, data protection, capital liberalisation, VAT and anti-trust. New company law has removed restrictions on foreign participation. Alignment in social affairs is already high. But state aids and free movement of people, capital and services need attention, particularly insurance. Proper *administrative structures* ready for establishment: Slovenia needs to guarantee them sufficient funds.

World Bank Facilitates Candidates' EU Entry

Through financial and technical assistance and advisory services, the World Bank is helping to ease the accession of the 10 transition economy candidates—all members of the Bank. Some examples of the Bank's efforts include:

- Financing projects that help the accession countries meet EU norms and requirements. Examples include renewable energy projects in Hungary, Lithuania, Poland, and Slovenia; a solid waste management project in Latvia; new roads and road safety projects in Poland and Romania; and railway restructuring and construction in Lithuania and Romania.

- Providing budgetary support to accelerate reforms, including privatization of enterprises and banks and restructuring of the agriculture in Bulgaria and Romania.

- Assisting the public sector to more efficiently use its resources and improve the fiscal balance in the long term. There are pension reform initiatives in the Czech Republic, Hungary, Latvia, Lithuania, Poland, and Slovenia, public expenditures and civil service reforms in Hungary, Lithuania, and Poland, and tax reform and tax administration capacity building in Latvia and Poland.

- Proposing solutions for minimizing potential costs of adopting EU regulations and policies. This includes helping Poland introduce EU environmental standards with least possible cost.

- Providing detailed economic analysis in individual countries, focusing on the accession to the European Union. Country Economic Memorandum have been completed for the Czech Republic, Estonia, Hungary, Lithuania, Poland, Slovakia, and Slovenia.

- Organizing cross-country programs—including studies, workshops and conferences—to derive lessons for all acceding countries and support their European networks.

Research by the World Bank's EU Accession Team focuses primarily on macroeconomics and growth issues, public expenditure management, and social issues. The team closely collaborates with the European Commission and intends to analyze accession experiences of current EU members, in particular Ireland, Portugal, and Spain. The team is working on the following areas:

Studies

Macroeconomic Management of Structural Funds. The candidate countries may receive significant financial assistance (in the order of 2 to 3 percent of GDP) from the EU. Together with a probable surge in private capital inflows, absorbing these funds while avoiding overheating (by inflation, increases in the current account deficit, or both), and a decline in competitiveness will be a challenge. While a large body of literature on capital flows exists, the team study would analyze if and how the process of EU integration changes the standard policy recommendations in dealing with surges in capital inflows. Comparing the experiences of three current EU countries, as well as several more advanced candidate countries (such as Hungary) will provide useful policy lessons.

Growth Impact of Structural Funds. Structural funds have been important means of financial assistance of the EU to its poorer member states and regions. This team study would analyze the growth impact of structural funds on both national and sub-national units in current member states such as Ireland, Portugal, and Spain.

Public Expenditure Management and Structural Funds. The work area in this area will focus on best practices and issues of fiscal and budgetary management of structural funds in sub-national units. This study will draw on the experiences of Ireland, Spain, and Portugal, and it will look at developing practice in Bulgaria, Hungary, and Poland.

Wider Measures of Real Convergence. This study will analyze real convergence in recent EU members and the 10 candidate countries using a wider set of indicators than just per capita income. It would analyze the extent to which wider sets of indicators suggest similar development performance, both in terms of levels and deltasbefore and after EU accession.

Safety Nets and Competition. Both domestic and external liberalization of product markets have increased competition dramatically in Eastern Europe, in particular as imports from the EU are being eliminated. The work program in this area would analyze whether existing systems provide adequate safety nets to displaced workers, and will also discuss how the systems could be improved.

Prague 2000. This is an important report of the **Prague 2000** series. The transition in Eastern Europe has been largely successful, and the report will demonstrate how proximity to Europe (in the wide sense of the term) has helped the transition to a market economy. While adopting the "acquis" is largely beneficial to the candidate countries, the report will also discuss how implementation needs to be carefully sequenced and complemented with actions in structural areas mostly outside this acquis (especially in the social areas) to maximize the benefits of EU accession.

Conferences, Seminars, and Workshops

Workshop on Public Finance Priorities for EU Accession. The objectives of this

workshop are to assist our clients in building public administration capacities to identify and implement public finance priorities, to share the experiences of EU member countries in enhancing efficiency and prudence in public finance decisions, and to promote the role of civic society in the EU accession process so as to strengthen public finance institutions. The seminar is to be held in Helsinki in collaboration with the government of Finland and the European Commission in spring 2000.

Labor Markets Conference on "Labor Markets and the EU Enlargement Process-Changing Perspectives and Policy Options." This workshop on labor market issues will disseminate cross-country policy papers and papers prepared as parts of country economic memorandums in the Czech Republic, Hungary, Poland, and Slovenia. The seminar is to be held in Vienna in February 2000 in collaboration with the Kreisky Forum and the European Commission.

The Fourth European Borrowers Network (EBN) Seminar focusing on " Development of Government Securities Markets and EU Accession." The Fourth EBN seminar focuses on another EU accession topic, the development of government securities markets. Once gain, the seminar will be co-sponsored by the European Commission and will take place in Krakow, Poland in April 2000.

Joint World Bank-Bertelsmann Foundation workshops on EU Integration. The objective of this partnership is to establish both a physical and electronic network of economic and political research institutes in the EU accession countries for the promotion of cross-border dialogue on key political, social, and economic issues that are pertinent for EU accession. Two or three workshops are to be organized in fiscal year 2000. The dates, locations, and topics of these seminars have yet to be determined.

Independent Think Tanks Roll On in Transition Economies

Interview with Raymond J. Struyk

*A new book, **Reconstructive Critics, Think Tanks in Post-Soviet Bloc Democracies**, by Raymond J. Struyk of the Urban Institute, evaluates the efforts of private, independent, policy-oriented research institutes—in other words, think tanks—in transition countries. Struyk surveyed 37 institutes in Armenia, Bulgaria, Hungary, and Russia. Because think tanks identify and analyze policy options and make their findings widely available to the public, they can play an important role in strengthening democracy in transition economies. The author, a senior fellow at the Urban Institute and senior analyst in the fields of housing policy, housing finance, and community development, has had a major role in the establishment of the Institute for Urban Economics in Moscow. The following is a recent interview with the author by **Transition** editor Richard Hirschler.*

Q. What is the real significance of think tanks in transition economies?

A. Without doubt, democratic government and economic performance are closely interrelated. A strong economy improves the decisionmaking environment simply by promoting political stability. Representative government is likely to restrain large investments in low-return prestige projects. Democracies are associated with higher levels of education and better health among their populations, which in turn brings about higher growth. Think tanks—private public policy research institutes—can strengthen a country's democratic institutions, improve the decisionmaking process, provide policy advice and alternative solutions, and engage citizens—either directly in policy debates or through the dissemination of information—to take responsibility for the conditions in their country. In short, think tanks also help develop civil society.

Q. How many think tanks are operating in the countries of Central and Eastern Europe and the former Soviet Union?

A. The 1997 tally of Freedom House in Budapest suggested that 106 think tanks were operating in 11 transition economies of Central and Eastern Europe. The smallest number was reported for Macedonia (3) and the largest number for Hungary (21). About 40 percent of the think tanks identified were already in existence in 1991, including some National Academy of Sciences institutes and some reconstituted former state organizations. Only about a quarter of those included were created after 1993. And most are small operations.

Q. In your book you categorize think tanks according to their different stages of development. What are the criteria?

A. First-stage think tanks are in the start-up phase (which may last indefinitely) and are characterized by a permanent research staff of one or two, a small administrative staff, basic financial and administrative systems, and significant instability in the level of operations. This group has been the focus of most of the training of the donor community, often receiving the same help as other NGOs.

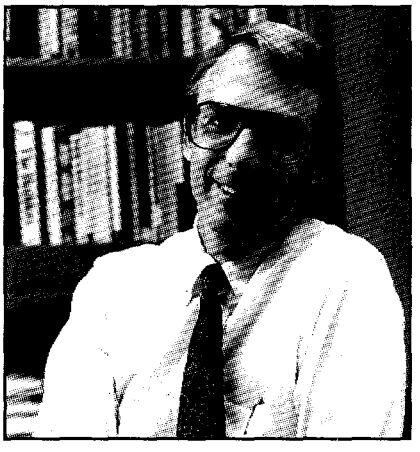
Second-stage institutes are at the point where they move to a higher level of activity—larger staff, more projects, more opportunities in the policy process and for educating the public on current policy issues. A permanent research staff of 8 to 10 is an important indicator of attaining this status. Perhaps one-quarter to one-third of the think tanks in the Eastern Europe-CIS region are in this group.

Those in the third phase of development are established think tanks in the West such as the Brookings Institution and the Urban Institute in the United States and the Institute fur Wirtschaftsforschung in Germany.

Q. So what is the real impact of think tanks in these countries?

A. There is no question that think tanks influence the policy development process. But when one asks a group of senior policymakers where they obtain information for their decisions, generally think tanks are not prominently mentioned. Actually, only about 25 percent of policymakers interviewed reported working regularly with think tanks.

Q. The role of Western governments, foundations, and other institutions has clearly been critical in supporting the formation of many of these institutions. Will they survive a waning of Western interest and financial support?



A. Survival will definitely be a challenge for many of them. Nevertheless, a principal finding of my book is that a few think tanks are engaged in strategic planning for a future with sharply less Western funding. Others are positioning themselves for the withdrawal of Western funding by making alliances with political parties and business associations. And a few more, really the best, are engaged in active programs of client and topic diversification. The Institute for Urban Economics in Moscow, for example, set up the country's first credit rating agency as a for-profit subsidiary. The

Urban Institute: A U.S. Think Tank in Eastern Europe

The International Activities Center at the Urban Institute (UI) has provided technical assistance to help solve social and economic problems in more than 40 countries since 1983. Based in Washington, the UI is a nonprofit, nonpartisan, public policy research organization. The Institute's involvement in Central and Eastern Europe and the former Soviet Union is focused mainly on creating new systems of local governance grounded in market and democratic principles. With policymaking and service delivery responsibilities shifting from central governments to local governments and the private sector, the UI has focused on developing efficient and sustainable local capabilities.

Building Credit Markets. UI experts have offered support to local governments seeking to finance infrastructure development and public service delivery—water supply, waste removal, roads, and mass transport—by building stronger credit markets. Beginning in 1996 the UI worked with the Czech Ministry of Finance and commercial banks to create the Municipal Infrastructure Finance Program, a financial intermediary designed to reduce municipalities' reliance on central government for infrastructure financing. By making capital funds available to municipalities through commercial banks, the program has increased competition among banks, lowered municipal interest costs, and lengthened terms for commercial bank loans. The UI has examined similar municipal finance and credit issues in Albania, Croatia, Poland, and Romania.

Assisting Housing Finance. The UI has been deeply involved in easing the difficult shift to private housing markets in the region. The UI has provided technical assistance in the development of several demonstration projects in Russia, beginning in 1993 with a project that introduced competitive, private maintenance for municipal housing in Moscow. Initially, three private firms took over management of 7,000 rental units following a competitive procurement process. Maintenance improved at no additional cost and, in 1998, the program expanded to cover nearly 1 million units.

A second major demonstration project in Moscow, based on simulations conducted by a UI team, enacted a program of significant rent increases combined with the introduction of housing allowances. The largest component of the UI's technical cooperation program in Russia has been the establishment of long-term mortgage lending. On a pilot basis, the UI team prepared one of Russia's largest banks to make financially responsible mortgage loans. By the summer of 1996 the UI had worked with an additional 30 banks to help them begin or expand mortgage lending. Housing privatization and housing financing projects are also being conducted in, Slovakia, Hungary, and Poland.

Support for Policy Analysis. The UI considers the building of local capacity for policy analysis as important as the direct technical assistance it provides in Eastern Europe. The UI was instrumental in the foundation of the Institute of Urban Economics in Moscow, which provides analysis and guidance to policymakers on a range of public policy issues. More recently, the UI has helped support the formation of the Transition Policy Network, an alliance of independent think tanks that work on public policy issues across the region. So far, the Network extends to Albania, Armenia, Bulgaria, Hungary, Poland, Romania, Russia, and Slovakia.

Think Tank Archetypes

In Europe think tanks are often more closely aligned with political parties, business associations, labor unions, and ministries that do high-quality work to develop or support the policy positions of the institutions to which they belong. In the United States think tanks generally operate with more institutional independence. According to their activities, there are three major types of think tanks.

Universities without students. These privately funded institutions do high quality technical research, competing in quality with university faculties. They distinguish themselves from universities in the policy orientation of their research. They analyze the ultimate implications of broad policy choices, such as changes in the tax regime, not with current legislative proposals. Their output is oriented to the policy community. In the United States, think tanks in this group, such as the Brookings Institution and the National Bureau of Economic Research, are the oldest and most venerable.

Contract research organizations. The primary source of funding for institutions in this group is government contracting. The primary products are technical papers and reports for government agencies, but these are often converted into journal articles or harder-hitting policy briefs. The contract work may be balanced and complemented by funds from foundations to undertake research on other topics, extend research funded by government agencies, and disseminate the results of agency-funded research for other audiences. While much of the research undertaken could, in principle, be done by agency staff, external contracting is preferred because of staff limits and to ensure objectively in the analysis and better guarantee the quality of the work. In the United States the Rand Corporation and the Urban Institute are among the most prominent contract research organizations.

Advocacy tanks. These institutions combine a strong policy, partisan, or ideological bent with aggressive salesmanship and an effort to influence current policy debates. Advocacy tanks seldom conduct sophisticated research themselves. Rather, they repackage and summarize work done by others to support their position. They work hard at presenting information in crisp, brief, and readily understood formats. What advocacy tanks lack in scholarship and objectivity they make up for in access to senior policymakers in both the legislature and government agencies. In the United States the best known of the advocacy think tanks is the conservative Heritage Foundation.

Because the U.S. model was introduced to Central and Eastern European and CIS countries by U.S. foundations, which were active in the early days of the transition, most think tanks in the region have adhered to the U.S. model. But as U.S. foundations are leaving the scene, more and more think tank adhere to the European model. In the transition economies support for "universities without students" has come more from abroad than locally. Governments appear to have done relatively less contracting for policy research than their Western counterparts. Advocacy think tanks, however, are relatively more numerous than in the West.

agency, since affiliated with Standard and Poor's, is doing well and helping support the Institute's main research activities. Similarly, the Center for the Study of Democracy in Sofia uses its independent survey research center to take commercial contracts as well as to conduct the scientific surveys needed by the Center. These revenues support the main operations. These are exciting examples, but are exceptional.

Western support is likely to be withdrawn in stages. Many Western foundations will probably be the first to exit, followed by the bilateral donors. The World Bank and IFC will stay longer. And the European Union programs will remain active even longer than others, particularly in countries with prospects for early accession to the EU. This sequencing means that think tanks will have some time to adjust, and the survival rate may be higher than one at first might think.

Q. After extensively studying these institutions what are your proposals to increase their effectiveness?

A. I would advise institutes at any stage of development to improve their policy recommendations. Policymakers in the four study countries complained that recommendations were often too general, too long, not based squarely on the analysis, seemed to be politically motivated, and frequently didn't address the demanding budgetary and administrative issues. The other issue is the media strategy. Although the general perception is that think tanks are engaged actively with the media in educating the public on current policy issues, in fact, more often think tank directors are delivering their personal view rather than speaking on behalf of the institute's research team. Think tanks need to take a step back and determine how best to exploit their advantage in the news arena as research organizations.

Q. Any suggestions for stage-one think tanks?

A. Several do not have a prestigious board of trustees or do not publish an annual report—some do neither. The lack of a board denies the think tank the advice of experienced individuals and the marketing advantage of the board members' association with the think tank. Similarly, the lack of an

annual report limits the think tank's record of accomplishment and reduces its visibility to the donor community and other potential sponsors.

Q. How can stage-two think tanks improve their performance?

A. First, they can put their financial management in order. They should establish indirect billing rates and have a clear strategy for external audits. Most think tanks have not established an indirect rate or an overhead rate that includes cost items that are difficult to assign and bill directly to each project. Thus they often are not able to request funding for these items. Audits are key elements to establishing credibility with sponsors, particularly for large projects. The question is how much should be invested in an audit, which in turn depends on the institute's vision of the nature of its future opportunities.

Second, strategic planning is often missing. One of the greatest challenges to all but the largest and most established think tanks is to modify the research and policy agenda and its sources of support in concert with the shifting principal policy questions facing the country and the interests of its supporters. In fact, very few think tanks have a conscious strategy for the future. Nor do they have consultative processes that lend themselves to developing one.

Third, the personnel strategies of think tanks should include adopting the part time rather than the full time staffing model and provide staff with feedback on their performance. Finally, it is surprising how little attention many think tanks pay to monitoring or controlling the quality of their product. Some think tanks, for example, are not using dissemination techniques designed with busy policymakers in mind—their reports are too long and too academic. So improvements are needed.

Raymond J. Struyk's book is available from the Urban Institute Publications Office. Address: 2100 M Street, NW, Washington, DC, 20037, tel: 877-847-7377, email: pubs@ui.urban.org, web: www.urban.org.

Russia: Rise of a Dual Economy

by Pekka Sutela

Russia has changed profoundly in the past 15 years. It is no longer governed by a single socialist party that imposes its official ideology on the citizenship. Russian society has opened itself up to the rest of the world and to a new pluralism of views and ways of life. All of this was unthinkable during the many years of closed Soviet socialism.

The Russian economy has also changed. It is transforming itself from a centrally managed to a market economy—but a very peculiar market economy. The economic stagnation that began a quarter of a century ago has become a steep production decline. Inequality has also increased, and mass poverty has become a fact of life. Russia's economic decline is unprecedented in recent economic history. Most surprising, the decline has taken place in a country well-endowed with natural resources, a relatively well-educated labor force, and rich industrial and technological traditions. For Russia the abnormal seems to be entirely normal. The question to ask is what surprises does the future also have in store?

A Coming Boom?

Whatever happened to "the coming Russian boom," the one prophesied by Layard and Parker just a couple years ago? Russia's initial conditions were always understood as worse than those in Central Europe: its distance from a market economy was greater, its socialist period lasted longer, its structural deformations (such as the share of military and civilian heavy industries) were greater, its socialist economic reforms were negligible, its economy and society were more closed, and the share of the private sector in its economy was almost nil. Russia also lacked such forces of civil society as the Catholic Church (as in Poland) or an independent intelligentsia (as in Hungary). The introduction of transport costs, absent under Soviet planning, induced great relative price shifts in the geographically enormous Russia. The dissolution of the Soviet system exposed the absence of several critical institutions in Russia.

The list of Russia's handicaps is even longer than this one. But the scales can be counterweighted, perhaps, by three factors:

- Russia could count on foreign assistance because of its size and history of military and political importance.
- Because natural resources were underpriced relative to manufactures during the Soviet era, Russia could expect to gain from a huge price shift relative to manufactures.
- Abundant natural and other resources, such as education and technology, might become a bonus for growth.

But how positive are these factors? The relative ease with which Russia has received foreign assistance—witness the repeated easing of IMF conditionality—may well have been a burden in disguise, as Russia has been able to substitute assistance for reforms. As for natural resource endowments, while it is true that Russia gained handsomely as a higher share of energy exports have been priced at world market levels, this windfall may have contributed to the further concentration of Russian exports on basic commodities. Experience also advises caution: worldwide it is clear that bountiful natural resources are more often a handicap than a source for growth and prosperity.

Four Features of the Russian Economy

In assessing the potential of the Russian economy, four specific features of the economy demand special attention: duality, distribution of property rights, nonmonetary aspects, and regional influences.

Dual Economy

Russia has the markings of a dual economy. It has a dynamic export sector consisting of oil, gas, raw materials, and some basic processed goods like chemicals. And while these exports generate about one-fourth of Russian GDP (this is no longer a closed economy), they provide only a small number of jobs. Most jobs are in the domestic branches of the economy. So, while many raw and basic processed materials are exported, Russian industry and services mainly produce goods that are competitive only in home markets—resulting in undervaluation of the ruble and low real wages.

A dual economy is sustainable and may generate growth—particularly when commodity prices are high. That fact has been demonstrated by many commodity producers in developing countries. But a dual economy also provides little welfare for most of the population and tends to generate wide income differentials. A dual economy, therefore, has an authoritarian tendency.

Although Russian officials talk about maintaining and developing the technological basis of the economy, recent Russian policies have contributed to the creation of this dual economy. If this trend continues, Russia can remain Europe-oriented in her foreign economic policies, but it will be a one-sided integration with the world markets, because domestic jobs need protection. Domestically, a crucial question would be the willingness and ability of the central authorities to tax some of the revenue received by the exporters to use for infrastructure maintenance and redistribution. This tax revenue would also need to be shared across regions, whose exports earning potential is very unevenly distributed.

Property Rights

Russia's distribution of property rights is unique. As a consequence of the mass privatization path chosen, company insiders own most Russian industry, agriculture, and services. Employees are quite often majority owners, but managers are always the active owners. The position of insiders was strengthened by the 1998 crisis, as their potential challengers—domestic and foreign outside investors—lost the ability or appetite to invest in Russian firms. Because there is no previous experience with property rights, any speculation on their economic impact must be tentative. But theoretically and in recent practice such inside owners:

- Have little, if any, resources for investment other than the cash-flow generated.
- Tend to see their position more in terms of power than as economic agents.
- Tend to concentrate more on job and social benefit provision than efficiency and structural change, undertaking more defensive than aggressive restructuring.
- Often see their companies as personal fiefdoms to be exploited for private benefit. Insider ownership thus might be good for jobs but it is bad for efficiency, competitiveness, welfare, and growth.

Nonmonetary Exchange System

Russia may be a market economy but it is not really a monetary economy. Ordinary market economies and transition economies usually have a M2 (the wide money stock, consisting of cash and deposits) to GDP ratio of 60 percent or higher, depending on characteristics of the financial system. In Russia the ratio of ruble M2 to GDP was never close to 20 percent and is now below 10 percent. In addition to rubles, Russians hold and an unknown but pre-

Russian Upturn—Helped by Devaluation

A closer look gives some insight into the problematic character of the recent industrial upturn in Russia. Industrial production has surged since October 1998 so that in January–May 1999 it was up 1.5 percent from a year earlier. Year-to-year growth in May was 6.1 percent. But this growth should be seen against the backdrop of ruble devaluation. During the first half of 1999 the ruble real exchange rate was still some 40 percent lower than the previous year. The price competitiveness of Russian producers has thus improved hugely. This fact is reflected in January–April imports that were an astonishing 47 percent lower than in January–April 1998. Russian companies have gained market shares in domestic markets, and there has been improvement in traditional export branches. During the first quarter the best performing branches were wood and paper, chemical and petrochemical, construction materials, and nonferrous metals. Still, in spite of such improved price competitiveness, Russia has been unable to introduce new export commodities. Overall, January–April exports were down by 10 percent, showing that the actual problem continues to be real, not price, competitiveness.

Russia simply seems unable to produce manufactures that foreigners might wish to buy—even at post-devaluation prices. A trade account surplus of some $20–25 billion is expected for 1999, but that is a consequence of imports that declined even more than exports. The downside of a weaker real exchange rate is that statistical real wages are still 25–30 percent lower than the previous year. May retail trade turnover was 16 percent lower than in 1998, and light industry output collapsed by 17 percent during the first quarter. As investment also continues to drop (by 11 percent during the first quarter), surging industrial production was unable to translate into GDP growth. In the first quarter GDP was still 4 percent lower than in 1998.

sumably large amount of dollars abroad, as a store of value. Also, a variety of quasi-monies—usually IOUs issued by the authorities, banks, and companies—are used. Finally, about half the industrial production is based on barter.

While the ingenuity of complicated multilateral barter arrangements is admirable, a nonmonetary exchange-based economy has several handicaps:

- Barter arrangements are costly and cumbersome.
- The acceptance of quasi-monies and offsets as tax revenue reduces revenue liquidity, to the detriment of fiscal policy effectiveness.
- The use of regionally based quasi-monies tends to destroy the unity of Russia's economic space.
- The wide use of nonmonies lowers enterprise cash flow and contributes to tax and wage arrears.
- An economy with several exchange systems is unstable and difficult to regulate by economic policies; with little money in use the possibilities of generating savings to be channeled into investment finance are modest at best. Therefore, these peculiarities of the Russian economic system go a long way toward explaining why the economy continues to contract, why investment is still declining fast, and why, as a result, the prospects of investment-based growth are slim.

Regional Decisionmaking

Russia, once a unitary state, is undergoing long overdue regionalization, but with little design and consistency. Russia's regions, with an average population of 1.9 million, are too small to become true economic agents on their own. A single large industrial enterprise is usually depended on for jobs, social services, and tax income and is often a hotbed of cronyism, insider deals, and corruption. In principle, regional decisionmaking is close to the population and easier to monitor than central decisionmaking. In practice, however, regional economic policies are often worse than those that the center wants to pursue. But there is also a silver lining: some good practices have spread from one region to another—a solid argument for the competition of foreign and domestic investment.

Can Something Be Done?

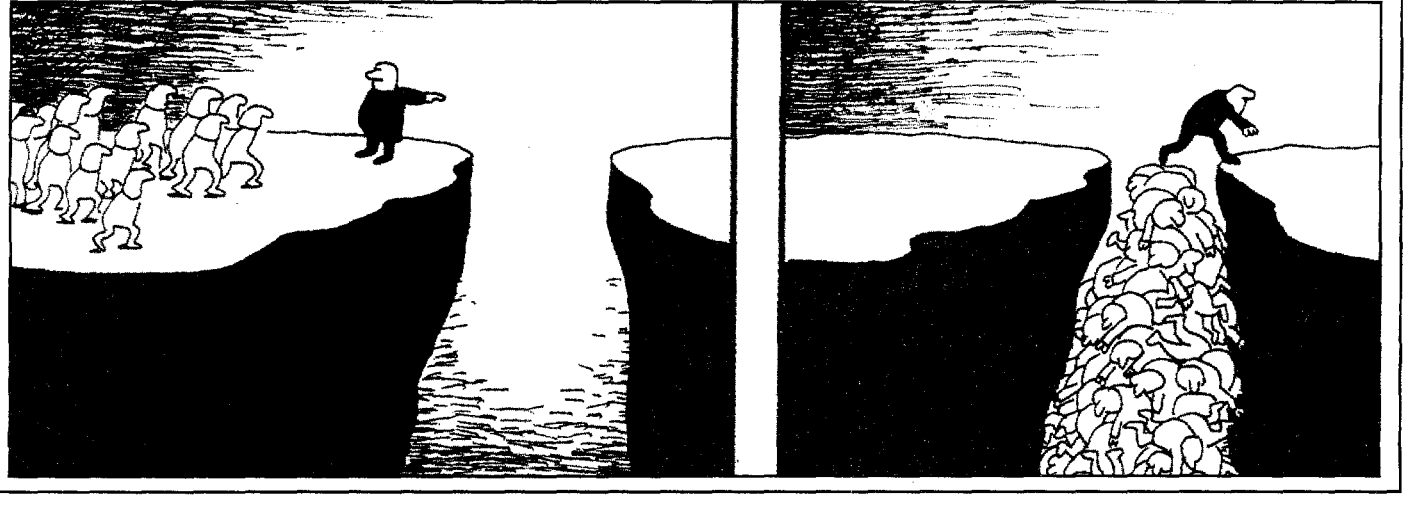
Russian authorities should adopt three priorities. First, Russia should recognize that as a European economy it is medium-size at most, with a $370 billion GDP in 1998—about 2.5 times that of Finland—and a weight in the world economy that is smaller than, for instance, Sweden's. All official expenditure commitments should be reassessed with this in mind, and only commitments that can be financed from available resources should be maintained.

Second, Russian authorities should also work to abolish the nonmonetary economy by declining to accept anything but money as tax revenue.

Third, the authorities should help new private economic activities. Public sector barriers—licensing, taxation, inspections, and legislation and its implementation—must change if Russia is ever to become a wealthy and stable society. But reaching that goal demands that the country be rebuilt: state, institutions, the economy, capital stock, infrastructure, the civil society, and the values of the people—almost everything.

Pekka Sutela is head of the Bank of Finland Institute for Economies in Transition (BOFIT). Address: PO 160, 00101, Helsinki, Finland; Tel: 358 9 1832297; Fax: 358 9 1832294; Email: pekka.sutela@bof.fi. *This article is based on the author's paper entitled "Russia: The State and Future of the Economy," presented at the Second Suomenlinna Seminar in Helsinki, June, 1999.*

Showing the Way



From the Hungarian magazine *Hócipő*

Stable Ruble Needs Sound Fiscal Policy

by Tuomas Komulainen

After the high inflation of 1992–94, the Central Bank of Russia embarked on a policy of stabilization. The aim was low inflation and a stable currency. Indeed, the ruble was stabilized and annual inflation was brought down to single digits. However, this stabilization success was not permanent. Following the events of August 17, 1998, the ruble depreciated nearly 70 percent against the dollar in just two months. By August 1999 consumer prices had risen 121 percent. What went wrong with Russia's stabilization policy, and what kind of monetary and exchange rate policy should Russian authorities aim for in the future?

Playing Chicken

Most of the early macroeconomic literature emphasizes the monetary determinants of inflation. A fixed exchange rate is used as a nominal anchor, and the central bank—with its money supply—determines inflation. The money supply needs to be in harmony with the exchange rate goal. This stabilization strategy—with its good and bad results—has been widely used in transition countries and elsewhere.

The recent literature, by Woodford, Sims, and Canzoneri, challenges these earlier assumptions by emphasizing the role of fiscal policy in price determination. Notably, the public sector's present-value budget constraint should be seen as an equilibrium condition. Thus the real value of the nominal liabilities (debt and monetary base) issued by the public sector equals the expected present value of current and future primary surpluses and central bank transfers. If fiscal policy does not ensure this budget constraint, the price level has to jump and diminish liabilities in real terms. Thus a game of chicken occurs: either the central bank or the fiscal authority has to abandon its goal.

This notion is not new. In 1981 Sargent and Wallace, in an article in the *Quarterly Review* of the Federal Reserve Bank of Minneapolis, observed that when the fiscal authority independently sets the budget, the monetary authority is unable to control inflation. Even so, most price determination theories overemphasize the role of monetary policy, neglecting the role of fiscal policy.

If the exchange rate is fixed, the situation becomes even more difficult. If fiscal policy is still an exogenous political process not satisfying the present-value budgetary constraint, the exchange peg has to break. The domestic currency will devalue and prices will jump in order for the present-value budgetary constraint to hold. In other words, a country cannot have low inflation and a stable currency if fiscal policy is not sufficiently disciplined.

The High Price of Indebtedness

Annual inflation in Russia fell from 224 percent in 1994 to 11 percent in 1997. Using a crawling peg regime, the Central Bank of Russia reduced the yearly nominal depreciation rate of the ruble from 30 percent in 1995 to 7 percent in 1997. Direct transfers from the Central Bank to the government ceased.

The federal budget deficits were 5–8 percent of GDP during 1995–98. The government short-term debt (GKO) market was created in 1995. By August 1998 the amount of ruble-denominated GKO debt had grown to 300 billion rubles ($49.2 billion), or 15 percent of GDP. The federal debt to GDP ratio increased from 30 percent in 1995 to more than 55 percent before the August 1998 crisis. Under a crawling peg regime, the Central Bank was still able to use higher interest rates to keep the exchange rate target and control inflation, but only at the cost of increased debt payments by the government. By August 1998 debt service expenditures corresponded to 50 percent of federal budget revenues.

By the winter of 1998 calculations showed that Russia would need a GDP growth rate of more than 4 percent or crucial primary surpluses to keep the debt-to-GDP ratio under 100 percent in the future. Russia's fiscal policy was not sufficiently in balance with the present-value budget constraint to hold.

Defining Targets

The new theory of price determination and the Russian experience indicate that the Central Bank and Ministry of Finance should decide together what fiscal policy and inflation rate to target. A poor public sector places certain restrictions on tax collection and budget discipline. If Russia wants to have a money-based economy where investments and growth are present it needs a predictable monetary policy and stable currency. The government and the Central Bank must address this link between fiscal policy and stable currency.

In the first seven months of 1999 the federal budget showed a primary budget surplus of 1.6 percent of GDP—a glimmer of hope that Russia is moving toward a more balanced fiscal policy. If this more disciplined fiscal policy continues, a stabilization program might be realized—and this time, in a floating exchange rate regime. If this occurs, there will be a need for a clear, credible declaration by the Central Bank of Russia of its inflation or monetary policy target.

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THE WILLIAM DAVIDSON INSTITUTE
AT THE UNIVERSITY OF MICHIGAN BUSINESS SCHOOL

Latest from the Davidson Institute's Publication Profiles

Marketing Issues in Transitional Economies

Edited by Rajeev Batra, William Davidson Institute and University of Michigan Business School

A volume in the William Davidson Institute Series on Transitional and Emerging Economies, Kluwer Academic Publishers, 1999. *Used with permission.*

This book examines issues facing marketing managers and scholars as the markets in transitional economies become more deregulated and open. The issues examined include changes in consumer behavior, challenges to making firms in these countries more "market-oriented," issues in creating and managing distribution channels, and issues in competitive strategy and tactics, including market entry and brand-building.

Excerpts from two chapters out of the sixteen in the volume follow. The first, by Russell Belk, draws on research in China, Romania, and Russia to help us understand why the presumably poor consumers of transition economies seem to place such a high value on luxury and status goods. The second, by Ronald Savitt, reports field data from the Czech Republic to conclude that the firm-level restructuring to date has been mostly "shallow" and that deeper changes are still necessary.

Leaping Luxuries and Transitional Consumers

by Russell W. Belk, University of Utah

According to Abraham Maslow's (1954) well-known hierarchy of needs, as humans we satisfy our lower-order bodily needs for food, shelter, clothing, and some measure of safety before we become concerned with the more symbolic social and psychological needs for love, esteem, and self actualization. Although Nevis (1983) has suggested that a somewhat different hierarchy applies in the East, it still shares with Maslow's a hierarchical prioritizing of lower order needs over higher order needs. This logic would suggest that the least likely place to find luxuries in the world is in a society where the majority of people must struggle to meet basic needs and where extravagance in consumption is likely to reduce the thin accumulations that allow any margin of security in providing for the health and well being of family members. Yet this logical premise is countered by early human propensities for making art, assembling collections, and burying our dead with ornaments, armaments, and floral bouquets (Belk 1995). Cave paintings, sculptures, and grave goods can be traced back at least 30,000 years, while collections of curious pebbles have been found in caves inhabited 80,000 years ago. Such objects seem clearly to be luxuries appealing to "higher order" needs rather than necessities that address "lower order" needs. Ger (1997) argues that the desire for the beautiful is, in fact, a basic human need.

I will attempt to demonstrate and explain how this long-standing lure of luxuries has become even stronger in our contemporary and increasingly global society, especially among consumers in transitional economies. Besides attempting to explicate and understand this phenomenon, I wish to assess whether the leap to luxuries is laudable or lamentable. Based on this assessment, I will then consider what, if anything, responsible global marketers and their local counterparts in transitional economies should do about this luxury-loving contradiction of Maslow's hierarchy.

Luxuries in the Least Likely Places

My interest was initially drawn to this anomaly from an historical content analysis of U.S. magazine advertising in which Rick Pollay and I found that status appeals curiously peaked during the heart of the 1930s Great Depression (Belk and Pollay 1985). In addition, motion picture depictions of luxurious living were especially common at this time, which also seems curious in light of high

unemployment levels and other forms of impoverishment during the 1930s. As an initial result of noticing this anomaly, I investigated the seemingly inexplicable presence of luxuries in the Third World (Belk 1988), finding ironic consumption practices such as people putting up unconnected television antennas on huts lacking both electricity and televisions, and families forgoing needed food in order to afford a refrigerator which subsequently remained empty. Ger (1992) cites the example of selling nutritious cow's milk in order to buy candy for Turkish children who have seen it advertised on television. But the presence of luxuries in transitional economies was driven home for me during a sabbatical year in Romania during 1991–92. After a decade of severe consumer deprivations during which the best food, clothing, shoes, tools, beverages, and other consumer goods were shipped abroad to repay a massive foreign debt, retail availability began to change suddenly. Goods that were long absent from store shelves as well as never before seen consumption items had rapidly begun to enter the Romanian market. The trigger for this avalanche of consumer goods was the execution of the Ceaucescus during the 1989 Christmas season revolution. But the goods that most quickly and prominently appeared in new retail kiosks, established state stores, and in the streets and markets, were not the desperately needed and still rationed goods such as sugar, petrol, meat, flour, and bread. Instead they were such luxury items as imported candies, liquors, perfumes, cigarettes, televisions, VCRs, cameras, cosmetics, and high-end automobiles such as Mercedes and BMW, which had quickly established Romanian franchises. Even during the revolution itself, one of the first broadcasts by the revolutionaries who captured the state television network was not a political message or news of the revolution, but a showing of a copy of the American film, "E.T. The Extraterrestrial."

These impressions of rampant desire for luxury in Romania were confirmed by some quantitative results obtained measuring materialism in a dozen countries (Ger and Belk 1996a). These data confirmed that Romanians were the most materialistic of these consumers and that Ukrainians were fourth and reunified Germans fifth (the United States and New Zealand were numbers two and three, respectively, while India, the United Kingdom, France, and Sweden were the least materialistic nations). We had also measured Germans before reunification and found their former level of materialism to be much lower, like that of the other Western European nations in the sample. The high levels of materialism (defined as the belief that material possessions are the greatest source of happiness and unhappiness in life) in Eastern and Central Europe provide further suggestive evidence of the important role of luxuries for consumers in transitional economies. But these data do not explain why this should be the case. There are implications of pursuing status, prestige, material achievement, and aesthetic desires that seem quite different from those of pursuing desires for adequate nutrition, comfort, and safety (Ger 1992). Are those who pursue luxuries, even at the expense of necessities, better off because of it? How does this differ between rich and poor consumers? How is this phenomenon different in affluent and transitional economies? Why does it occur at all?

In [his chapter's] analysis I more thoroughly consider the popularity of luxuries in transitional economies. I begin by exploring what constitutes a luxury and then briefly consider the history of luxuries and attitudes toward luxuries, primarily in China and Russia. Historical analysis helps to frame the current fascination with luxuries in these countries and raises the very basic questions of whether luxuries are good or bad for individuals and societies as well as why luxuries are especially appealing to consumers in transitional economies. I draw upon diverse evidences to help enlighten the role of luxury in transitional economies today and discuss how this may be impacted by yesterday's patterns of consumption in these same countries.

An Evaluation and Conclusion

Why do consumers in transitional economies so improbably want extravagant luxury goods? The answer differs somewhat depending on the culture, but part of the explanation seems to be the increasing visibility of consumer lifestyles elsewhere in the world. The propaganda of the kitchen debate and the American exhibition in Moscow in the late 1950s has now been replaced by global television, films, travel, multinational corporations, foreign tourists, the Internet, and other windows on a shrinking world. Some would argue that the consumption of luxuries in transitional economies is only a factor among the fortunate few who have managed to quickly become rich. But as the examples above suggest, the demand for luxuries among consumers in transitional economies is considerably broader than this. The desire for luxuries is also exacerbated by feelings of deservingness due to prior deprivations, as was the case with the Cultural Revolution in China and the Ceaucescu's decade-long consumer austerity program to repay Romanian foreign debt at the expense of Romanian consumers (Belk 1997). In small scale Third World cultures there are barriers to status seeking through consumption, often couched in the fear of provoking the envy of others (Belk 1988). All are known to all in such societies, and fears such as that of the evil eye tend to keep luxury consumption in check (Gell 1986). But in formerly Communist societies where suspicions of even family members were built up over periods of "cultural purification," such barriers are more negligible. Fear of envy may persist longer in rural villages than in more anonymous cities, but the world is shrinking in this respect also; what comes to the city comes to the village, often sooner rather than later.

Then too, there is the national equivalent of the nouveau riche desire to suddenly join what are perceived to be a finer class of people, even though the luxuries consumed in this pursuit may

lack what these "betters" take to be taste and sophistication. That is, on the world stage, newly wealthy nations may lack the subtlety of consumption that has been gained by nations that are heirs to old wealth. And like the rags to riches millionaire entrepreneur, these nations may well echo a Queen song lyric that was popular in Romania in the early 1990s: "I want it all! I want it now!" But perhaps the most basic explanation for the desire for luxuries by consumers in transitional economies is the desire that Karl Marx showed with his overcoat: a desire for respectability.

As Wilson (1972) notes, "Respectability at its material level, at its level of signification, is a show of luxury. It is a grand, well-furnished home, well equipped with modern appliances, fine furniture, china and linens, good stylish clothes, an expensive education, manners, and deportment. These signifiers are also the foci of ambition for the population as a whole" (p. 226).

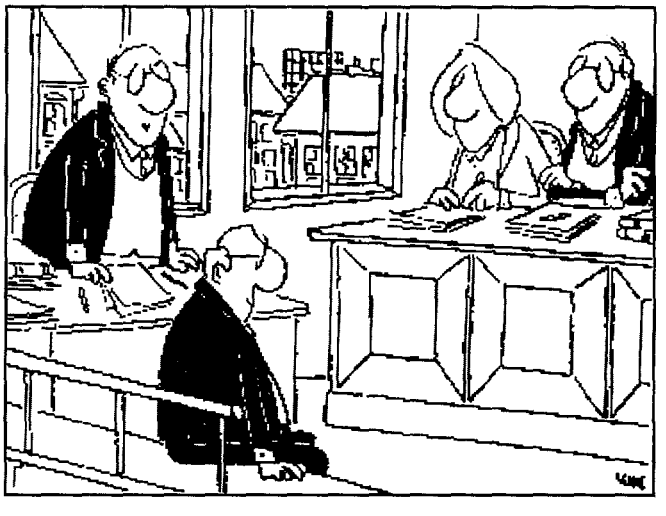
Seen in this way, the pursuit of luxuries is a basic and innocent human right. It also helps make some sense of the "wish lists" that my Romanian informants provided, including both large luxuries like cars, houses, and computers, and things that would be considered necessities in much of the world, like soap, deodorant, heat, and clean water.

Of course many objections might be raised about a conclusion that luxury consumption in transitional economies is good, humane, and desirable. Have we not learned that the materialistic pursuit of happiness is generally illusory? Mightn't the sacrifices made on behalf of luxury consumption be at the expense of health, nutrition, education, childcare, and other "higher" and more humane goals like those suggested by Maslow? Isn't the growing prospect of a billion Chinese consumers driving cars an invitation to environmental disaster? And can't a drive for material luxury overwhelm concern for others and cultivate a passive dependency on novel trinkets (Ger 1997)? Yes. But at the same time, following a "Do as I say, not as I do" philosophy is as hypocritical as it is ineffective. Long-standing critiques of luxury as enervating, dissipating, and frivolous have never been very successful for very long (Berry 1994). And if a key role of desire for luxuries is to provide hope and the motivation for achieving a better life, it would be small, paternalistic, and wrong-headed to attempt to curb these desires. There will always be a socially constructed line between outrageous decadent luxury and morally justified decencies. But as long as this line is not crossed, marketing luxuries in the least likely of places is no more problematic, and arguably less so, than marketing them in the most likely of places.

After all, by far the greatest resource depletion and environmental threat comes from the consumption of the more economically developed world. If someone is to be targeted on these grounds, those in transitional economies are far down on the list of logical candidates. It also seems apparent that there is a cycle of desire and that what is once fervently wanted loses its appeal soon after it is acquired (Belk, Ger, and Askegaard 1997). This suggests that the strong desire for luxury goods among consumers in transitional economies may quickly pass. While there is some evidence of this already, the social comparison to those in more affluent countries continues to provide an engine for further consumption aspirations among transitional consumers. Furthermore, as Russia learned under Communism, democratized luxury is oxymoronic. When everyone has something it is no longer a luxury. Under these circumstances new luxuries must be created as the old ones fall from this category. This becomes part of the motor for consumer culture. And as the histories of China, Russia, and prehistoric communities all suggest, the desire for luxury has long been with us and will likely persist into the indefinite future. Dignity through more luxurious consumption appears to be a strong panhuman motivation.

Finally, we should try to avoid reestablishing the same situation that led to the collapse of Communism. It might be argued that to attempt to impose Maslow's need hierarchy by giving people what we believe they need rather than what they want, harks back to Meng's (1995) parody about the purity of water during the Chinese Cultural Revolution. These days in China, people want *Perrier*, *Yibao* [a local Chinese brand], and other expensive bottled waters (Belk and Groves forthcoming; Li 1998; Wong and Ahuvia 1997). And why should they not have it? Regardless of whether the product is water or cellular phones, the proliferation of the desire for luxury is nothing new. It is only its pace and geographic place that have leaped traditional boundaries in our postmodern world.

Corruption in Court



"In case of a favorable sentence, my client is ready to add a substantial sum to the salary of the prosecution team."

From the Hungarian daily *Népszabdság*.

The Prospects of Becoming Market Oriented: Evidence from the Czech Republic

by Ronald Savitt, University of Vermont

Dramatic changes have taken place in the industrial structure of the Czech Republic as a result of the economic transformation of the last seven years. However, while macro economic studies and business reports have discussed changes in companies such as reductions in labor and changes to product lines (e.g., Myant 1997, p.146), what marketing programs they have implemented and how far they have gone in becoming market oriented has not been established. All we have is scattered evidence about what Czech firms are doing in adapting to the market.

This chapter explores the hypothesis that neither marketing nor market orientation programs are really well understood by managers in the recently restructured "old state enterprises." We argue that, in spite of the major restructuring activities, these firms are moving at a relatively slow pace in changing their previous structures and behaviors toward anything that is similar to the practice of marketing in firms in developed market economies. While there have been major changes in the structure and operations of these firms, most of it has focused on financial and ownership issues, with less emphasis on what in Czech transformation activities is referred to as "commercial planning."

Such a situation is not hard to understand. One of the greatest challenges in the area of organizational restructuring that Czech firms are going through is recognizing the importance of the market and buyers. In the past, what was produced had little relevance to what buyers wanted. Enterprises were driven by production goals set by central plans that showed little concern for market demand. Central planning provided production quotas and hence managers did not have to understand the needs of intermediate and final user. These enterprises were shaped to take advantage of economies of scale and as a result were very large and "the small number of enterprises and the high degree of vertical integration have implied rather strong ties between suppliers and customers" (Elster, et. al., 1988, p. 159). For example, the average number of workers in each firm in Czechoslovakia in 1989 was 3,000 compared to approximately 300 in the West (Estrin and Takla 1993, p. 46). Creating new relationships was going to be difficult in so far as it meant that most of the past relationship had to be abandoned. This often meant breaking social and political ties as well as economic ones. It is a process that requires new thinking and the willingness to change and it results in replacing the comfortable and familiar previous social and institutional bases of authority (Clark and Soulsby 1996). Most confounding about the process is that there are no instructions or maps.

The absence of market coordination led to what became known as "the shortage economy" in which there was forced consumption (Kornai 1992, pp. 229-234). Ultimate consumers and intermediate buyers learned how "to make do" within the system. They were exceedingly skilled negotiators around the gathering, hoarding, and allocation of materials (Newman and Nollen 1996, pp. 118-119). Enterprises had no need to deal with marketing activities because responding to demand was not a critical element for managers in the individual organization. Even in those cases in which state enterprises exported to non-socialist markets, they were able to use the service of state operated export agencies. Customer satisfaction was not an issue.

Marketing in the Restructuring Process

An important element of organizational restructuring is marketing. The challenges for accomplishing this objective were significant because of the widely held attitudes about marketing, limited resources, and a lack of understanding about what marketing should be in the organization, and how it operates. Basically, two approaches were taken. The first has been to establish a separate marketing department to undertake and direct marketing activities for the entire organization or for specific units. This often took the form of integrating what managers thought were marketing functions in a single department structure. Packaging, distribution, and sales were often merged to become the marketing department. In other cases, old functions such as data collection were brought into marketing. In still other cases activities including market research, new product development, and promotion were combined (Hitchens, Birne, Hamar, Wagner, and Zeinplinerova 1995, p. 101). Not only were there the internal difficulties of how to organize a marketing department, there were other issues. Most important of these was how the new marketing department should relate to the traditional departments in the enterprise. In theory all should have equal footing, however, that was not to be achieved. Production remained and remains fairly dominant. There has been only limited movement toward the integration of marketing with other management functions.

The second approach has been to combine what management views as marketing within the traditional organizational divisions. In this case, something like "marketing" or more correctly, selling became part of the historical production divisions. People who were once "technical representatives" now became the marketing representatives for individual lines of insulation, resins, and

steel products. In such cases, the goal was to build better relationships with consumers (Edwards and Lawrence 1994, p. 64).

In an extensive study of the transformation of an East German pharmaceutical company, researches concluded "There appeared to be a problem within the company with understanding the role of marketing (rather than sales). This was compounded by the cost of marketing activities and the internal lack of experience" (Edwards and Lawrence 1994, pp. 75–76). What often prevailed in this process was an attempt to be seen as moving toward marketing. Adapting western concepts and words, printing business cards in English, and producing slick promotional materials represent some of the artifacts that are easily found. More than once this has been described as moving from "the Marxian dialectic to the marketing dialectic."

What is missing is some overall strategic view of what the organization should look like and how it should behave. Whether the western model is the most appropriate or not, what the transforming enterprises did not have was a clear idea of what they should become. The past was clear; however, the future was not and the broadly defined elements of market orientation were understandably beyond their grasp. "In short, it has proven impossible to erase forty years of state socialism, ideology, institutions, and behavioral patterns, and simply inscribe the new values, structures, and appropriate conduct of market capitalism" (Clark and Soulsby 1995, p. 216).

Some Czech firms have indeed been moving toward some market-oriented practices, but they do not have a clear idea of what they are and more importantly how to implement and manage them. "Quality, customer orientation, and competitiveness became the mantras of top management in 1992," for example, however, they were not a part of a comprehensive strategy for managing the enterprise (Newman and Nollen 1996, p. 129). As a result of the socialist culture and highly vertical organizational structure, managers had great difficulties in understanding a concept that transcends the organization. Managers were "well-qualified to make short-run adjustments to the production process, for example by closing particular product lines, changing the product mix toward more saleable goods...and reorganizing production toward cheaper or higher quality inputs" (Estrin, Gelb and Singh 1995, p. 142). However, they have had difficulty with developing "the strategic direction for a business that plays a critical role in achieving a business's long-run objectives with respect to growth, financial performance, and market position" (Best 1997, p. 267).

There are only a few examples of old state enterprises that have been able to make significant changes without extensive foreign investment. The most interesting case is from Poland where a shipyard, not yet privatized though fully restructured, carried out a sophisticated market-oriented program. It came as the result of the insights of a single individual who had both the insights and the authority to make major changes in the enterprise. He was able to move it quickly from a traditional state-owned shipyard building ships for local use or building ships for hard currency without regard for efficiency or profits to one that successfully competed in world markets. The strategy concentrated on understanding market conditions and then adapting production to demand. "The creation of a focused marketing and product strategy was driven by a careful assessment of the fit between the market conditions and the shipyard's relative advantage vis-à-vis worldwide competition" (Johnson, Kotchen, and Loveman 1996, p. 40).

In summary, given the challenges in getting marketing established and operating, it is little wonder that the more complex concept of market orientation has been difficult to develop.

This chapter goes on to describe interview and survey data compiled to understand how Czech enterprises are changing their business and marketing practices.

Tests of Financial Intermediation and Banking Reform in China

by Albert Park and Kaja Sehrt

China implemented a series of widely publicized financial reforms in the mid-1990s designed to improve bank performance. However, descriptive and estimation results suggest that the importance of state bank policy lending (to support state-owned enterprises and finance agricultural procurement) has not fallen, and may even have increased, during the recent period, and that lending does not respond to economic fundamentals. Only the group of smaller, less-regulated financial institutions appear commercially oriented. Despite reforms, significant barriers to efficient inter-regional financial intermediation remain.

As economies grow, financial institutions play an increasingly important role in directing financial resources to their most productive use. Through their greater size and scope, they are better able than informal institutions to safeguard deposits, diversify portfolio risk, provide liquidity to borrowers and depositors, and achieve economies of scale in evaluating projects and providing financial services. The depth of financial intermediation (loans as a share of GDP) has been shown to be positively associated with both the level of development (GDP per capita) and the rate of economic growth.

Economic literature's emphasis on the size of the financial sector overlooks differences in how well available resources are allocated. The recent Asian financial crisis and the experience of banks in transition economies, as well as historically poor bank performance in Latin America and Africa, highlight the difficulty of establishing successful commercial banking systems that allocate financial resources efficiently. Policy lending, barriers to inter-regional lending, distorted pricing, poor managerial incentives, and lack of prudential financial regulation all can undermine financial performance.

As a new approach to assess the effectiveness of financial intermediation by national banking systems, we develop a set of tests, derived from a model of bank profit maximization, which exploit regional financial and economic data. The tests are based on the expectation that in efficient systems, financial intermediation should not be overly influenced by policy variables, should be greater where projects are more profitable and require greater financing—typically in faster growing, richer, and more industrial areas, and should direct funds to the best projects regardless of where deposits originate. We then apply these tests to the case of China.

The Asian financial crisis has heightened scrutiny of China's state banking system, whose fragility stems from the continued use of the financial system to support urban-based state-owned enterprises. Recent estimates suggest that more than one quarter of the loans of China's four major state-owned banks are nonperforming, and that technically these banks are insolvent. 1997 provincial data reveals a striking inverse relationship between financial intermediation and GDP per capita that is at odds with the empirical regularity of positive correlation found in cross-country studies. This pattern suggests that the allocation of financial resources across provinces may be highly inefficient, with richer provinces being taxed relative to poor provinces.

In recent years the Chinese leadership has recognized the importance of improving financial intermediation and has made financial reforms a top policy priority. The most sweeping changes were implemented in the mid-1990s, and include:

- Relaxation of binding credit plans following the 1993 anti-inflation campaign.
- Centralization of the People's Bank of China's (PBC) re-lending to reduce excessive local influence on central bank financing of loans.
- A shift to ratio management of loans, giving more autonomy to state banks to reallocate funds among provincial branch offices.
- Adoption of a new Commercial Bank Law to improve managerial incentives and prudential financial regulation.
- Establishment of policy banks to separate policy from commercial lending.
- Establishment of a national, unified interbank market.

To be able to provide initial empirical evidence on the effect of these reforms on loan allocation decisions, we examine the performance of different Chinese financial institutions before and after the reforms, including all state banks (including specialized and policy banks); the Agricultural Bank of China (ABC), a specialized bank that later spun off China's largest policy bank, the Agricultural Development Bank of China (ADBC); rural credit cooperatives, the largest financial institution other than state banks, with a branch structure reaching to villages; and other financial institutions, including urban cooperatives and urban cooperative banks, national and regional commercial banks, and national trust and investment companies—a small but dynamic part of the financial sector.

The results suggest that financial intermediation in China is far from efficient and that financial reforms in the mid-1990s have not reversed a worsening trend. The responsiveness of lending to policy concerns such as state enterprise output and profitability and grain production is significant and has increased, if anything, in the recent period. Economic fundamentals have had little effect on total lending. However, there is evidence that for the specific case of the ABC and ADBC, separation of policy and commercial lending has allowed the ABC to become more commercially oriented, even though it still responds to policy variables as well. Such separation does not improve overall performance, with the ADBC incurring increasing losses from policy lending. Among other financial institutions, rural credit cooperatives seem poorly integrated into financial markets, suggesting potentially large gains once rural credit cooperatives are integrated into the national banking system. The small but rapidly growing group of other financial institutions (urban cooperatives and cooperative banks, national and regional commercial banks, and national trust and investment companies) are most commercial in their orientation and likely have filled important credit demand niches.

These results do not necessarily mean that reforms have been ineffective or unnecessary. Poor performance may reflect continued difficulty in dealing with the huge portfolio problems facing Chinese banks, so that despite stronger incentives to improve allocation of new loans, the sharply deteriorating performance of state-owned enterprises and the portfolio of older loans are overwhelming these efforts.

Financial sector reform was further extended after 1997. In 1998 provincial PBC branches were abolished in favor of multi-province regional branches and the government announced that the national credit plan would be eliminated in 1999. Banks have been allowed to adjust their branch structures based on commercial considerations rather than having a branch at each administrative level. Each specialized bank has established an

asset management company to salvage as much value as possible from nonperforming loans. All of these changes will continue to move China toward a more commercial banking system. However, while growth of alternative financial institutions and continued reform of specialized banks holds promise for future performance, the limited and highly regulated interbank market, government-set interest rates, centralization of financial management, and continued difficulty resolving the state enterprise problem continue to be major impediments to efficient inter-regional resource flows.

This article is based on William Davidson Institute Working Paper 270, by Albert Park, University of Michigan and Kaja Sehrt, Dartmouth College.

Fourth Annual International Conference on Transition Economics

The Fourth Annual International Conference on Transition Economics was held in Beijing, China from July 23–25, 1999, to commemorate the 20th anniversary of the initiation of China's transition toward a market economy. The William Davidson Institute at the University of Michigan Business School sponsored and organized the conference with London's Centre for Economic Policy Research and the National Center for Economic Research at Tsinghua University, in cooperation with the Ford Foundation and the World Bank.

More than 120 Davidson Institute and CEPR Research Fellows and other distinguished economists from Asia, Europe, and North America attended and presented papers at the conference. Drawing from the experiences of many transition economies, the conference covered a wide range of topics, including the role of government in transition, market liberalization, entry and exit of enterprises, money and banking, labor and human resources, corporate governance, financial crisis, international trade and foreign investment, and alternative paths of transition.

In addition, more than 15 leading policymakers from transition economies (mostly governors and deputy governors of central banks and deputy ministers of finance) presented their assessment of the past performances of and prospects for their countries. Several top policymakers came from China, including Li Jiange (Vice Minister, Office of System Reform State Council), Liu Mingkang (Deputy Governor, People's Bank of China), Lou Jiwei (Deputy Minister of Finance), Wang Xuebing (President, Bank of China), Wu Xiaoling (President, Shanghai Branch, People's Bank of China), and Zhou Xiaochuan (President, China Construction Bank). Policymakers from Central and Eastern Europe included Mitja Gaspari (Minister of Finance, Slovenia), Victor Geraschenko (Governor, Central Bank of Russia), Miroslav Hrncir (Deputy Governor, Central Bank of the Czech Republic), Krzysztof Ners (First Deputy Minister of Finance, Poland), Cristian Popa (Deputy Governor, National Bank of Romania), and Marko Skreb (Governor, Croatian National Bank). Topics included transition experiences in retrospect, next steps to take toward a successful transition, new sources of growth, the restructuring of state enterprises, tax and fiscal reform, and financial system reform.

Joseph Stiglitz (Chief Economist and Senior Vice President, Development Economics, World Bank), Nicholas Stern (Chief Economist, European Bank for Reconstruction and Development), Jan Svejnar (Executive Director, Davidson Institute), and Gerard Roland (Co-Director, Transition Programme at CEPR) moderated the policy sessions and provided comments.

The Annual Conference on Transition Economics is a forum held every summer in a different location, bringing together scholars of transition economics and key policy leaders from major financial institutions and transition countries. Most of the papers presented at the conference are online at the Davidson Institute's website www.wdi.bus.umich.edu following the Working Papers links. Plans are underway for the Fifth Annual Conference on Transition Economics and will be announced in the **Transition Newsletter** *at a later date.*

10th Asian Business Conference, University of Michigan Business School
January 20–21, 2000

This conference will bring together about 30 senior business executives and high-level government officials from around the world to discuss current trends and issues affecting firms doing business in or with Asia. The program will feature panel sessions on general business activities in China, India, Japan, the Republic of Korea, and Southeast Asia, along with several functional and industry panels on topics such as corporate restructuring, consumer marketing, privatization, high-tech and telecommunications, and infrastructure development.

Organized by students from the business school and various other academic units at the university, the annual Asian Business Conference is the longest running event of its kind in North America.

For additional details, including registration information, please visit the conference website: www.umich.edu/~asiabus.

China's State-Owned Enterprises Did Their Job—Now They Can Go

by Gary H. Jefferson

Until the early 1990s China's state-owned industrial enterprises provided approximately 45 million urban jobs and more than half of the country's industrial output, tax revenues, and exports. It is unimaginable that living standards and overall economic growth could have risen as robustly as they did during the first 15 years of China's economic reform had productivity not been rising in state industry. Consistent with our earlier studies and most others in the literature, my colleagues Thomas G. Rawski, Zheng Yuxin, and Wang Li recently concluded that during 1980–93, total factor productivity (TFP) in state industry rose at an average annual rate of about 2.5 percent.

While modest in relation to some other sectors, productivity gains in state industry averted the collapse of state-owned enterprises during the 1980s and into the 1990s. Had productivity in the urban sector remained stagnant, the likely result would have been either persistent macroeconomic instability and a slower opening to the world economy or the collapse of state industry and the uncertainty associated with disintegration of the country's enterprise-based social welfare system. In short, the partial restructuring of state industry created a gradual reform option for China's leadership. The point of this observation is not to argue that China's chosen reform scenario has been better or worse than the alternatives. It is only to point out that the process of gradual reform in China was predicated on the rising productivity in state industry.

Rising Productivity, Falling Profits

If productivity has risen in China's state industry, then why has its financial performance fared so poorly? Returns to capital historically remain relatively flat even as productivity moves upward. This phenomenon occurs in all market economies because as industrial productivity and purchasing power rise, new firms enter the market and existing firms expand to create new capacity. Thus gains in profits tend to be eaten up by expanding investment and increasing competition.

While numerous hypotheses have been proposed to explain this apparent paradox of rising state industry productivity and falling profitability—new business formation, the failure of managers to pursue profits among them—my colleagues and I find that state enterprise profitability is driven by differential productivity performance. Either a fall in state enterprise productivity or a rise in TFP outside the state sector depresses state industry profitability. Although state enterprise productivity generally rose during 1980–93, its growth lagged behind that of the non-state sector. The *relative* fall in state enterprise profitability, therefore, arises from the *relative* decline in state enterprise productivity.

Interestingly, the same research suggests that once we control for productivity differentials between state and non-state industry, new business formation outside the state sector did not depress productivity in state industry, rather, it enhanced state industry profitability. This result may reflect the ability of new firms to serve complementary roles as suppliers and subcontractors, thereby alleviating the excessive vertical integration of China's plan system.

How to Avert "The Tragedy of the Commons"

Our current research confirms that productivity growth in the state sector has slowed in the past few years—from earlier rates of 2–3 percent to near zero now. The recent drop in growth may support the view that without fundamental ownership reform, China's state industry has exhausted the potential for further productivity gains. Most striking was state industry's continuing decline in capital productivity.

> **Tragedy of the Commons**
>
> Garrett Hardin in his 1968 article "Tragedy of the Commons" postulated an agrarian community where all citizens graze their livestock on a commonly owned field. The field can only support a limited number of animals before it is denuded and ruined. The cost-benefit analysis performed by an individual townsperson using the commons will always lead to the conclusion that the immediate benefit of adding another animal, far outweighs the remoter, less visible harm of degradation of the commons. What's more, the benefit from the additional animal belongs to the townsperson alone, while the harm to the commons is shared proportionally across all its users.

What explains this chronic weakness? I believe that the best explanation is that many of China's state-owned enterprises exhibit the features of a commons. State-owned enterprises are the fisheries of China's enterprise system from which stakeholders extract more than they contribute. The state enterprise commons is abused by workers shirking, managers stripping assets, and officials siphoning profits. But state-owned enterprises are also overtaxed to finance China's social welfare system and resource transfers to the collective sector, including technology, equipment, and material inputs. State-owned enterprises bear a disproportionately large tax burden. In 1995 state industry contributed 47 percent to total

manufacturing output but paid 71 percent of all tax revenues.

In the oft-invoked theory of "the tragedy of the commons," the cause of public overexploitation is an ambiguous assignment of property rights. Similarly, in China's state-owned enterprises, individuals or entities without the clear right to use and receive a return from state-owned assets lack both the authority and incentive to monitor these assets. Under such circumstances, the commons normally would be exploited to exhaustion. Like the overexploited fishery, why does the state enterprise commons not simply shrivel up and disappear?

The reason is that the tier of economic institutions that lies above the enterprise sector—the fiscal and banking systems—also assumes the function of a commons in China's economy. The banking system, largely comprised of state-owned enterprises that are also weakly monitored, serves as a kind of unsupervised hatchery for the depleted fisheries. It is the ability of the state enterprise system to replenish itself by capturing eggs—such as unsecured loans—from the banking system that allows state-owned enterprises to exhibit the properties of public goods. Their resources are, to a significant degree, both non-excludable and non-diminishable or non-rivalrous. Like unmonitored public goods, the state-owned enterprise system creates negative externalities. What are these?

Non-performing loans of the banking system may be financed by one or a combination of three sources. The first is by printing money, which results in inflation and macroeconomic instability. Bad loans can also be financed by debt, which crowds out private economic activity through higher rates or higher taxes. Finally, non-performing loans can be sustained through financial repression, in which saving options are restricted to bank deposits.

The inability of the enterprise and financial systems to effectively monitor their resources creates the moral hazard associated with overconsumption. Chronic overconsumption gives rise to the externalities described above and to banking crises when these externalities are no longer sustainable. The basic problem arises from the inability of the socialist state to assign property rights effectively. Property rights motivate businesses—whether industrial enterprises or financial institutions—to monitor their resources responsibly.

The work of the 1991 Nobel Laureate in Economics, Ronald Coase, specifically the logic of the "Coase Theorem," suggests a remedy for China's state-owned enterprises. To prevent the siphoning off of natural resources and to ensure their efficient use, the Coase Theorem requires the following:

- Clearly specified property rights, including the right to monitor, receive the return from, and sell the asset.
- Low transaction costs so that the entrepreneur who can employ the asset most efficiently will purchase its control.

In China, the U.S., or any other industrial market economy these conditions—clearly specified property rights and low transaction costs—are essential for a property-rights market. By forcing the governments and agencies that currently own China's state-owned enterprises to face the opportunity cost of public ownership and by enabling the sale and restructuring of assets, an increasingly active property-rights market is needed to resolve China's state enterprise problem.

Recent Gains in Enterprise Reform

Currently China's leadership is juggling numerous, conflicting policy goals. These goals include employment stability along with state enterprise reform, and enterprise reform along with a stable exchange rate. The press often gives the impression that reform is slowing, but the numbers suggest otherwise.

After remaining relatively stable (in the range of 100,000 during the past 10 years or so), the number of state-owned industrial enterprises fell precipitously during 1997–98—from about 110,000 in 1997 to 64,700 in 1998. Moreover, many of these state enterprises, possibly more than 11,000, are not state-owned enterprises by the conventional measure—they are enterprises in which the state retains a "controlling share." During 1997–98 the number of foreign-invested enterprises rose by 19,000 and the number of private and state enterprise–collectively owned enterprise joint ventures rose by 8,500, increases that probably reflect the influx of converted state-owned enterprises. Therefore, we see that in terms of the number of firms that are distributed across ownership types, the policy of "release the small and retain the large" (*juada-fang xiao*) has begun to take effect.

Continued weak monitoring within the financial system and clogged channels for liquidating poorly performing enterprises are sustaining ubiquitous excess capacity. In this environment, all sectors have exhibited declines in productivity, particularly in returns to capital. No sector has demonstrated a greater productivity decline than China's new shareholding enterprises, most of which were converted from state-ownership status. Thus effective enterprise reform in China is not simply a matter of relabeling ownership or shuffling boards of directors. Effective enterprise reform requires further progress in establishing a property rights market in which both of Coase's requirements are progressively satisfied—increasingly well-specified property rights reform and lower transaction costs of bankruptcy and market-mediated restructuring with access to competitive capital markets and professional accounting, auditing, and legal services. These are the elements of an effective property rights market, which must lead the way during the next stage of China's enterprise reform.

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World Bank/IMF Agenda

Kosovo to Get World Bank Grant

In early October the World Bank announced plans—outlined in a **Transition Support Strategy Paper**—to spend $50 to $60 million during the next 18 months to support Kosovo's reconstruction and economic recovery efforts. Following the recent decision by the Board, the first $25 million tranche of this support will be made available from the World Bank's net income and will be provided to Kosovo on grant terms. The **Transition Support Strategy Paper** describes three priority activities for the World Bank in the overall reconstruction and recovery program for Kosovo:

- **Aid coordination**. In collaboration with the European Commission the Bank is finalizing the development of the Reconstruction and Recovery Program for Kosovo and has begun planning, preparing, and cohosting international donor conferences to mobilize financial support.
- **Policy and technical advice**. The Bank is providing economic policy advice to the United Nations Mission in Kosovo (UNMIK) during its interim governing of the province and later to local Kosovar authorities, over time.
- **Limited financial support**. This support would be provided on a highly selective basis; however, the Bank will seek to maximize the impact of its limited resources by leveraging donor funds.

Challenges Remain in Rebuilding Kosovo

During its second meeting in Washington, D.C., in late September the High Level Steering Group for Southeast Europe, under the joint chairmanship of European Commissioner for Economic and Monetary Affairs, Pedro Solbes Mira, and World Bank President, James D. Wolfensohn, called on international donors to disburse the money that had previously been pledged for both budgetary support and humanitarian aid in time for the onset of the Balkan winter. In addition, mindful of the need to protect both domestic revenues and external donor support from corruption or misappropriation, the Group also welcomed the setting up of strict financial and auditing controls to ensure that all transactions involving the Kosovo budget are transparent and fully accountable.

President Wolfensohn Reappointed to Second Term

Executive directors of the World Bank in September unanimously endorsed the renomination of President Wolfensohn for a further term of five years, beginning June 1, 2000.

Inspection Panel Returns from China

The World Bank's Independent Inspection Panel returned on October 28 from a three-week visit to China, which included an extended visit to the proposed site of the China Western Poverty Reduction Project in Qinghai. "The team came back to Washington with a vast amount of facts and information which it must now assess," the Panel's chairman, Jim MacNeill of Canada, said. The panel will undertake further interviews with Bank officials in Washington involved in the design of the project.

On June 24 the Board approved the China Western Poverty Reduction Project, subject to the results of an investigation by the Inspection Panel. On September 9 the Board formally requested that the Panel undertake an investigation into whether Bank management had observed its policies on, among others, involuntary resettlement, indigenous peoples, and environmental assessment. Earlier the Panel had received a Request for Inspection claiming that the proposed migration of 60,000 poor people from regions in eastern Qinghai Province to Dulan County would adversely affect the lives and livelihoods of 4,000 Tibetan and Mongolian ethnic peoples.

Blood Transfusion to Croatia's Ailing Health System

On October 5 the World Bank approved a $29 million loan for a Health System Project in Croatia that will contribute to a more effective, efficient, and financially sustainable health system. The total amount of the project is $39.9 million, including $10.9 million from the government. The loan has a maturity of 15 years, including a five-year grace period at the standard interest rate for LIBOR-based, single currency loans in dollars. Since Croatia joined the World Bank in 1993, commitments to the country total about $783.42 million for 18 projects.

World Bank Investigation Launched into Acts of Russian Ex-Official

The World Bank announced on October 22 that it has hired the law firm of Venable, Baetjer, Hower, and Civiletti to investigate the alleged misconduct of Leonid Grigoriev. Grigoriev worked as a senior official in the World Bank's Washington headquarters between 1992 and 1997, first as alternate executive director for Russia, then as advisor to Russia's executive director. **The Wall Street Journal** reported that Grigoriev was suspected of having provided "insider" investment advise—tips on debt-market investments—to the Moscow-based Inkombank (one of Russia's largest, until it lost its license last year) while carrying out his duties at the World Bank. If true, World Bank officials point out, Grigoriev's actions would have constituted violations of World Bank conflict of interest rules.

Currently, Grigoriev heads a Moscow-based economic policy analysis institute, the Bureau of Economic Analysis (BEA), which is supported through a World Bank

loan. At the request of the Russian government, the board of BEA has placed Grigoriev on administrative leave pending the results of the investigation. The Russian government and the World Bank have agreed that, in addition to earlier audits, they will review the transactions and accounts of the BEA.

World Bank Backs Bulgaria's Debt-for-Shares Plan

The World Bank has been considering new loans for Bulgaria in support of the reform in education and administration, crime control, and a project on reclamation of swamps and marshes along the Danube River. So said Andrew Vorkink, World Bank Country Director for Bulgaria and Romania, at the Southeast Europe Economic Forum in Sofia in mid-October. Vorkink stated that the World Bank has contacted the Paris Club on behalf of Bulgaria to propose the idea of exchanging this country's debt to the Club for investments in priority projects. Bulgaria owes the Paris Club some $900 million; together with Albania and Macedonia, they had offered the swap for consideration earlier this year.

IMF Forecasts for Nations in Transition

The International Monetary Fund's annual **World Economic Outlook** report, released in September, contains the following forecasts for economic growth in 1999 and 2000 for each of the countries in transition. It also includes inflation forecasts.

	Annual growth rate forecast (percent)		*Annual inflation rate [CPI] (percent)*	
	1999	*2000*	*1999*	*2000*
Albania	8.0	8.0	7.0	6.0
Armenia	3.5	5.0	3.0	8.0
Azerbaijan	3.8	2.8	-5.0	4.0
Belarus	-2.0	0.0	320.0	250.0
Bosnia	8.0	14.0	5.0	3.0
Bulgaria	1.5	4.0	-1.0	4.0
Croatia	-2.0	2.5	4.0	3.0
Czech Republic	0.0	1.5	3.0	5.0
Estonia	0.5	5.0	4.0	3.0
Georgia	2.0	5.0	22.0	5.0
Hungary	3.7	4.5	9.0	8.0
Kazakhstan	-1.5	3.0	7.0	11.0
Kyrgyz Republic	2.7	3.5	32.0	16.0
Latvia	2.0	4.0	2.0	3.0
Lithuania	0.5	4.0	2.0	3.0
Macedonia	-4.0	3.0	2.0	2.0
Moldova	-5.0	1.0	28.0	6.0
Mongolia	3.5	4.0	9.0	6.0
Poland	3.7	5.0	7.0	5.0
Romania	-3.5	2.5	40.0	17.0
Russia	0.0	2.0	88.0	23.0
Slovak Republic	0.7	4.9	9.0	7.0
Slovenia	3.0	3.8	5.0	5.0
Tajikistan	5.5	6.0	15.0	7.0
Turkmenistan*	18.5	-1.0	27.0	54.0
Ukraine	-2.5	0.0	26.0	15.0
Uzbekistan	2.1	2.0	28.0	22.0

*The IMF staff was queried on the Turkmenistan figures, which seem out of line with the rest of the region, but there was no immediate explanation. (Robert Lyle, RFE/RL)

Milestones of Transition

From 1997 to January 2000 the European Investment Bank (EIB) will lend up to 7 billion euros to the 10 Central and East European applicant countries—Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic, Slovenia, and Romania. The EIB recently has lent 40 million euros for developing a mobile telecommunications (GSM) network in Slovenia. With the latest loan, total EIB financing in Slovenia increases to 550 million euros. Another EIB loan of 21 million euros to Lithuania's government will finance environment projects by local governments across the country.

www.Financial-Conferences.com. The first online database of finance courses and conferences has been launched on November 3 by Global Investor, a UK-based distributor of financial products and services. On this site it is possible to list all of the financial courses and conferences for a particular week on a specific subject. Users can automatically be notified of new events in their interest area through Email Alert. The website carries course and conference details on more than 2,000 events from 180 organizations worldwide. Users can search the database with keywords or browse by category, location, or date.

Information: Philip Jenks, Director, Global Investor; tel: 44 1730 233 870; email: pjenks@financial-conferences.com; Internet: http://www.global-investor.com.

Russia

Productivity of Russian industry declining. According to a new study by McKinsey and company, reported in the **Wall Street Journal**, Russian industry is only half as productive as it was in 1992. The study scrutinized 10 sectors of the

economy, from oil to software, to examine why Russia's GDP has declined 40 percent since 1992 while economic performance has surged in formerly communist countries such as Hungary and Poland. The findings lend new weight to the theory that privatization and other economic reforms have often aggravated rather than solved problems inherited from the Soviet Union. Unfair competition and widespread corruption have decreased the incentive to invest in and boost productivity of Russian industry, despite a privatization program that has put most state-owned enterprises in private hands. Normal evolutionary processes that reward productive companies and push unproductive ones out of business don't exist. However, Russia's core industrial assets are actually quite good, and each investment is needed to spark huge gains in productivity.

Population expected to fall drastically. A U.S. expert on Russian social trends predicts that falling birth rates coupled with an alarming rise in diseases like tuberculosis and AIDS could cut Russia's population by more than a third by 2050. Murray Feshbach, research professor at Washington's Georgetown University and a top specialist on Russian social and environmental trends, predicts that Russia's population could fall from the current 146 million to as low as 80 to 100 million. Such a fall would have large economic and social consequences that could undermine Russian stability. Feshbach based his projections on Russian statistics as well as data from nongovernmental organizations and international institutions.

Russia to experience grain and meat shortfall. The U.S. Department of Agriculture is predicting that Russia will face a shortfall of grain totaling 7.5 to 9.5 million tons in 2000, Interfax reported. They also concluded that there will be a meat shortfall, noting that the meat supply of 3.8 million tons of domestic production, combined with 1.45 million tons of imported meat, will be insufficient to meet the country's current meat demand of 5.5 million tons.

"Living standards of 57 percent of the population of Russia are below the minimum subsistence level, the unemployment rate has reached 14.2 percent, and the average life expectancy does not exceed 61.7 years," Duma Speaker Gennady Seleznyov declared, commenting on an appeal to join the worldwide movement against poverty launched under the UN auspices. According to Labor Minister Sergei Kalashnikov, "only" 29 percent of Russia's population is living below the minimum subsistence level.

Central and Eastern Europe

Hungary

Growth over three years predicted. Ecostat predicts Hungary's economic growth to be 4 percent this year, with a current account deficit of $2.7 billion. According to the report, annual economic growth could average 4 to 5 percent over the next three years, in the absence of any external shocks. Rates of growth for both imports and exports are forecasted at 9 to 10 percent, meaning the trade deficit could reach $4 billion by 2002. Tourism and EU transfers should prevent deterioration of the current account deficit. Ecostat puts the public finance deficit for 2002 at 3.6 percent of GDP. The cumulative public sector deficit fell in October and is now below the full-year target. The September current account deficit was $93 million, less than half the level expected by the markets. Industrial output for the month rose 10.7 percent year-on-year in September, suggesting sustainable growth built on rising exports. The government target of 4 percent GDP growth now appears within reach.

Lithuania

A rise in current account deficit. The current account deficit for the second quarter rose to 1.5 billion litas ($378.8 million), a rise of 29.6 percent from the same period last year. The deficit was estimated at 14.0 to 15.0 percent of GDP, up from 9.6 percent in the first quarter. The central bank blamed the increase on a rise in the consolidated fiscal deficit, owing to government payouts under a compensation scheme for citizens who lost ruble-denominated savings in the Soviet Vneshekonombank.

Romania

In late September the government approved the revised 1999 budget draft following months of dispute both within the coalition and between the cabinet and the IMF. The consolidated budget deficit is now targeted at 4.1 percent of GDP, against the initial aim of 2.5 percent. The impact of the Kosovo crisis on exports has set the economy back considerably since budget discussions began. The economy is expected to contract by 4.8 percent over last year, compared with an initial estimate of 2.0 percent. The government estimates year-end losses of more than $900 million as a result of the Kosovo crisis, which has affected industrial output, inward investment, and trade. Although most forecasts predict slight recovery in the year 2000, the debt burden remains high and parliamentary elections next year may introduce new political instability. Recent opinion polls give the opposition a majority, reports Oxford Analytica.

Asia

China

Growth to exceed predictions. There is no pressure to devalue the yuan due to a rebound in exports and a rise in foreign currency reserves, Premier Zhu Rongji said in an interview published in November by German daily **Handelsblatt**. Zhu also predicted that economic growth in China will likely exceed the forecasted 7 percent increase. (Official figures show

that China's GDP expanded by 7.4 percent in the first three quarters, after a 7.8 percent rise in 1998). While foreign direct investment in China fell in the first eight months of 1999, it has picked up again in September, Zhu said. Official statistics show that actual foreign direct investment fell 6.9 percent to $29.2 billion in the first nine months of 1999. Solvency of China's four largest government-owned banks has considerably improved, the Premier noted. China recently set up four bad debt clearing agencies for the four state-run commercial banks. The asset management companies are favoring debt-for-equity swaps as the vehicle for taking over ailing state firms and forcing them to restructure.

Lao PDR

Lao PDR sinks deeper into socioeconomic morass. International donors say that Lao PDR, one of Asia's poorest nations, is sliding deeper into a socioeconomic mess that can only worsen unless urgent government action is taken to stem the tide, Reuters reports. Hyperinflation and a violently fluctuating currency have combined with some of the worst social indicators in the East Asian region. Buffeted by the Asian financial crisis, a weak macroeconomic management, and a lack of decisive and speedy decisionmaking on the part of the government are contributing to the decline, says the story. Some donors like the World Bank have cut development assistance and tied aid increases to decisive action. With the financial sector in a precarious state and half the population living below the poverty line, donors say authorities must quickly launch strong stabilization measures to curb inflation, stabilize the kip (the Laotian currency), and restore a growing loss of local and foreign confidence in the economy and currency.

We appreciate the contributions from Radio Free Europe/Radio Liberty.

Conference Diary

Special Announcement!

EACES Award 2000—The best doctoral dissertation in comparative economic systems and economics of transition

The European Association for Comparative Economic Studies (EACES) invites proposals for **EACES Award 2000**—the best doctoral dissertation in the fields of comparative economic systems and economics of transition.

The award is endowed with 700 euro for the winner, who will be given the opportunity to present his or her work at a plenary session of the 6th EACES conference in Barcelona, Spain, on September 7–9, 2000. EACES will furthermore provide assistance to enable the winner to publish the dissertation.

The prize will be awarded to the work that, in the opinion of the jury, has the greatest potential to impact the field of comparative economic studies in the future. Both theoretical and empirical contributions are appropriate. The topics may cover any area of research sponsored by EACES including comparative analysis of different economics systems, evolution of economic systems and institutions, and the transition from central plan to market economy.

Inquiries and Submissions

To be eligible for the EACES Award 2000, the doctoral dissertation must have been accepted for the degree of Ph.D. (or equivalent in continental Europe) between January 1998 and December 1999. Further inquiries may be addressed to the contact below. The deadline for submissions is January 31, 2000. Proposals, accompanied by one copy of the dissertation and five copies of an abstract in English of no more than 15 pages (1.5-spaced, normal fonts, and including exhibits) should be sent to:
European Association for Comparative Economic Studies (EACES), c/o Dr. Klaus Meyer, CEES, Copenhagen Business School, Dalgas Have 15, DK- 2000 Frederiksberg, Denmark; tel: (45) 3815 3033; fax: (45) 3815 3037; email: km.cees@cbs.dk.

Forthcoming Conferences

Third Meeting of the ECPD International Permanent Study Group on Transition and Privatization
November 26–27, 1999, Ohrid, Republic of Macedonia

Organizer: The European Center for Peace and Development (ECPD) of the University for Peace established by the United Nations in cooperation with the government of the Republic of Macedonia. Topics: Recent lessons from transition and privatization—problems of institutions and corporate governance and the place of privatization in the economic rehabilitation of the region of South East Europe, as well as the most appropriate policies and methods of privatization in circumstances of post-conflict economic disruption.
Information: Gordana Hofmann, European Center for Peace and Development (ECPD) of the University for Peace established by the United Nations; tel: (381 11) 3246-041, 3246-042, 3246-043, 3246-044, 3246-045; fax: (381 11) 3240-673, 3234-082; email: ecpd@EUnet.yu

HEERO 1999: Heads of East European Regional Operations Roundtable
November 23–24, 1999, Vienna, Austria

Information: Katrin Klausecker, The Economist Conferences, Schwarzenbergplatz 8/7, A-1030 Vienna, Austria; tel.: (431) 712-416141; fax (431) 712-4165; email: katrinklausecker@eiu.com

E-commerce in Central and Eastern Europe
January 27–28, 2000, Warsaw, Poland

Information: Katrin Klausecker, The Economist Conferences, Schwarzenbergplatz 8/7, A-1030 Vienna, Austria; tel: (431) 712-416141; fax (431) 712-4165; email: katrinklausecker@eiu.com

Third Roundtable with the Government of Hungary
February 21–23, 2000, Budapest, Hungary

Information: The Economist Conferences, Schwarzenbergplatz 8/7; A-1030 Vienna, Austria, tel: 431-712-41 61/0, fax: 431- 712- 4165, Internet: http://www.eiu.com/catalogue/conferences/calendar/cal_East.html

26th Annual Conference
March 24–26, 2000, Washington, D.C., United States

Organizer: The Eastern Economic Association.
Information: Dr. Mary Lesser, Executive Director, EEA, tel.: 914-633-2088, fax 914-633-2549, Email: mlesser@iona.edu, *Internet: http://www.iona.edu/academic/arts_sci/orgs/eea/eea.htm*

Ten Years of Transition: Prospects and Challenges of the Future for Public Administration
April 13-15, 2000, Budapest, Hungary

Information: NISPAcee, Hanulova 5/B, 840 02, Bratislava 42, Slovak Republic. tel.:/fax: 4217- 642-85-557, 4217- 642-85 357; email: Viera@nispa.sk; Internet: http://www.nispa.sk/

Sixth EACES Conference: Globalization and European Integration
September 7–9, 2000, University of Barcelona, Spain

Information: Department Politica Economica, Universidad. Avda. Diagonal, 640, 08034 Barcelona, Spain; tel.: 3493-4021949; fax: 3493-402-4573; email: gate2000@eco.ub.es

New Books and Working Papers

The Macroeconomics and Growth Group regrets that it is unable to provide the publications listed.

World Bank Publications

To receive ordering and price information for World Bank publications, contact the World Bank, P.O. Box 7247-8619, Philadelphia, PA 19170, United States, tel: 202-473-1155, fax: 202-676-058, email: books@worldbank.org, Internet: http://www.world bank.org or http://www.world bank.org/html/dec/Publications/Work papers/tranecon.htm, or visit the World Bank bookstore in the United States, at 701 18th Street, NW, Washington, D.C., or France, at 66 avenue d'Iena, 75116 Paris.

Working Papers

http://wbln0018.worldbank.org/research/workpapers.nsf/policyresearch

Michael M. Lokshin, **Household Childcare Choices and Women's Work Behavior in Russia,** WPS 2206, October 1999, 35 pp.

Replacing family allowances with childcare subsidies in Russia might strongly influence women's participation in the labor force and thus could be effective in reducing poverty. Lokshin models mothers' participation in the labor force, their working hours, and household demand for childcare in Russia. The model estimates the effects of the price of childcare, mothers' wages, and household income on household behavior and well being.
To order: Patricia Sader, Room MC3-632, tel: 202-473-3902, fax: 202-522-1153, email: psader@worldbank.org. The author may be contacted at mlokshin@worldbank.org.

Hua Wang and Ming Che, **How the Chinese System of Charges and Subsidies Affects Pollution Control Efforts by China's Top Industrial Polluters,** WPS 2198, October 1999, 28 pp.

China's unique combination of emissions charges and pollution abatement subsidies has given its most heavily-polluting industrial firms incentive to invest in pollution abatement.
To order: Hua Wang, Room MC2-626, tel.: 202-473-3255, fax: 202-522-3230, email: hwang1@worldbank.org.

Jean-Jacques Dethier, Hafez Ghanem, and Edda Zoli, **Does Democracy Facilitate the Economic Transition? An Empirical Study of Central and Eastern Europe and the Former Soviet Union,** WPS 2194, October 1999, 30 pp.

Empirical analysis shows that democracy has facilitated economic liberalization in 25 post-communist countries of Central and Eastern Europe and the former Soviet Union. The existence of a vibrant civil society at the start of the transition has the most explanatory power in this team's regressions.
To order: Hafez Ghanem, Room H4-201, tel.: 202-458-5557, email: hghanem @worldbank.org. The other authors may be contacted at jdethier@worldbank.org or ezoli@worldbank.org.

Constantine Michalopoulos, **The Integration of Transition Economies into the World Trading System,** WPS 2182, September 1999, 38 pp.

With few exceptions, economies in Central and Eastern Europe, including the Baltics, have been well integrated into the multilateral trading system. One of the main challenges they face is integration into the European Union. Armenia, Georgia, the Kyrgyz Republic, and Moldova have adopted relatively liberal trade regimes and are either already members of the WTO or close to it. But to facilitate trade they need to strengthen customs, the finan-

cial sector, and institutions. Trade regimes of Kazakhstan, Russia, and Ukraine are not especially restrictive, but weak institutional capacities inhibit their effective integration into the world trading system and accession to the WTO. The remaining countries in Central Asia, as well as Belarus, have a long way to go to be integrated in international trade.

WTO members, especially the United States and the European Union, need to review their policies toward nonmarket economies on antidumping practices and on safeguards. Countries where market decisions prevail should not be subjected to nontransparent and arbitrary procedures. In particular, countries that have been judged to be "market" economies in the process of gaining access to the WTO should be excluded from procedures applied for antidumping and safeguard measures in nonmarket economies.
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Technical Papers

Mustapha Nabli, **Integration, Vulnerabilities to Crisis, and EU Accession in Five Central European Countries,** TP 439, 1999, 75 pp.

The study assesses the possible vulnerabilities in the Czech Republic, Estonia, Hungary, Poland, and Slovenia—slated to be the first in the region to join the EU—as they proceed with global financial integration and EU accession.

Gordon Hughes and Magda Lovei, **Economic Reform and Environmental Performance in Transition Economies,** TP no. 446, 1999, 80 pp.

Most global economic and environmental watchers expect transitions to market economies to yield environmental benefits. The changing incentives that a market economy introduces should foster more efficient production, better use of resources, and increased community input. The advanced reformers of the Central and Eastern European countries proved this to be the case. They improved energy efficiency and reduced the emissions intensity of pollutants.

The slower-reforming countries of the Newly Independent States (NIS) also experienced reduced pollution. This downturn, however, coincided with an economic decline, one which shut down many major polluters. This report looks at air and water pollution and health indicators, analyzing the environmental effects of transition with a view to identifying priority areas for investment and policy initiatives.

Other World Bank Publications

Czech Republic: Toward EU Accession—Main Report, World Bank Country Study, 1999, 344 pp.

The Czech Republic was perceived until 1996 as the most successful transition economy in Central and Eastern Europe. But the Czech miracle came to a halt in mid-1997. Its future economic development and successful integration into the EU depends on its capacity to recover a sustainable output growth path. This report focuses on the Czech economy from the perspective of its pursuit for EU membership.

TradeCAN: Database and Software for a Competitiveness Analysis of Nations, 1999, CD-ROM.

TradeCAN is a powerful new CD-ROM designed to analyze international, national, and regional competitiveness in commodities and manufactured exports. The source of TradeCAN data is the COMTRADE database.

World Bank Research Program—Abstracts of Current Studies, September 1999, 221 pp.

The volume covers more than 202 research projects initiated, underway, or completed in fiscal 1999 at the World Bank, grouped under nine major headings, including transition economies.

Albert Nyberg and Scott Rozelle, **Accelerating China's Rural Transformation**, 1999, 152 pp.

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Zuzana Brixiova, Wenli Li, Tarik Yousef, **Skill Acquisition and Firm Creation in Transition Economies**, WP/99/130, 31 pp.

Sanjay Kalra and Torsten Slok, **Inflation and Growth in Transition: Are the Asian Economies Different?** WP 99/118, 1999, 24 pp.

Economic Reforms in Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan, Occasional Paper 183, 1999, 77 pp.

Carlo Cottarelli and Peter Doyle, **Disinflation in Transition, 1993–97**, Occasional Paper 179, 1999, 46 pp.

This paper focuses on the 1993–97 experiences of 10 Central and Eastern European countries and the Baltics, Russia, and other countries of the former Soviet Union. It reviews a range of policies implemented in transition economies through the prism of their contribution to disinflation and factors that were particular to the transition context. Some Central and Eastern European countries managed to reduce inflation to the two-digit range by the end of 1992, while inflation remained close to or above 1,000 percent in the Baltics, Russia, and other countries of the former Soviet Union. But by the end of 1997, inflation exceeded 100 percent in only

one country. Median 12-month inflation in the whole transition group fell from 950 percent at the end of 1992 to 11 percent at the end of 1997.

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Discussion Papers

Jukka Pirttilä, **Evasion and Economies in Transition: Lessons from Tax Theory**, 2/1999, 43 pp.

This study considers the pervasive tax evasion of transition economies, with particular reference to Russia's tax system. Starting with a survey of theoretical literature on tax evasion and corruption, it argues that, although standard tax theory offers many insights, certain special features of transition economies deserve attention. These include the legacy of socialism resulting in a state willing to exercise discretionary power but possibly lacking credibility and public support, the "disorganization" phenomenon, which hampers efficient tax administration, and the relationship of restructuring, speed of reform, and the tax system. It also contains recommendations on reform of the tax system to achieve reasonable deterrence of evasion.

Rupinder Singh and Juhani Laurila, **Azerbaijan: Recent Economic Developments and Policy Issues in Sustainability of Growth,** 5/1999, 53 pp.

Macroeconomic stabilization in Azerbaijan has been successful. Following cessation of conflict with Armenia, and the decline of GDP by 60 percent from 1990 to 1995, the government, in effect, implemented a big-bang reform process in 1995. The inflation rate has now declined to the lowest rate of any transition country and important reforms in the monetary-fiscal mix have been undertaken. Liberalization, the second plank of first generation reforms, has also been successfully implemented with the liberalization of prices, the trade and foreign exchange regimes, and the near completion of small-scale privatization, although the onset of the Russian crisis in 1998 negatively affected both internal and external balances. This paper presents the current economic picture for Azerbaijan and then assesses economic policy issues facing the country.

The potential flow of oil-based monies into Azerbaijan can produce "Dutch Disease" syndrome, affecting Azerbaijan through a rising real exchange rate, which endangers the nonoil sector. This should become a policy concern in the medium-to-long term. Structural reforms in public finance to deal with expected surpluses are lagging and are necessary in the next phase of the transition of Azerbaijan. Significant reforms are required also in banking, specifically privatization, improvement in regulation, and supervision.

Andrei Yakovlev, **Black Cash Tax Evasion in Russia: Its Forms, Incentives, and Consequences at Firm Level**, 3/1999, 44 pp.

The main idea of this scheme is the replacement of high-taxed elements of total revenue, such as salary or profit, with low-taxed elements, such as material expenditures. The basis of such a replacement is the contract between a client and an intermediary "sham" firm. Under the terms of the contract, the client (a real-sector enterprise) transfers money to the bank account of the sham firm in exchange for a phony work report. In exchange for bank payments to the sham firm, the client receives unaccounted for cash—"black cash." The total amount of black cash returned equals bank payments minus the commission of the sham firm, typically less than 2 to 3 percent of the initial client's payment. These black cash funds are thus available for unofficial salary payments, investment, or discretionary use by the entrepreneur.

Russian black cash tax evasion schemes differ from traditional Western-style cash evasion schemes. First, Russian schemes concern mainly firms, not individuals. Second, this evasion is possible even when a firm does not get its receipts in cash. Third, Russian schemes are almost risk-free for a legally operating firm. Therefore, the level of tax evasion in Russia exceeds the levels in developed countries. Virtually all enterprises in Russia have an incentive to use a black cash scheme: thousands of sham firms affiliated with private banks go unpunished. Indeed, black cash evasion is presently one of the most profitable businesses in Russian banking.

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Beata Smarzynska, **Composition of Foreign Direct Investment and Protection of Intellectual Property Rights in Transition Economies**, 2228, September 1999, 49 pp.

Contrary to the hopes of transition economies, foreign investors in the region are characterized by low, rather than high, research and development (R&D) intensity. The results also indicate that investors with higher R&D spending are more likely to engage in nonmanufacturing projects than in local production. The empirical analysis links these findings to weak protection of intellectual property rights (IPRs). The negative effect is especially strong in those technology-intensive sectors that, according to surveys, rely heavily on IPRs. Weak IPR protection encourages investors to undertake non-manufacturing projects rather than local production.

Irena Grosfeld, Stanislav Kolenikov, Elena Paltseva, Claudia Senik-Leygonie, and Thierry Verdier, **Dynamism and Inertia on the Russian Labor Market: A Model of Segmentation**, 2224, 1999.

The puzzling coexistence of elements of inertia and dynamism on the Russian labor market can be explained by the fact that risk-averse workers face a tradeoff between wages and access to social services provided by the firm. Wage arrears can be viewed as an implicit contract between firms and those less productive workers. The most productive workers leave their initial firm, contract on the spot labor market, and concentrate in the best performing firms. The model uses a panel dataset containing 13,410 firms for the period of 1993–97.

Chong-en Bai, David Li, Yingyi Qian, and Yijiang Wang, **Anonymous Banking and Financial Repression: How Does China's Reform Limit Government Predation without Reducing Its Revenue?** 2221, August 1999.

China's economic performance of the past two decades presents a puzzle for the economics of transition and development. Enormous private business incentives were unleashed that have fueled rapid economic growth despite the fact that China has had very weak "conventional institutions"—like the rule of law and separation of powers—to constrain the government from arbitrary intrusion into economic activities. One mechanism that has limited the government's ability for predation and harassment is commitment through information decentralization, where the key institution is "anonymous banking"—a combination of the use of cash for transactions and the use of anonymous savings deposits. The government has benefitted from improved private incentives by collecting quasi-fiscal revenues from the state banking system through "financial repression"—a combination of controls on international capital flows with restrictions on domestic interest rates.

Stanislav Gelfer and Enrico C. Perotti, **Red Barons or Robber Barons? Governance and Financing in Russian FIG**, 2204, August 1999.

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To order: OECD Washington Center, 2001 L. Street, NW, Suite 650, Washington, D.C., 20036-4922, tel. (202) 785-6323, or 1-800-456-6323, fax (202) 785-0350, Internet: http://www.oecdwash.org

Financing Newly Emerging Private Enterprises in Transition Economies, 1999, 286 pp.

Other Publications

Paul J.J. Welfens, **Economic Aspects of the Eastern Enlargement of the European Union,** Bericht des BIOst 7, January 15, 1999.

The EU intends to expand itself eastward in two stages as of the year 2001, bringing the number of members up to 21 and eventually 26. Any manner of eastern expansion commencing immediately after full consummation of monetary union will face the EU with a number of adaptation needs. While the eastern expansion will place an additional financial burden on the 15 countries of the EU, there is no mistaking the economic advantages—at least in the long term. A serious politico-psychological problem posed by the intended expansion is that the higher budgetary contributions that the major member countries will have to pay are visible immediately, while the "club benefits" of expansion, at least for the existing members, become visible only indirectly.

A model simulation performed for Austria, by way of example, shows that the burdens on the national budget and the labor market as a result of the first round of expansion will be relatively light. Indeed, there are even bottom-line benefits to be expected. Greater problems are likely in the second round of expansion, and, due to the inherent links between the two stages, it would be highly expedient already to take these problems into account in the first round. One particularly important necessity is a reform of the EU constitution, including measures to prevent a relative political preponderance on the part of the smaller EU members. Proposals for a reform of the EU's structural policy and for a re-assessment of its budget priorities are also urgently needed.

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Gerhard Heilig, **Can China Feed Itself? A System for Evaluation of Policy Options**, 1999. Internet http://www.iiasa.ac.at/ and CD-ROM.

China has enough arable land and water to feed its projected population of 1.48 billion in 2025,even at currently available levels of agricultural technology. According to a detailed Agro-ecological Assessment model (AEZ), which was developed by IIASA and FAO and recently applied to China on the basis of greatly improved soil, terrain, and climate databases, the country has enough cultivation potential to produce about 650 million tons of grain. The assessment takes into account that about 25 percent of the arable land will be reserved for other types of agricultural production, it also discounts land needed for infrastructure. However, China should take the following measures:

- Greatly improve water use efficiency in agriculture.
- Remove bottlenecks in transportation infrastructure, technology, and logistics.
- Promote larger farm sizes by gradual privatization of the arable land. (A modification of the strict land-transfer rights and introduction of private ownership would introduce a market for arable land).
- Moderately increase imports of (feed) grain and use good cropland in the labor-

intensive cultivation of high-value crops, such as vegetables, fruit, or nuts.

- Support further research in biotechnology.
- Intervene in the grain sector to guarantee a sufficient grain supply through more attractive producer prices.
- Actively use family planning as a means to prevent a larger than expected growth in food demand

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Jarmo Eronen, **Cluster Analysis and Russian Forest Industry Complex**, Discussion Paper 682, Elinkeinoelaman Tutkiuslaitos, 1999.
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M. Holt Russin, and others, eds., **The Post-Soviet Handbook: A Guide to Grassroots Organizations and Internet Resources, Revised Edition**, University of Washington Press, October 1999, 416 pp.
To order: University of Washington Press, P.O. Box 50096, Seattle, Washington, 98145-5096, United States, tel.: (206) 543-4050, fax: (206) 543-3932.

István János Toth, **Ownership Structure, Business Links, and Performance of Firms in a Transforming Economy, The Case of Hungary**, Discussion Paper 1999/3, Institute of Economics, Hungarian Academy of Sciences, Hungary, June 1999, 82 pp.

The business conditions of Hungarian enterprises in 1997-98 were characterized by a stable company structure developed by 1996, a holding structure that has appeared but is not dominant, and dominant private ownership. Foreign-owned companies have a decisive role in this structure. They have the most outstanding growth and profitability parameters.
To order: Library of Institute of Economics, H-1502, Budapest P.O. Box 262, fax: 361-319-3136, email: biblio@econ.core.hu.

Jiri Vecernik and Petr Mateju, eds., **Ten Years of Rebuilding Capitalism: Czech Society after 1989**, Academia, Prague, 1999.

This is the first "social report" on the Czech Republic, describing changes in the demographic, economic, social, and political areas in 1989–98.
To order: Jiri Vecernik, email: vecernik @mbox.cesnet.cz.

Barry J Eichengreen, José De Gregorio, Takatoshi Ito, and Charles Wyplosz, **An Independent and Accountable IMF: Geneva Reports on the World Economy 1**, September 1999.

The liberalization of capital movements has deeply affected the IMF's business. Crises occur with more violence, and leave deeper scars. The IMF has mobilized ever-larger rescue packages, yet it has often failed to achieve its stated aims. Does this mean that the IMF must transform itself, or even, as has been suggested, that it has become useless? The new world economy still needs an IMF but many of its practices have to be rethought and its role redefined. The IMF's traditional views of exchange rate regimes and the desirability of unfettered capital mobility no longer correspond to the situation of many developing countries. It needs to recognize that 21st century crises fundamentally differ from those that dominated during the first 50 years of its existence.

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Peculiar Interpretation of Corruption

From the *World Press Review.*

Marie Lavigne: The Economics of Transition–From Socialist Economy to Market Economy

Reviewed by Martin Schrenk

Literature on transition tends to be a highly perishable commodity. A rare exception is Marie Lavigne's book, **The Economics of Transition**, first published in 1995, of which a revised second edition recently appeared. What makes this book different? Probably the thorough attention that the author pays to the take-off conditions of the transition process: the framework of central planning and political control under Soviet-type real socialism.

Part I of the book, "The Past: Real Socialism," is unchanged. This succinct review of socialism is more than an exercise in economic history. Its key message is that devotees of the neoclassical model, who rely solely on the premise of the genetically programmed "homo economics," can hardly understand the institutional obstacles that thwarted transition in many countries. This model tends to ignore that cognitive and behavioral parameters of economic and political actors evolved during the lifetime process of socialization and then were suddenly exposed to a radically different sociopolitical culture. "Learning" a new sociopolitical paradigm is at best a time-consuming process—at worst it is impossible within a single generation.

The next chapters have been substantially revised to include the lessons learned during the past decade. Deciding which factors caused the collapse of the Soviet system 10 years ago is still widely debated. There are many widely differing interpretations. Lavigne claims three interrelated developments were decisive:

- Unable to cope with new challenges of development, the socialist system in the 1980s lost its economic vitality.
- The politically elite gradually lost confidence in the future. Poorly designed and inconsistent efforts to fix the systemic defects by piecemeal patching were unsuccessful, further weakening the economy.
- The shaken ideological self-confidence and political events in 1989 strengthened each other and, as a result, the leadership of the established order deserted, speeding up the collapse.

The author didnot miss a chance to note that the hotly debated issues of the early 1990s—shock therapy versus gradualism, speed and sequencing of reform steps, gradual versus rapid privatization, restructuring versus privatization as the first step of enterprise sector reform, grand design versus learning by doing, and so on—have by now all but vanished from the agenda, receiving only passing reference. Now they are dealt with as matters of ideology, not economics.

When is the transition process over? It depends on the target point. From the systemic perspective, Lavigne rules out "market socialism" or any other "third way" as ineffective—and otherwise rejected by the new political elite. In this sense, transition countries, while not yet fully-fledged market economies, are moving toward "normal" countries. Nevertheless, their legacy requires the need for an extended—both in scope and time—period of active state involvement in order to cope with the gaps in the institutional structure and the deficient microeconomic practices. In the author's view this implies maintaining features of a "mixed economy"—which, in turn, requires an enhanced political economy orientation of economic policy, distinct from that of the free-market model.

The author also approaches the question of the end point in the transition process from the perspective of outcome. She raises serious doubts about the assumption that adherence to the prescriptions of the "Washington Consensus"—the macroeconomic framework conceived to stop the downward spiral of crises in Latin American countries in the 1980s rather than as a prescription to the return to growth—is sufficient to ensure vigorous and sustainable development in the transition countries. In support of this contention she refers to the predictions of an authoritative IMF study: even in the absence of any external shocks or cyclical disturbances, the Central and East European economies will need on average 30 years to converge even to the levels of three lowest income countries of the present EU. She concludes, "in this sense, transition may well never be over."

The author's analysis of post-socialist privatization and associated changes of the financial sector follow a distinct institutionalist approach. This is evident when she deals with the unresolved issue of corporate governance. Field research in this area has still failed to show a convergence of standard patterns in the transition economies with the text book model of capitalist economies. In particular the insider-outsider separation remains largely blurred in transition economies. The emphasis on naively egalitarian-motivated voucher privatization frequently resulted in pronounced insider control. She criticizes the neglect of agriculture—an issue largely ignored in the literature.

The Economics of Transition—From Socialist Economy to Market Economy, *Second Edition, Marie Lavigne, St. Martin Press, New York, 1999, 328 pp.*

Martin Schrenk is a retired World Bank specialist. **Transition** *welcomes back his reviews that for many years became regular features of our newsletter.*

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Transition is published six times per calendar year, in February, April, June, August, October, and December.

Volume 10, Number 5, October 1999

Printed on recycled paper