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Interview with World Bank President

James D. Wolfensohn

The New Development Approach and the Transition Economies

What can be expected from the first experiences with the World Bank's new approach to development, the Comprehensive Development Framework? What are the distinguishing characteristics that separate "good" transition from "bad"? Are recent events influencing the Bank's policy toward Russia and China? World Bank President James D. Wolfensohn answers these and other questions in the following exclusive interview granted to Transition editor, Richard Hirschler.

Q. A few months ago, in January 1999, you came forward with the comprehensive development framework (CDF). That approach is generating intense debates—both inside and outside the Bank. Could you tell us more about its significance?

A. The CDF changes the focus of what we are trying to do in the Bank. The idea is to give a framework for countries and governments to look at their development programs and also to give a comprehensive view for the World Bank Group to look at what we do. Macroeconomic and financial aspects of a country's development get high prominence, particularly in times of a crisis. The CDF is intended to demonstrate that the structural, social, and human dimensions are equally important elements in any country. There is nothing revolutionary about the CDF; it is simply an organizational tool. Some have commented that it is not a new concept and that it had been done before. But the fact is that in a majority of countries, this holistic method of development hadn't been applied yet, and surely the Bank had not always taken this approach.

Q. Besides a healthy macroeconomic policy what are those dimensions—those fundamental elements—that should accelerate development in a country?

A. The CDF targets for an educated and well-organized government with properly trained and remunerated officials, an open legislative and transparent regulatory system, a relentless anti-corruption drive, an effective legal and judicial system, a well organized and supervised financial system, and a widely available social safety net and social program. Along with those structural elements, there are other criteria, including broad-based and accessible education, high quality health care, effective distribution and saving of water, well developed energy, road, and telecommunications networks, effective environmental policy, and dedication to preserving national history and culture.

Q. Will government, civil society, private sector, and the international providers of funds come to consensus on these issues? What is more, will they

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implement the required programs in partnership?

A. This is the aim of the CDF—to bring together these partners to achieve a common set of goals that have been previously agreed upon. We should think of development as a long-term framework, a 15- to 20-year, long-term strategy. We should think more strategically about the sequencing of policies, programs, and projects and the pacing of reforms. For example, privatization prior to establishing an effective regulatory or competition framework can be a recipe for a disaster, as it has been proven in Russia.

Q. What results do you expect from the experiments in three transition countries—Kyrgyzstan, Romania, and Vietnam—that among 13 economies are testing grounds for the CDF in an 18-month trial period?

A. The first thing that I would expect is the establishment of a fundamental structure

on which development can take place. One of the distinguishing features between good and bad transition is the attention that has been paid to the establishment of a proper structural framework. Appropriately



strengthening governance, attacking corruption, establishing a legal system, having an honest judiciary, putting in financial supervisory mechanisms and controls for both banks and capital markets, and es-

tablishing a social safety net—these are lacking in many transition economies.

Hereafter, an assured transition requires establishing a comprehensive action program over the medium to long term. It would incorporate priorities for an effective social program, education, health, energy, water, telecommunications, environmental, cultural, and other issues. The goal is to go beyond individual projects and I don't think a lot of that has been done.

Q. What is the overall impact of these new ideas on the Bank's operations?

A. As I mentioned, the CDF is a useful tool, a framework that will help us to focus on the interdependency of the problems. In my recent trip in the caucasus, in Azerbaijan, Georgia, and Armenia, I realized that just exchanging ideas within the framework of the CDF gave a structure to the discussion and to policy setting. It is a normal way of looking at fundamental issues and has guided recent discussions in a sensible,

The CDF Matrix

The CDF matrix is designed to provide all players involved in a country's development—especially the national governments and parliamentary bodies—with a shared framework of information, a basis to coordinate efforts. The matrix can also be used for examining the roles of different stakeholders and for identifying intersectoral linkages and information gaps. The matrix will vary from country to country depending on individual circumstances and priorities. Individual countries design and "owns" the matrix; opting for a version that appropriate to them. The CDF matrix tries to set out "development essentials" for each nation.

The prerequisites for sustainable growth and poverty alleviation are the following:

A. Structural needs of development

- Good and clean government.
- An effective legal and justice system.
- A well-organized and supervised financial system.
- A social safety net and social programs.

B. Human needs

- Education and knowledge institutions.
- Health and population issues.

C. Physical needs

- Water and sewerage.
- Energy.
- Roads, transportation and telecommunications.
- Sustainable development, environmental and cultural issues.

D. Specific strategies—rural, urban, and private sector

- Rural strategy.
- Urban strategy.
- Private sector strategy.

E. Special national considerations

The players in the development field include:

- Governments—national, state, city, and municipal.
- Civil society in all its forms.
- Private sector—domestic and foreign.
- Multilateral and bilateral agencies.

The matrix will look as follows:

The Activities of Partners who can Assist in the Process	The Prerequisites for Sustainable Growth and Poverty Alleviation						

interconnected, and logical manner. To that extent it is useful. If Bank staff approach development by balancing the financial and macroeconomic issues with structural and social features, and if the CDF becomes the Bank's language of communication both in dealing with clients and applying it in country strategies and analyses of country programs, it will provide continuity and coherence to the way in which we look at issues. There is already some evidence that this has happened; the Bank has moved beyond supporting individual projects or policy reforms and started to address broader topics, such as social development and governance. Thus the need for organizing

the World Bank's activity in an even more integrating framework became plausible.

Q. Are you able to get other international donor organizations on board?

A. The answer is yes. There was, of course, an initial suspicion that the CDF was an attempt by the Bank "to take over the world," but, in fact, in the pilot countries where this approach is already implemented, leadership responsibilities in most areas have been allocated to other assistance providers. So we have already demonstrated that we are not trying to lead, finance, and do everything. The Bank can

learn and gain from having other donors take the lead. On our part, we are ready to share our knowledge with them if we are taking on leadership responsibilities. The important thing for us is to be modest in our assertions and be a good partner.

Q. Will the new approach also influence how the World Bank organization is set up? Do you foresee some organizational changes?

A. Substantive areas in our "matrix management" broadly relate to the development essentials of the CDF. So I don't think there will be any massive changes

Three Transition Countries, Three Experiments with the CDF

Vietnam: Improved Partnership

The government of Vietnam intends to work with international donors and domestic partners—including private businesses and NGOs—to implement key principles of the CDF. Vietnam is potentially well suited to CDF partnerships since a growing portfolio of small and uncoordinated donor-financed programs often overwhelms the government's capacity. The government, while retaining "ownership" of the development agenda, has also expressed interest in embarking upon a more systematic dialogue with the donor community.

The experimental implementation of the CDF approach has already begun in the health and transport sectors of Vietnam, as well as in agriculture. In the health sector, donors, NGOs, and government work together to study key constraints, agree on a common strategy, and move toward allocating tasks more coherently. Supporting the government's new rural thrust, as defined in the "Vision to Action" document, donor-government groups will design strategies to address the needs of the poorest 1,700 communes and implement a 5 million hectare afforestation program. Furthermore, the Consultative Group will be extended to nongovernment stakeholders. Joint working groups will deal with the environment and governance and the issue of analyzing and sharing information over public expenditure, budget data, and donor programs.

Romania: Shared Vision

Romania's authorities are striving for a national consensus on medium- and long-term development priorities—termed

Romania's "shared vision." To ease this process, the government joined the pilot group of countries involved with the CDF. To help the country articulate its own development strategy the government hosted, together with the World Bank, a series of in-country consultations, involving more than 550 people from all segments of the Romanian society. Co-hosts invited a wide range of stakeholders—including business leaders, labor representatives, members of academia, and activists of civil society—as well as local officials. A more effective collaboration between these social groups, the government, the Bank, and other donors could contribute to economic growth and poverty reduction based on objectives set by Romanians. Participants agreed that institutional reform and the rule of law are basic requirements. They also expressed a strong desire for creating an innovation-friendly environment that provides equal opportunities for all citizens of Romania.

Kyrgyz Republic: Defining Common Goals

In the Kyrgyz Republic the government, with the participation of representatives from parliament, the NGOs, and the private sector, is in the process of outlining the country's vision and goals. At the same time donors are discussing better ways to coordinate aid efforts. The first in-country CDF workshop is scheduled for July to discuss macroeconomic stabilization and growth, the role of the state and private sector, as well as poverty and its social impact. The challenges are significant: the economy grew by only 1.8 percent in 1998 and the Economist Intelligence Unit forecasts a 1 percent decline this year. Sixty percent of the population is below the poverty line and the per capita income is under \$400.

at all because the organizational structure is already there.

Q. Structural weaknesses are especially excruciating in Russia. What are the chances that World Bank support to Russia will continue? How do you see the prospects of cooperation with the Stepashin government, following your recent trip to Moscow?

A. President Yeltsin has indicated that he intends to continue the program we agreed to earlier. And Prime Minister Stepashin has given similar indications. The projects that started earlier will continue, once the Russian partner is prepared to engage in those programs and agree with the mutually accepted conditions. Sometimes conditionality is needed by both sides in order to bring about effective results. So it is not the Bank as a policeman with a big stick—these were jointly negotiated conditions that made sense to both of us. We have to get away from the notion that conditionality is an imposition. We are trying to work much more on the basis of a partnership.

CDF's four governing principles:

- Solving social problems, and curing structural weaknesses in a country are as important as stabilizing the economy and consolidating finances.
- Governments, civil organizations, private businesses, and international donors should draft and implement development policies in partnership.
- Countries themselves, not donors, should eventually determine the goals, timing, and execution of development programs.
- These programs should have long-term perspective, projecting a vision in its entirety, based on nationwide consultations and striving for the widest possible national consensus.

Q. Transition soon will have a Chinese language version, published in China, adding to the English and Russian editions. Despite recent difficulties, relations between the World Bank and China have been stable, China being the number one borrower of the World Bank Group. What is your assessment of future relations?

A. The Chinese government has done a remarkable job in terms of poverty alleviation

and in terms of meeting the economic challenges. But now, notwithstanding the expected 7 to 8 percent growth this year—it has to confront weaknesses in the banking system, maintain industrial and agricultural development, and address international trade issues. All of this while making further efforts to eliminate poverty within the society. In solving these difficult tasks, China can count on the continuing support of the World Bank Group.

Situation of Russia's Poor Aggravates A World Bank Proposes Better Safety Net

The economic crisis that hit Russia in August 1998 did not cause any new or unprecedented ills for Russia's social protection system—already in a state of persistent malaise—but rather aggravated existing problems. Russia's labor market and social protection system was vulnerable long before the crisis began.

In Russia growing wage arrears, wage payments in kind, and losses in real wages (currently 50 percent of 1991 levels) have been the main modes of labor market adjustment to declines in real output—as opposed to layoffs—carried out in many Central and Eastern European countries. Employment decreased from 75 million in 1990 to 64 million in September 1998—a 14 percent drop—while GDP fell in the same period by more than 40 percent. Many workers have been forced to take administrative leave (16 percent in 1996). Although open unemployment reached more than 9 percent in 1997, registered unemployment was only 3.2 percent, reflecting a low level of benefits and growing arrears in benefit payments. In the second quarter of 1998, the ratio of average unemployment benefit to average wage was 30 percent.

Malfunctioning Labor Market

Payment of the benefit is often in kind. Moreover, the benefit is not indexed to account for inflation, and the minimum

amount is set at the minimum wage, which is currently 83 rubles—less than \$4. By extending the benefit to first-time job seekers, re-entrants to the labor market, and some other workers with no history of insurance contributions, the system works as a quasi-social assistance program. The system allows for huge interregional differences, with 80 percent of the employment fund revenues retained in the regions. As a result some regions do not have resources to pay benefits, while others have resources for capital construction. Employees are reluctant to leave formal enterprise rolls, even if forcibly placed on administrative leave without pay. Losing a job means not only receiving a low unemployment benefit but often also losing many benefits that have traditionally been supplied by the firm.

These trends indicate limited enterprise restructuring and insufficient labor shedding and are related to the dominance of insiders among shareholders of Russian enterprises—a result of the voucher privatization of the early 1990s. About 50

to 60 percent of enterprise shares are in the hands of insiders: employees and managers. Thus company boards can effectively vote down managers even when the issue of reducing the workforce is raised. Managers are reluctant to lay off workers for several other reasons: their own positions may be in jeopardy; they feel a sense of paternalism and social responsibility toward workers; they hope for an increase in demand for their products; and they want to avoid high separation costs.

Poverty and Inequality Are on the Rise

Poverty in Russia has increased throughout the 1990s. If calculated on the basis of the Russian Longitudinal Monitoring Survey (RLMS), more than one-third of Russian households—comprising some 39 percent of the population—consumed less than the official subsistence minimum in 1998. [Currently about \$80 per month]. The increase in poverty is a result of a decline in real income and of growing inequality in the distribution of income and expenditures.

Extreme poverty exists in households in which less than 50 percent of the official subsistence minimum is consumed. These “very poor” individuals and households made up 15 percent of the population in 1996. Extreme and potentially long-term poverty in Russia is increasingly associated with the following:

- Households with either children or children and elderly comprise more than 75 percent of the very poor (only 41 percent of the non-poor). The vulnerability of children to poverty is a matter of increasing concern.
- Extreme poverty is mostly a rural phenomenon. Rural areas account for 27 percent of the non-poor but 43 to 44 percent of the very poor. Only 3 percent of the poor live in the major metropolitan areas of Moscow and St. Petersburg.
- Extreme poverty is rampant among those with low education, low entrepreneurial ability, and low occupational skills.
- The very poor lack private land and access to private land.

- Many of the extremely poor are unemployed. However, because of pervasive wage arrears and low salaries in some parts of the public sector, extreme poverty is not confined to those without jobs. Recent studies indicate a growing number of poor among workers with unpaid wages.

The hardship on workers by nonpayment of wages has led them to seek secondary paying jobs in the formal sector, as well as in the informal sector. Families have survived because of support from friends and relatives—and by using gardening plots for the home production of food, both for their own consumption and for sale. The most extreme poverty is likely to occur in households without the necessary contacts, skills, or resources to apply any of these coping strategies.

The Social Protection System Has Failed to Deliver

The lack of an effective safety net—one that is responsive to economic crisis and can ease restructuring—has limited the ability of Russia to deal with growing poverty.

- The Russian social assistance system was designed to provide several small benefits to defined categories of the population—such as the disabled—not to alleviate poverty. This approach to benefits allocation still prevails and excludes many of the new poor, such as those in large families and those unemployed who are capable of working.
- Since 1994 social assistance benefits have increasingly not been paid or, if paid at all, have been paid in kind. In a highly decentralized social assistance system, this failure to make payments has reflected both the fiscal squeeze and the collapse of official delivery mechanisms.
- The overall level of social assistance—amounting to about 4 percent of the poverty gap in 1994—would have been inadequate even with effective targeting.
- The performance of the system in targeting benefits to the poorest households has been extremely weak by any stan-

dards, including those of other transition economies.

The average monthly benefit per household is only about \$4, for both poor and non-poor households. The distribution of social assistance was almost entirely flat, with 13 percent of the poor and 13 percent of the non-poor receiving social assistance benefits. The proportion of total social assistance expenditure that went to recipients who should not have qualified on poverty criteria (a leakage in monetary terms) amounted to almost two thirds.

In terms of efficiency, only 8 percent of total social assistance in Russia was distributed to the lowest decile of the population, compared with 20 to 27 percent in Bulgaria, Hungary, and Poland and 35 percent in Estonia. Performance in targeting assistance to the poorest households, as measured by the concentration coefficient of social assistance, is also very weak in Russia in comparison to other transition economies. The more negative the coefficient, the more social assistance, in absolute terms, is targeted toward the poorest households.

Comparing Russia's Social Assistance System to That of Other Transition Economies

	Effective % of Social Assistance Received by the Lowest Decile	Concentration coefficient
Russia	8.2	8.2
Hungary	27.2	-25.8
Estonia	34.7	-16.2
Poland	20.5	-19.8
Bulgaria	22.3	-13.8

Source: Branco Milanovic, “The Role of Social Assistance in Addressing Poverty,” *The World Bank, February 1998, mimeo, p. 36.*

In 1998 Russia's per capita GDP dropped by 4.6 percent; it is expected to drop a further 3 to 4 percent in 1999. Wage earners

with limited or no savings were hit with re-kindled inflation. Inflation accelerated from 0.2 percent in July 1998, to 3.7 percent in August, and to almost 40 percent in September, before slowing to 8.5 percent in January, 3 percent in April, and 2.2 percent in May. While the annual consumer price index increased by 77 percent in the second half of 1998, average nominal wage increased by only 26 percent in the same period, indicating a drop in real wages of about 30 percent. The real monthly wage in April 1999—the latest date available—dropped by 1.8 percent from March. The real annual wage remains 38 percent lower than the 1997 average. At the same time, wage arrears decreased by 6.8 percent—to 63.1 billion.

Income Distribution Scenarios for Y2K

The beginning of the year 2000 is expected to be a difficult period in Russia. The average standard of living will reach a low point before stabilization and recovery are expected to occur. To assess the impact of the economic crisis on the poor, the effect of three economic scenarios is simulated. Each offers alternate assumptions regarding changes in the distribution of income in year 2000.

● **The first scenario**—a “baseline” scenario—assumes a drop in income would be distributed evenly across all income groups. In this scenario about 18.3 percent of the population would become very poor, an increase of about 20 percent. Severe welfare declines would hit the poor—especially the very poor—as falling real incomes would be accompanied by failing services and worsening social conditions.

● **The second scenario** assumes the decline in income would fall mainly on the poor, causing a 16.8 percent income decline for the poor and an 8.4 percent decline for the non-poor. In this scenario, the rate of extremely poor would increase to nearly 19.4 percent of the population.

● **In the third scenario** the fall in income would have a much greater impact on the non-poor, causing an estimated income decline of 15.5 percent for the non-poor and 7.75 percent for the poor. Even in this scenario the proportion of extremely poor would increase to about 17.1 percent.

In any of these scenarios social expenditures would decline steeply, related both to the per-capita GDP drop and to the expected decrease in tax and social security revenue collection. Social expenditures—basic education, primary health care, and social assistance financed by regional governments—would decrease by about 15 percent. Transfer payments, often delayed in the past, would likely to remain in arrears, further compromising the effectiveness of the safety net.

The 13 richest donor regions are likely to offset the income drop better than the federal government, while the 15 poorest regions—which depend on federal transfers for more than 50 percent of their total spending—will be unable to do this. Therefore the income and revenue crisis is expected to deepen already large income disparities in the country. Reduced inter-governmental transfers primarily affect poorer regions. Moreover, intra-regional transfers are likely to be reduced, increasing the risk to underfinance vital social services of local governments where most provision actually takes place.

What Is the Solution?

Expenditures on social assistance, primary schools, and basic health care—including immunization and protecting children from an irreversible adverse impact of the crisis—should be the priority and should be maintained at least at the level of the previous year. Financing should come from within the social protection system by savings, such as turning untargeted housing and related utility service subsidies into targeted benefits to the poorest.

The social protection system needs to be restructured with three objectives:

1. Radically improving targeting. Because of the enormous difference between reported income and consumption—attributable to the unofficial market—traditional means-testing methodologies do not work. The government has supported experimental approaches (see box on page 7). Estimates of potential household consumption can be used to determine eligibility for social assistance.

2. Strengthening the delivery of social assistance and social services. This includes creating a social fund-type delivery mechanism to deal with socially destitute groups—including institutionalized children, the handicapped, the homeless, the single elderly, and others. These groups have different needs and the hardship of transition affects them more severely, so they require special services and assistance. The one thing they have in common is being isolated from the society and excluded from most of the existing social programs or safety nets. Both public social services and nongovernmental assistance can play an important role in helping these groups, but with the following precautions:

● Responsibility should be shared among the federal, regional, and local municipalities.

● Participation of the population and local institutions in the delivery of services should be encouraged.

● Specific instruments should be used to ensure the rapid delivery and adequate control and accountability of funds. A social fund-type mechanism would ensure that fund staff evaluate proposals of local governments, NGOs, and local associations according to pre-defined criteria, submit these proposals to committees, and set up programs at the local level with representatives of different stakeholders. The fund's activities should be overseen by a Board set up at the central level.

● Labor-intensive public works—including

ing sanitation systems, school rehabilitation, and road maintenance as identified by municipalities, local associations, NGOs, or local administrations—should be initiated.

The local government should collaborate closely with NGOs in designing the response to the social impact of the financial crisis and in fighting social exclusion. NGOs are still relatively new in Russia and very few are active in social assistance at the federal level. The Red Cross is probably one exception and it is most active in delivering humanitarian assistance programs. At the local level there are some powerful NGOs, such as the Association of War Veterans or the Association of Mothers of Soldiers. The Russian Orthodox Church, which has a fast growing network of parishes, still has a relatively small

role in delivering programs to the poor, aside from limited charitable activities connected to the church parishes. The church is a potentially important stakeholder in the medium and long term.

3. Providing an adequate social safety net for displaced workers. The government should centralize the provision of unemployment benefits and increase their level, as well as set up special severance pay schemes whereby workers are eligible for payments conditional upon enterprise restructuring or closure. The unemployment benefit system should be simplified by the introduction of a flat-rate benefit. Available only to those workers who were employed earlier and paid contributions to the employment fund, the benefit's level would be determined by the availability of re-

sources. In the longer term the government must strive to raise the safety net above the subsistence level. The employment fund should be centralized to allow for redistribution of assistance to poorer regions.

This article is a shortened version of the study edited by Michal Rutkowski, "Russia's Social Protection Malaise: Key Reform Priorities as a Response to the Present Crisis," Social Protection Discussion Paper No. 9909, April 1999. The poverty and inequality projections are based on Jeanine Braithwaite's work. To order, contact Social Protection Advisory Service, The World Bank, Room G8-138, 1818 H St., N.W., Washington, DC, 20433. tel: 202-458-5267, fax: 202-614-0471, email: socialprotection@worldbank.org, Website: www.worldbank.org/sp.

Targeting Social Assistance—Experiments in Three Oblasts

The World Bank designed three social assistance pilot projects to identify the poorest of the poor. Identification of the poorest was based on estimating the potential consumption of extremely poor families. Households were eligible to benefit if their estimated per capita consumption was below 35 percent of the per capita subsistence minimum in Komi, below 50 percent in Voronezh and Volgograd. Three different approaches were used:

- In Komi, the estimation of household income was based on the economic potential of the family. The methodology imputed the worth of a private plot (to estimate income in kind), rental of an above-norm living space, and use of a private automobile (to estimate informal income).
- In Voronezh, the traditional approach for determining needs was refined. The benefit was previously made available only to the a priori poor—households with several children, single mothers, single pensioners, and the disabled. This was extended to include multimember families with more than three-month wage arrears, as well as the unemployed. Actual (not assigned) income was calculated, along with income from land and livestock possessions.
- The approach in Volgograd was two-fold. Three raions in the oblast were asked to pilot a proxy means test based on visible characteristics of the families (size, assets, and so on). The rest of the oblasts were left to a traditional "categories-only" approach.

Successful implementation of these different targeting systems in three different oblasts of Russia implies the following:

- **Targeting is feasible.** All methodologies relied on some estimate of economic potential, total potential income, or potential consumption of the applicants. Reliance on official income would have led to highly distorted outcomes because wages and transfers are often not paid on time, and individuals may underreport income because of tax considerations.
- **Targeting can be effective.** Oblasts that have introduced targeting report a higher degree of social consensus and a much better ability for the authorities to help the truly needy.
- **Benefits should be paid in cash whenever possible.** This enables beneficiaries to fulfill their basic individual needs.
- **Transparency is important.** In all three areas, the pilot program was widely publicized in the press, on the radio, and displayed on posters at local social assistance offices.
- **Errors of exclusion can be minimized.** The pilots were designed to reach the poorest of the poor—given the fiscal constraints of both the federal and local governments. Preliminary evidence suggests this goal was achieved.

World Bank Assistance to Russia's Social Sectors

The World Bank has an extensive assistance program to Russia's social sectors. It addresses many gaps or emerging problems that are being exacerbated by the crisis, as well as longer-term structural reforms in social protection and social services.

Projects under implementation or preparation include:

- **Social Protection Adjustment Loan (SPAL).** Approved in 1997 for an amount of \$800 million, this project supports strategies aimed at providing Russia with a social safety net. It focuses on the pension system (minimum pensions, short-term stability of the Pension Fund, and systemic pension reform), employment and labor market policy (unemployment benefits, active programs, labor code), child allowances (transition from a universal to a targeted benefit, institutional strengthening), rationalization of short term benefits (sick pay, maternity benefits), and social assistance (better targeting of funds). Following a government request to redesign the third tranche of the SPAL, changes were introduced to the program that take into account the constraints imposed by the current economic and financial circumstances, such as protection of minimum pensions, improvement in administration of Employment Fund, strengthening the minimum employment assistance, better guidelines for means-testing, and reduction of arrears in the Pension Fund.

- **Social Protection Implementation Loan (SPIL).** This technical assistance and investment companion of the SPAL, amounting to \$28.6 million and approved in 1998, supports the design and implementation of policies introduced under the SPAL. It directly addresses the fallout from the crisis: monitoring vulnerable groups and the impact of social programs aimed at them, examining the scope for rationalization of poverty benefits, and reviewing programs for the long term unemployed.

- **Structural Adjustment Loan (SAL 3).** The social protection agenda pursued in the context of the SPAL and the SPIL is supported and further developed under the SAL 3. This \$1.5 billion loan, approved in 1999, supports changes in the labor code, making it more market oriented, with better income and employment opportunities for workers and more efficient functioning of commercial enterprises. It also supports the removal of distortions in the current system for provision of sick pay and maternity benefits. This project is expected to allow reduction in the payroll tax for social insurance. SAL is expected to improve transparency in federal-regional fiscal relations, enabling better management of resources going to the regions and at regional levels, including for poverty alleviation.

- **Employment Services and Social Protection Project.** This project—approved in 1993 for the amount of \$70 million, with \$25 million still undisbursed—explores ways to strengthen the delivery of active employment programs (counseling, assessment, provision of occupational information), and provide office computer systems to speed up the delivery of pension payments (the

waiting period had been already reduced from an average of two weeks to two days). Recently, the Russian government has requested that the project introduce experimental community development programs to stimulate employment. This component is consequently being introduced into the project.

- **Pension Support Project.** This is a new investment project under preparation aims at improving the efficiency of the pension administration and at introducing individual worker accounts. It would also address the institutional changes necessary for reform of the public pension system.

- **Northern Migration Pilot Project.** At the request of the Russian government, this project is under preparation to develop incentive-based public migration assistance schemes that would encourage voluntary migration from settlements in the Russian Far North, making Northern development self-sustaining, reducing the need for public subsidies and northern-specific transfers from the federal budget.

- **Medical Equipment Project.** This \$270 million project, approved in 1996 (with about \$100 million still undisbursed), finances the supply of badly needed medical equipment, emergency drug purchases to hospitals, and other health care facilities.

- **Health Reform Pilot Project.** Approved in 1997, for an amount of \$66 million (most of which is undisbursed), this project will finance approaches to longer-term restructuring of the health sector at the oblast level. Implementation has begun and should continue as planned. Early findings are being used to design national level reform under the proposed Health Reform Implementation Project.

- **Health Reform Implementation Project.** This project, under preparation for fiscal year 2000, will address longer-term restructuring issues from the national perspective and build the Ministry of Health's capacity to lead reforms in partnership with the regions.

- **Local Social Protection Delivery.** The proposed project aims at mitigating the social impact of the Russian financial crisis. The operation consists of two components. The first focuses on improving the targeting of cash benefit programs and humanitarian assistance, as well as expanding the pilot experiment in three regions targeting the very poor. The second component helps to set up a new delivery mechanism for social assistance and social services in the form of a Community Solidarity Fund. This Fund would finance programs targeted at the poor and vulnerable and be implemented through community-level institutions—like raion and village councils, small town municipalities, and local associations. Fund-supported programs would extend to labor-intensive public works, integration of street children and isolated elderly, and helping poor and isolated villages and small towns improve delivery of social services to community members.

Distrusting Government Institutions, Russians Develop Survival Strategies:

Results of the New Russia Barometer Survey

by Richard Rose

When the Soviet Union collapsed, many fixed on a new goal: the transformation of Russia into a modern society with a market economy and democratic political institutions. The idea of “plugging in” the Russian market assumed that if one only followed the appropriate macroeconomic policy and enacted the correct institutional structures for the ownership of enterprise, behavior automatically would be transformed. “Market Bolsheviks” sought to introduce capitalism into a country lacking the prerequisites that a capitalist economy such as England had achieved centuries ago.

The legacy of the Soviet era is that of social failure, the consequences of which remain palpably evident today. The institutions of a market economy have yet to be created by a few “big bang” actions. Ironically, the “smart” institutions of Western societies have paid the highest dollar price to learn this obvious lesson from the financial collapse of last August. Ordinary Russians did not need to lose dollars to learn this lesson, nor were they well enough off to have savings in foreign currencies. As John Earle of the Stockholm Institute of Transition Economies pointed out, long before the Russian Federation defaulted on Western bankers, it defaulted on its own citizens, failing to pay wages and entitled social benefits.

The New Russia Barometer survey found that in early spring 1998, three in five Russians routinely did not receive the wage or pension to which they were entitled; the proportion has certainly increased since the financial collapse of last August. The state is more likely to pay wages late to employees of public enterprises, the mili-

tary, teachers, and health workers than is the private sector. Confronted with organizational failure, individuals have a choice about how to respond. Informal networks can substitute for the failure of modern bureaucratic organizations, or connections or bribery can be used to get bureaucrats to violate rules.

Taking Care of Themselves

Demonstrating the failure of large bureaucratic organizations to provide the social protection to which citizens are entitled, four-fifths of Russian households, including a majority of city dwellers, continue to grow some food for subsistence. Informal networks are the most practical forms of social security. While only one in four Russians has any savings, and most unemployed do not receive a state unemployment benefit, most Russians can turn to family and friends for money if in need. Sixty-six percent of those surveyed report they could borrow a week's wages or pension from a friend or relative.

The introduction of the market has increased opportunities for overt corruption—paying officials to break rules to the benefit of a recipient. Whereas party connections were crucial in Soviet days, now the average Russian thinks that dollars or Deutsche Marks speak more loudly than a party card ever did.

An estimated half of the anticipated state revenue goes uncollected—and some that is collected is “levied” rather than paid by modern means. Among the employed, only 41 percent say that taxes are deducted when their employer pays wages; 5 percent say that no taxes are deducted; 54

percent are unaware whether taxes are deducted or not.

A majority of Russians say that there is no need to pay taxes—the government will never find out. Three-quarters believe that a cash payment to a tax official enables someone to evade payment of taxes claimed. Altogether, five-sixths of Russians think that taxes can be evaded; they differ only in whether the best tactic is not paying at all or tipping tax officials to avoid legal obligations.

Finding a Network

Resources are not equally distributed in a society. Networks are exclusive as well as inclusive: individuals are often socially excluded from networks that secure everyday goods and services. While whole categories of people are socially excluded—such as pensioners, the unemployed, or women with children—social exclusion tends to be situation specific.

Most Russians are not socially excluded—they have a variety of networks on which they can rely. From 60 percent to more than 90 percent can draw on some social capital in hard times. When Russians are asked how much control they have over their lives (with 1 representing no control and 10 a great deal of control), the mean reply falls almost exactly in the middle, at 5.2. Only 7 percent of Russians place themselves at the bottom, feeling no control of their lives.

Although only a minority of Russians are prepared to rely on the police—less than half think that the police will protect their house from burglary—even fewer think that

nothing can be done to protect their home from crime. People invoke alternatives: making sure there is always someone in the house, keeping a dog, or even buying a gun. What is the situation most likely to produce a sense of helplessness? Nonpayment of wages. And enterprises are so short of money that cajoling or bribing them to pay is of no avail.

Overregulation Helps Corruption

Organizational failure in Russia reflects the combination of too many regulations and too little adherence to bureaucratic norms. An excess of rules imposes delays and unresponsiveness as different public agencies must be consulted. Individuals invest an unreasonable amount of time in pleading with and pushing bureaucrats to compensate for organizational inefficiencies. If bureaucrats offer to waive obstructive regulations in return for a side payment, a service is delivered. The result, however, is popular ambivalence about the rule of law. Seventy-one percent of Russians say that the national government is far from a law-governed state. Sixty-two percent think that laws are often hard on ordinary people. In such circumstances, law enforcement may be undesirable. Among Russians, 73 percent endorse the belief that harsh Russian laws can be softened by their nonenforcement.

The result is a crisis of governability, in which the state is too weak to collect taxes and control its own expenditure. It delivers too much money to the few of an elite circle, too little to the great majority of the people. Only 35 percent of Russians think that the social security office will pay the claimants money to which they are entitled. Less than one in three expect to have enough financial resources to consider buying a house, and only one in six reckon they could borrow a few weeks wages from a bank.

This article is based on the author's piece "Living in an Antimodern Society," published in the Winter/Spring 1999 issue of the East European Constitutional Review,

a quarterly published by New York University School of Law and the Central European University, Budapest.

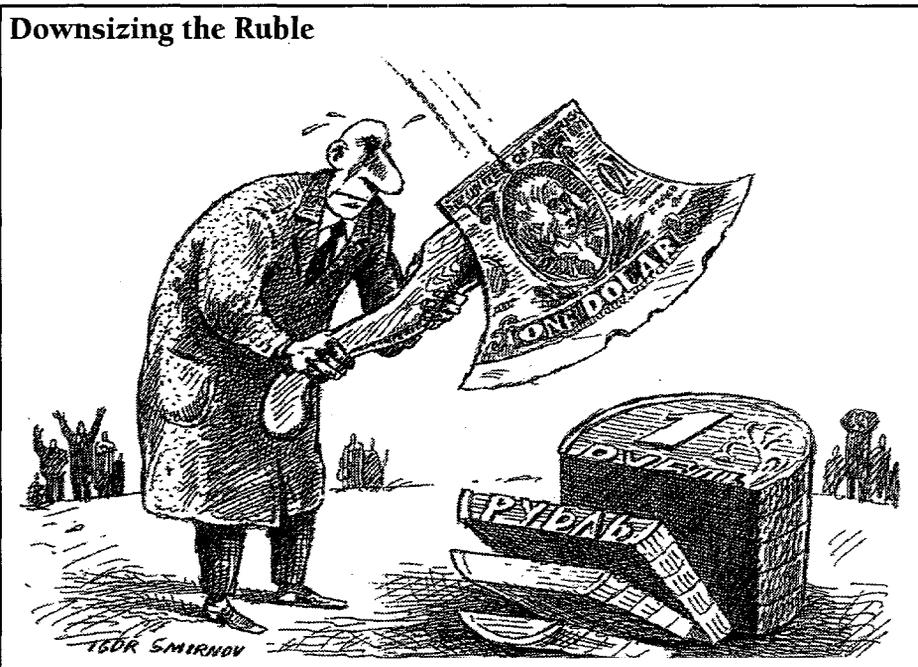
Richard Rose is the director of the Centre for the Study of Public Policy, University of Strathclyde, Glasgow G1 1XH Scotland, and founder of the New Russia Barometer and related survey studies of mass response to transformation in post-Communist societies of Central and Eastern Europe and the former Soviet Union. His latest book is Democracy and Its Alternatives: Understanding Post-Communist Societies, published by Polity Press and Johns Hopkins University Press, 1998, with William Mishler and Christian Haerpfer.

The seventh New Russia Barometer survey of the Centre for the Study of Public Policy collected data about how Russians deal with formal organizations to get goods and services. The survey was part of the World Bank's Global Initiative on Defining, Monitoring, and Measuring Social Capital, supported by the Danish Government. For details see <http://www.cspp.strath.ac.uk>.

Tactics for Getting Things Done: Responses of the New Russia Barometer

	Percent saying "yes" to:
Relying on Organizations:	
Requesting police to help protect house from burglary	43%
Asking social security office to pay entitlement if claimed	35%
Borrowing a weekly wage from a bank	16%
Informal Alternatives:	
Growing own food	81%
Borrowing a weekly wage from a friend	66%
Personalization:	
Demanding action at social security office to get paid	32%
Begging officials to admit person to hospital	22%
Anti-Modern Tactics:	
Using connections to get a subsidized flat	24%
Paying cash to doctor on the side	23%
Passive, Socially Excluded Behavior:	
"Nothing can be done" to get into hospital quickly	16%

Source: Seventh New Russia Barometer Survey (1998). Fieldwork by VCIOM; number of respondents: 1,904.



From the Russian monthly *Business in Russia*.

Kosovo—The Cost of War and Peace

A Snapshot from Late June

According to initial estimates, the post-war reconstruction in Kosovo could require 500 million to 700 million euro (about \$480-\$670 million) annually over the next three years—over and above humanitarian aid and macroeconomic assistance. Hans van den Broek, European Union (EU) commissioner for eastern Europe, said that estimate would have to be at least doubled through contributions from the rest of the international community, including the United States and other countries, international financial institutions, and spending from the national budgets of EU states. This would require that the international community would spend a total of more than 4 billion euro (\$3.8 billion) alone on Kosovo's reconstruction over the next three years.

The UK-based Oxford Analytica predicts the reconstruction effort in the Balkans, if extended to Serbia and Montenegro, would hike up to \$10 billion over a period of three to five years. Yugoslav independent economists from the Group 17 calculated a much higher figure. They estimate that reconstruction and reform of the Yugoslav economy could cost \$30 billion in the next three years. The funds would upgrade the road network, improve gas and oil pipelines, introduce a currency board to stabilize the dinar, reform the pension and health systems, and cover export losses over a three-year period. In a document called "Final Account," the group asserted that \$29 billion comes on top of an estimated \$1.2 billion in urgent humanitarian assistance to help refugees, reconstruct power supply and heating facilities, and rebuild private homes and bridges.

Balkan Countries Are Losing Billions of Dollars

The impact of the war will shave almost \$8 billion off the Balkan region's GDP in 1999, according to the latest *Economies in Transition* report of the Economist Intelligence Unit (EIU). In addition to the serious short-term economic costs, both economic and political, the after-effects are likely to be felt for many years to come.

According to EIU calculations, this year's total loss in output in Yugoslavia and seven frontline states amounts to \$7.8 billion, or 5.4 percent of the area's GDP. On average, these eight countries in 1999 should expect a 3.8 percent decline in growth, compared with a 1.6 percent growth rate forecast before the war. Yugoslavia's real GDP should decrease about 40 percent, and Macedonia's economy—which is dependent on trade with and transit through Yugoslavia—is expected to suffer a 15 percent decline.

The war is forecasted to limit projected foreign direct investment (FDI) inflows into the area to about \$4 billion—with a drop from \$5.6 billion in 1998. Some of the region's economies—where output is still far below 1989 levels—were heading for another decline in GDP in 1999, even before the war began. The war decimated the region's commerce and transport systems. For Kosovo and the rest of Yugoslavia the destruction has wiped out infrastructure and production facilities worth tens of billions of dollars. Domestic and foreign investor confidence has taken a severe blow. Some countries will lose tourism receipts and higher risk premiums will be paid on external borrowing. Although substituting official sources of finance with private ones will help immediate problems, it will contribute little to setting the foundations for sustainable growth—says the EIU report.

This year, the flood of refugees and the disruption of trade will cost Yugoslavia's neighbors about \$1.8 billion, according to Rory O'Sullivan, coordinator of the Bank's

After-Effects of War in Kosovo:

Less GDP in Hungary and Seven Balkan Countries in 1999

	Real GDP growth (percent)				GDP (million dollars)			
	1998	1999	1999	Differential	1998	1999	1999	Differential
	Actual	Earlier ^a	Current ^b		Actual	Earlier ^a	Current ^b	
Albania	8.0	8.0	6.0	-2.0	2,977	3,215	3,156	-59
Bosnia & Hercegovina	18.0	15.0	10.0	-5.0	4,082	4,694	4,490	-204
Bulgaria	3.5	3.0	1.0	-2.0	12,257	12,625	12,382	-243
Croatia	2.7	0.0	-2.0	-2.0	21,321	21,321	20,895	-426
Hungary	5.1	3.3	3.0	-0.3	47,621	49,192	49,046	-147
Macedonia	2.9	3.0	-15.0	-18.0	3,547	3,653	3,015	-638
Romania	-7.3	-2.0	-4.0	-2.0	40,226	39,421	38,636	-785
Yugoslavia	2.6	1.0	-40.0	-41.0	12,825	12,953	7,695	-5,258
Total/average	2.0	1.6	-3.8	-5.4	144,856	147,076	139,314	-7,762

^a Forecast before Yugoslav war. ^b Forecast for 1999, taking into account impact of war.

Source: EIU.

aid to the Balkans. FYR Macedonia, Bulgaria, Romania, Bosnia and Herzegovina, Albania, and Croatia are the six most affected countries. (See also "Additional External Financing Needs," *Transition*, April 1999, table on page 3). The World Bank had already promised additional loans of about \$500 million to compensate for part of the loss, and together with the EU Commission and the IMF is now organizing donor conferences to raise the rest of the money.

The first conference, to be held in Brussels in July, will concentrate on short-term needs in Kosovo, securing funds for immediate humanitarian needs (including refugee return), establishment of civil administration, and information sharing among donors.

It will be followed by an international summit discussing major issues of the Balkan reconstruction, to be held on July 28 in the Bosnian capital of Sarajevo. Discussions will center around the Balkan Stability Pact for South East Europe, signed on German initiative in Cologne on June 10, between the Balkan states, Hungary, the Group of Eight (G8), and international organizations, including the EU and the World Bank. The pact aims at creating conditions for a lasting peace through democratization and economic cooperation. It offers financial aid and the prospect of European Union membership to countries in southeastern Europe in exchange for establishing regional security and economic ties, democratic reform, and respect for human rights. It would set in place an open trade area with close links to the EU, built around country-by-country agreements across southeastern Europe.

The EU hopes to begin negotiating a "stability and accession agreement" with FRY Macedonia and Albania. An agreement for Bosnia and Herzegovina could follow, and, depending on political developments, for Croatia, which lacks a bilateral trade agreement with the EU. The stability pact, designed to run years after Kosovo is rebuilt, will require a large and long-term commitment on the part of the West.

The World Bank and the Commission will co-host a second donors' conference, probably in October or November. This will provide an opportunity to take stock of current operations and further mobilize reconstruction funding based on a detailed damage assessment.

European Reconstruction Agency

The EU Commission has proposed setting up an European Reconstruction Agency for rebuilding Kosovo with wide-ranging powers to disburse funds quickly. When it is up and running, the agency would operate out of the Kosovar capital of Pristina, carrying out a large number of small projects. It will manage a considerable budget and have short-term contracts with about 200 to 300 experts in a wide range of fields, including engineering, mine clearance, architecture, agriculture, health and welfare, and micro-enterprise. The agency also will spread to other countries in the region.

Three types of EU assistance will be involved in the Kosovo reconstruction:

- **Humanitarian aid** to help resettle returning refugees in their homes. To date, 182

million euro have been allocated via the European Community Humanitarian Office (ECHO), working closely with the UNHCR.

- **Reconstruction aid** based on the existing Fund for the Reconstruction of Former Yugoslavia (OBNOVA). Kosovo is eligible for grant aid under OBNOVA. Invitations to tender will follow OBNOVA rules and be open to local procurement as much as possible.

- **Macroeconomic aid** essentially in the form of loans (notably for balance of payments support), with the aim of building a viable economy and increasing regional integration in the future.

The latest information about "Economic Development and Reconstruction in South East Europe" is now on the Internet: <http://www.seecon.org/>.

This article was excerpted from news agency reports and the latest report of EIU's Economies in Transition, Second Quarter, 1999. For information about EIU, contact Laza Kekic, tel: 44-207- 830-1180, email: london@eiu.com, EIU Website: www.eiu.com.



From the *World Press Review*.

Strengthening Weak Spots in China's Economic System

by Jiang Conggan and Liu Zheng

During the gradual economic reform of the past 20-years, China's economy has undergone wide-ranging structural changes. Average annual growth reached 9.7 percent between 1979 and 1997. During this same period, the mining and extraction industry averaged 5 percent annual growth, production of investment goods and other heavy industry items increased by 11.9 percent, and consumer good production expanded by 10.6 percent. As a result of structural adjustments in the 1980s, the share of the mining and extraction sector shrank from 28 percent to 19 percent while the share of consumer products rose from 24 percent to 32 percent. The quality of consumer goods—including foodstuffs, electrical appliances, and clothing—also improved considerably, and in the early 1990s, there was a shift toward electronics, telecommunications, heavy, and chemical industries. These adjustments helped China's economy to expand steadily for 20 years.

Structural adjustments in China's economy, however, were basically self-generated," market pressure played only a minor role. These adjustments eliminated the "shortage economy" and made commodities—especially staple consumer goods—widely available. To some extent, the industrial structure has been optimized, and the nonstate sector has developed by leaps and bounds. The expansion of hasty investment, however, has ignored effective demand, and rapid construction has resulted in surplus production capacities and excess supply—all leading to more structural imbalance.

More than 50 percent of China's enterprises were temporarily forced to halt production because of inadequate demand. In many enterprises, an oversupply of capital and labor contrasts with low-level effective demand, weak demand elasticity, and

declining marginal consumption by urban and rural residents. But while ordinary commodities became oversupplied, demand for high-tech and high value-added goods couldn't be met due to scant domestic manufacturing capacities. These shortages could only be alleviated by imports. At the same time, the present production structure makes it difficult to apply economic levers—prices, interest rates, and tax rates—to correct the supply-demand relationship.

China's economy is already an open one. Making it a more international economy could be quickened if China enters the WTO on schedule this year. Any changes in the external environment will affect China's economic structure.

Making the Global Adjustment

In the 1990s the global economy has undergone profound structural changes. A full-scale adjustment of global economies is underway. Adjustment for the high and new technology industries in the United States, particularly in the information industry, has been almost complete. Japan's economy—after a high-speed growth for nearly 30 years—sank into economic recession in the 1990s. East Asia's newly emerged economies—grounded by financial crises after miracle growth—will also have to undertake structural changes. The launch of the euro provides a unified monetary policy in the Euro Zone, which will quicken the adjustment of EU members. These developments, together with the worldwide symptoms of a global economic deflation, will affect China's economic structure in the following ways:

● **Multinationals dominate the worldwide information industry.** While China is upgrading its information industry, large multinational corporations—dominated by the United States—have already divided

the market. The difficulties of exploring new markets will affect the development of China's information industry.

● **Imports of high technology will become relatively more expensive.** Last year the world market price of oil decreased by 30 percent. World market price of other primary products decreased by 15 percent, and the price of most finished goods also declined. Only the price of high-tech products increased. This trend could impair the export of global technology. China's strategy—offering its huge market in exchange for technologies to restructure traditional industries and develop high and new technical industries—will definitely face challenges.

● **China's industrial structure is similar to those of the newly emerged East Asia economies.** East Asia succeeded in adjusting and strengthening the competitiveness of its goods through local currency devaluations. Direct competition from East Asia with China's exports will make it imperative for China to quicken its structural adjustment.

● **Frequent mergers of global corporations demonstrate the trend of realignment among large and strong corporations.** As multinational companies intensify their penetration into the Chinese market, the development opportunities for domestic enterprises decreased.

Foreign Trade and FDI Barriers

Last year, Asia's financial crisis affected other regions and put China under the dual pressure of reacting to declining overseas demand and falling export prices. China's export growth was severely restricted, equaling only 0.5 percent in 1998. In the first two months of 1999, China's foreign sales decreased by 10.5 percent. These trends will affect China structural adjustment in three ways.

- It is hard to utilize idle production capacities for foreign demands.
- Deterioration of trade conditions and decrease of export prices will continue to cut into the profits of China's foreign trade companies.
- The decline in certain exports could set back China's progress in modernizing its industry. Manufactured goods account for more than 80 percent of China's exports. Machinery and electronic products are the most important drivers in promoting export of the manufacturing industry. In October 1998, China's monthly export of machinery and electronic products decreased the first time since April 1996. This trend is continuing and could set back the adjustment process.

The Role of Investment

Because of domestic demand constraints, total imports decreased by 1.5 percent in 1998. For the first two months of 1999, China's imports increased by a mere 4.7 percent. While fewer imports stimulates demand for domestic products and investment, the lack of foreign technologies could slow the process of industrial modernization. Domestic investments aim for basic infrastructure construction and hardly affect the import of foreign technology and equipment.

Foreign direct investment (FDI) plays a key role in China's structural adjustment. FDI enhances the country's development potential, improves technological enterprises, and improves organizational and management structure. But last year the disbursed foreign capital decreased by 7.9 percent and contracted FDI was barely able to keep up with previous year's 0.7 percent growth.

As for China's short-term prospects, the continuing boom in the U.S. economy will attract investors—even those who previously invested in Asia's economies. After forming the Euro Zone, capital funds originating from EU can be circulated globally

rather than being restricted within the EU. Economies in Asia will continue their slow recovery. These developments predict the continuation of a downward trend of FDI in China, and the difficulty in reversing it.

Constraints of Domestic Market

In the face of external difficulties such as global overproduction and shrinking demand, maybe China's economic structural adjustment should be aimed more at the domestic rather than the foreign market. This would mean boosting consumption, housing construction, exploring rural markets, and creating massive support for medium- and small-sized enterprises in the nonstate (private) sector.

China's private savings are estimated at 5,000 billion yuan, while foreign exchange reserves have reached \$145 billion. All of those assets could provide a wide range of maneuvering space for the country's structural adjustment. However, the potential difficulties should be recognized and addressed.

● **Technological innovation represents a declining portion of total investments.**

Taking a total annual fixed asset investment as 100, the portion of innovation investments was 16.5 percent in 1995, 15.8 percent in 1996, and 15.7 percent in 1997. In 1998, innovation investments grew 6.1 percent less than infrastructure investments. Many technologically innovative projects have long been delayed. Stressing capacity building but neglecting technology innovation—likewise emphasizing extension but neglecting the content of projects—constitute a blind spot in China's investment structure.

● **The cost of rebuilding traditional industries, including the textile, coal, and wood industries, would be expensive.**

With severe excess production capacities, these traditional industries comprise a large number of state-owned enterprises and are struggling with heavy burdens that are historically inherited. These enterprises are in

no position to bear the cost of replacing their production lines, let alone eliminating excess capacities. They also are traditionally labor-intensive industries and thus face extreme difficulties in laying off employees.

So who will finance these costs? State-owned enterprises continue to lose: state-owned and state-holding companies last year registered accumulated losses of 102.3 billion yuan, 21.9 percent more than in 1996. Township and village enterprises have also been on the decline for several years. So, everybody relies on financing of the central government. But the ratio of the central government's revenue to GDP is decreasing year by year, and is now very low. With little revenue, implementing active fiscal policy to stimulate domestic demands becomes difficult.

● **There are barriers to the development of many nonstate (private) small- and medium-sized enterprises.**

Private enterprises create millions of new jobs, alleviating unemployment. The major problems they face are in producing products similar to those of large enterprises, low levels of specialization, difficulties in getting bank loans, and heavy tax burdens. In the marketplace, they also face discrimination. To allow small and medium-size enterprises to compete with the large ones and to conduct specialized operations takes time and a comprehensive approach that includes adjustments in business operations, application of new technologies, finance system innovation, and enforcement of market discipline.

● **Changes in product structure is constrained by imperfect markets in a number of ways.**

The expansion of consumption is blocked by low personal income and gloomy consumer expectations—foreseeing stagnant earnings and rising future expenditures. Due to the general decrease in prices, the consumer goods market is inactive and fails to give signals to suppliers. Also, when housing, social security, and finance system reforms are delayed, the dis-

tribution structure is distorted. Insufficient investment in agriculture and the slow pace of its industrialization will generate low income in rural areas. And when urbanization lags behind industrialization it sets back consumption. While industrial output represents 40 percent of GDP, less than 30 percent of the population lives in urban areas. Slow urbanization means market constraint.

The Urgent Need for System Innovation

Unnecessary, irrational investments across the industry are caused by the following:

- Driven by the economic growth index, local governments have an unquenchable appetite for more investment. Local rivalry results in developing similar industries and products, promoting local interests regardless of market demand.
- Soft budget constrains, budget support in granting directed credits, and capital injections to loss-makers result in irrational investment expansion in state-owned enterprises. Last year, 86 percent of bank loans were provided by state-owned banks to state-owned enterprises. Nonstate enterprises have to obtain financing through indirect means.
- Fiscal resources are dedicated to rescuing a number of inefficient state-owned enterprises operating in the "sunset industries," instead of supporting expansion of fast-developing areas of the national economy.

It is urgent to reform the investment, financing, and distribution systems, as well as to establish a modern enterprise system, including a fiscal spending strategy and the marketization of financing operations. What should be put on the agenda? The following items: improving capital markets and capital allocation, ensuring fair competition, setting up a modern social security system, and clarifying principal-agent relationships in state-owned enterprises.

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Milestones of Transition

Central and Eastern Europe

1998 FDI to Eastern Europe higher than in 1997. Despite a global financial crisis, foreign direct investment (FDI) to Eastern Europe was up last year, according to UNCTAD. The UN agency reported FDI to the region amounted to \$16 billion, 25 percent more than in 1997. FDI to Russia, however, fell to \$2.2 billion, its lowest level in more than three years. In 1997, FDI to Russia exceeded \$6 billion.

Who will join the EU—and when? On 22 June, after a meeting of the EU foreign ministers in Luxembourg, German State Secretary for Foreign Affairs Gunther Verheugen told journalists that the Czech Republic and Slovakia will join the EU together. This confirms reports on Czech tardiness in complying with EU requirements as well as Slovakia's improved chances following the demise of former Premier Vladimir Meciar, reports the Reuters news-agency. Verheugen also said that Poland's ambition to join the EU by 2003 is "not unrealistic." Hungarian Foreign Minister Janos Martonyi said that his country aims to enter the EU by 2002, and Sloven Foreign Minister Boris Frlec said his country intends to join one year later. Estonian Foreign Minister Toomas Hendrik Ilves said that while Estonia will be ready to join in early 2003, he was "not counting" on the EU to accept this date.

Nuclear un-safety in Eastern Europe. The Chernobyl nuclear disaster in 1986 prompted fears that the 67 Soviet-designed reactors in operation throughout Central and Eastern Europe and the Soviet Union were fundamentally flawed and needed to be repaired, if not shut down altogether. In 1992 the G-7 group of nations recommended that the 25 most dangerous Soviet-designed reactors in operation—particularly two older reactor types known as the RBMK and the VVER-

230—should not operate any longer than was absolutely necessary. The G-7 also urged safety upgrades at safer Soviet-designed power stations. Eight years later, however, not one of the suspect Soviet-designed nuclear power stations has been closed. Even an agreement between the G-7 and Kyiv to close the remaining functioning reactors at Chernobyl by 2000 faces an uncertain future. (Contributed by Anthony Wesolowsky).

The Baltics

Public sectors running deficits in Estonia, Latvia, and Lithuania. The public sectors of all three Baltic countries showed deficits in the first months of this year. In **Estonia**, the public sector deficit for the first four months of this year amounted to EEK 1.7 billion (\$120 million), corresponding to about 8 percent of GDP for the period. Estonia's GDP contracted by 5.8 percent in the first quarter of 1999 (year-on-year), mostly the result of the Russian crisis. **Latvia's** state-level deficit for the first quarter of 1999 was LVL 7 million (\$12 million). Expenditures have ballooned 17 percent, while revenues have remained virtually unchanged from the same period a year earlier. The IMF has recommended that Latvia reduce its projected 1999 budget deficit to 0.5–1.0 percent of GDP. Latvia's GDP fell by 2.3 percent in the first quarter of 1999. Coupled with a drop of 1.9 percent in the fourth quarter of 1998, this indicates that Latvia is technically in a recession. In **Lithuania**, the state deficit for the first four months of 1999 came to LTL 274 million (\$70 million). Both revenues and expenditures ran about 10 percent below budget. The IMF indicated that Lithuania needs to reduce both its budget deficit and its current account deficit. The IMF currently forecasts Lithuanian GDP to rise 2.0–2.5 percent this year.

Continued on page 33

Readers' Forum

Thoughts on Social Contradictions of Economic Transition

By László Antal

Future economic historians will probably view as miraculous the fact that a number of countries succeeded in laying the foundations of capitalism in less than a decade—in transforming state ownership into private ownership with the assistance of a self-restrictive state. The process has been marked by mishaps, dreams and wishes (in other words, trial and error), intertwined with outlandish anti-capitalist ideas of proposing a “third way”—a welfare system for poor countries.

The initial transition years were not attractive. In a period of ever-changing and uncertain rules—and as-yet missing ethics of a market economy—values were bound to be trampled. Many individuals saw a unique opportunity for gaining wealth and stature. They chose a rewarding party, an activist career, or undertook shrewd privatization transactions, negotiated through the minefield of laws and loopholes.

This early transition period is characterized by quick success stories, spectacular failures, and corruption and organized crime—deeply condemned by the majority of society. In the following years, however, the situation should stabilize, or at least revert to a more normal track. Those who don't make it during this extraordinary period should consider the principles of Max Weber's protestant ethic: reliability, professionalism, hard work, saving, and slow and gradual ascension.

The key short-term benefit that citizens gained from the systematic changes is freedom. Freedom of choice as a consumer, as an employee, and as a citizen—having the right and opportunity to take a stand at political issues. Citizens now may

travel anywhere without limits, invest money in securities, take a job abroad, or become managers without political discrimination. But this freedom currently provides palatable benefits only to rather small groups of the society—the wealthy and the highly qualified.

A much larger segment of the population is missing the sense of security offered in the communist period, even if that was security gained without perspective or without hope of improving one's status in life—best phrased in the lyrics of a popular Hungarian song of the period “The beer is lukewarm, but we don't care.” The quiet, slow growth in wealth that had been guaranteed for a large percentage of society—as well as the accompanying sense of pragmatism—may have been the values that legitimized the communist regime for a large number of people.

The economy of the communist regime was characterized by price stability and full employment, even with covert unemployment within the factories. Indeed, citizens were guaranteed the right to work. Contrast this to the present condition where many of the unemployed become permanently jobless, especially those living in depressed regions with scant job opportunities.

During communism, consumer goods and services were heavily subsidized by the state—even though durable consumer goods were extremely expensive in terms of the number of hours an average employee had to work to be able to afford them. Although often at very low standards, health services were provided essentially free of charge, excluding the extensive and necessary practice of tipping. All of this went on within the

framework of a still-existent—indeed destructive—attitude: that the state must provide everything, while the individual is responsible for almost nothing. The average citizen felt security—albeit at the poverty line.

There is little point in meditating on which is worth more in the long term—freedom or security. Having passed the crisis point, economic policy will probably introduce a social safety network that is more efficient than the existing one. Clearly, increased freedom and stronger incentives to perform, will, in the long term, expand the resources available for redistribution, simultaneously creating additional social inequalities. Moreover, allowing individual responsibility to play greater role (as reflected in Hungary's new pension scheme or in the current changes to the health system) is a positive value and an additional economic driving force, even if it necessarily creates social tensions that should be eased by the social safety net, or even if its efficiency varies.

The idealized model of the market economy, and its long-term advantages, thus stand in sharp contrast to the contradictions and dramatic consequences of transition. Those thinking in terms of the long-term model of the market economy tend to argue that the temporary problems will soon be resolved by the properly functioning market mechanisms. But others argue that these problems are permanent features of the market economy. Therefore a third way should be sought.

In my view, the forced march of transition toward a market economy has been a significant event and a success, despite all its contradictions and attendant social up-

heavals. After decades of the “economy of shortage,” market balance has been achieved almost overnight. Today only those with the sharpest memory will recall the seemingly unquenchable thirst for convertible currencies. Such anomalies have been squashed almost immediately by the operation of the market. However, several

predictions—which envisaged, for example, the disappearance of corruption as a result of market operation—haven’t come true. Overall, the lesson is that hardly anybody could have foretold and prepared us for the serious social tensions that have accompanied our transition to a market economy.

The author is Chief Adviser to the Chairman of the Hungarian Foreign Trade Bank, Budapest. This article is based on his study published in the Central European Banker (CEB), February 1999. The Budapest-based CEB is a joint enterprise of the Hungarian Foreign Trade Bank and the Institute for East West Studies Budapest Centre.

Pretence of Market Economy and Legacy of Old Regime—Political Economy of System Transformation

by Tsuneo Morita

In 1993–1994 many economists referred to the “Czech miracle,” thought to have been accomplished via radical voucher privatization. While enthusiastically praising Czech-type privatization characterized as “shock therapy,” they harshly criticized the Hungarian-type privatization characterized by reluctant gradualism. In my book *Taiseitenkan no Keizaigaku (Economics of System Transformation)*, published in Tokyo in 1994, I pointed out that with the Czech miracle, voucher privatization couldn’t solve the dilemma of corporate governance.

In 1996 economists and analysts already began to mention weak corporate governance and delays in restructuring voucher-privatized Czech companies. Gradually it became clear that managers of quasi-privatized Czech companies established various types of subsidiaries, made money flows complex and non-transparent, and acquired individual wealth by leaking money through subsidiaries to their own registered companies—called tunneling.

Apples and Oranges

Many economists thought that transformation from a so-called planned economy to a market economy could be accomplished in a relatively short period, providing government was able to boldly liberalize economic activities, speed up privatization,

and establish the legal infrastructures of a market economy. Therefore, some international finance institutions took these criteria as progress indicators of market economy, as if a market revolution can be achieved at the same speed as a socialist revolution.

Comparison is reasonable if the countries compared are at the same stages of social development. However, if they are at different stages of social development, then comparison of common criteria yields little meaningful information. In other words, is it meaningful to compare weight increase among pigs, cows, sheep, and chickens? It may be more meaningful, for instance, to compare the market developments in Central Asian countries separately from the performances of Central European countries.

In successive Transition Reports of the EBRD, the Czech Republic has always come first in country rankings based on private sector share in GDP, thanks to its voucher privatization. The EBRD indicator is based on the legal transformation of state companies into joint-stock companies. Even if the government keeps a majority stake, the company automatically classifies as a private one, regardless of its actual status. Thus, formally transformed companies, actually controlled by the state, are counted as private firms.

Recipe for Getting Rich Fast

In many cases voucher privatized companies lack effective and responsible management. Instead, a single manager, or set of managers, is legally appointed by the government and has an overriding power to manage and execute business and political activities that maintain and strengthen his or her position. These appointed managers often are bureaucrats, politicians, or reform intellectuals from the old regime who succeeded in surviving amid the new surroundings.

For example, the government keeps a 40 percent stake in Russia’s huge gas monopoly, Gasprom. Ex-bureaucrats and ex-central bankers, appointed by the government, carry out managerial and supervisory roles. The firm, once under the supervision of the Soviet Gas Ministry in the 1980s, was run by Victor Chernomyrdin. After the collapse of the Soviet Union, it transformed itself into a capitalist monopoly, setting up its own financial institutions and buying enough stakes in various banks to become a leading financial-industrial group. Other industrial and financial groups in Russia have similar stories. In many cases the elite of the old regime are playing key roles just by changing their positions and functions.

The Postabank Nightmare

In Hungary, Postabank remained the only large commercial bank in state ownership. Other big banks had been privatized and taken over by foreign strategic investors. More precisely, not even the government had a controlling stake in Postabank. A carefully divided ownership structure was designed to prevent effective control over the management. It was masterminded by Gabor Princz. It was his initiative to establish a commercial bank by utilizing the nationwide post office network. He became CEO of Postabank after being a junior officer at the National Bank of Hungary.

After the opposition party won the general election in 1998, the new government immediately dismissed the old management together with Princz, who had reigned for ten years. The new management revealed that the bank—thought to be financially sound—had in fact accumulated a loss of about 150 billion forints (\$700 million). The loss was derived mainly from various suspicious real estate investments both in Hungary and abroad, risky portfolio investments, loss-making media holdings, and various thefts. Princz's monthly salary of 8.8 million forints was 500 times higher than the minimum wage and 150 times higher than the average wage in Hungary.

At the end of the 1980s when commercial banks were established by dividing up the functions of the National Bank, many senior officers moved from the central bank to commercial banks as managers of newly established banks. How was it possible for state bankers to earn large amounts of money and decide on almost everything as private bankers do without effective state control?

- First, the government argued that competitive payment system was required to keep competent bankers in state banks.
- Second, the managerial and supervisory function of the government as major-

ity owner didn't work. Most government officials formally represented the state at the boards of directors as a private second job, without taking due responsibility.

- Third, politicians were eager to maintain good relationships with state banks and expected money to finance their political activities in return.
- Fourth, astute managers, like Princz, distributed money to all main political parties and invested in newspapers and magazines that were thereby incapable of dispatching unbiased information to the public.

The Root of Corruption

In most transition economies prosecutors initiated few indictments in connection with bribery and corruption; partly because quasi bribery is de facto legalized in these countries and partly because prosecutors are traditionally weak and can not insulate themselves from political pressure.

Many high-ranking politicians in these countries buy luxury cars and build mansions shortly after winning in the parliamentary elections. How is it possible to earn that amount of money through uncorrupt politics in the transition period?

- Politicians of a governing party can get insider information about privatization plans. If direct participation of politicians is not possible, they delegate family members and co-operators. If winning an international tender is at stake, then the amount of the "success fee" for lobbying can be enormous.

- The ruling party has decisionmaking power in redistributing budgetary expenditures. Politicians, if awarded, can forward insider information about the money flow. They can also lobby for changes in the distribution pattern, for budget spending on specific projects.

- Not only bureaucrats but politicians, including members of parliament, are being appointed as supervisory board members to quasi privatized and fully privatized companies. The amount of individual honorarium may not be significant but it multiplies when the same person takes on nominal supervisory jobs that are offered by company managers looking for political and governmental connections. The honoraria are conceived as complementing the low salary of the bureaucrats. However, this practice leads to various types of corruption contrived by government officers and company managers.

To sum up, in East and Central European societies corruption is widespread, social disciplines and ethics are low, and demand for social justice is weak. Therefore social disciplines and ethics should be restored for rolling back de facto bribes and corruption effecting government and semi-privatized institutions. Governments should motivate people to play a more active role in business and social life, not only through economic measures but also by establishing rightful social normative in public life.

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The above article is based on Mr. Norita's lecture "Culture and Modernization in Light of the Japanese and Central European Experience," delivered in December 1998, Cracow, Poland.



THE WILLIAM DAVIDSON INSTITUTE
AT THE UNIVERSITY OF MICHIGAN BUSINESS SCHOOL

Are Central and East European Firms Ready for EU Accession?: A Comparison of Manufacturing Firms in Poland, Romania, and Spain by Wendy Carlin, Saul Estrin, and Mark Schaffer

Ten countries from Central and Eastern Europe (CEE) have signed agreements with the European Union (EU) and five have been assessed as ready to commence negotiations for entry into the Union. The first tier countries are the Czech Republic, Estonia, Hungary, Poland, and Slovenia, and the second tier includes Bulgaria, Latvia, Lithuania, Romania, and Slovakia. This proposed expansion of the EU—relative to previous expansions such as the inclusion of Portugal and Spain—is large in terms of number of countries and population, but small in terms of GDP, and income per capita—both much lower in the countries seeking accession than the EU average.

The planned accession of Central and Eastern European applicants will be different from previous accessions. As specified by the Copenhagen Agreement of 1994, applicants from Central and Eastern Europe are expected to adopt in full the Single European Market regulations (*acquis communautaire*), and prepare for membership in the European Monetary Union (EMU)—if necessary, over an adjustment period.

There is little understanding or information about the implications of satisfying these requirements for employment, working conditions, pay, environmental protection, and health and safety. Moreover, the ability of Eastern European firms to compete successfully in a single European market against companies from the higher pro-

ductivity countries of Western Europe has yet to be examined. We hope to provide some preliminary information on these issues, drawing on a unique survey of more than 600 firms: more than 200 each from Poland (as a first tier country), Romania (a second tier country), and from Spain (used as an EU benchmark).

This survey provides the first systematic evidence from the two contrasting pre-accession countries on their enterprises' "accession readiness." The survey was designed to address three issues:

1. How successfully have privatized and state-owned firms in the two transition economies strengthened their initially weaker position relative to enterprises operating in a comparable EU economy?
2. How well do enterprises from the applicant countries satisfactorily meet the legal and administrative requirements of the EU?
3. How do the performance and characteristics of the firms from Poland and Romania compare with those of the firms from Spain?

Withstanding Competition and Firm Characteristics

The survey permitted us to address the issue of the ability of enterprises to withstand competitive pressure—one of the requirements placed by the EU on applicant countries. We did this by studying the

relationship among performance, ownership, and competitive environment in the accession countries, relative to the benchmark country.

We found significant differences in enterprise characteristics—in ownership, foreign direct investment, and exposure between firms in Eastern European and the EU. Firms in Poland founded from scratch as private companies (*ab initio*) and, to a lesser extent, Polish privatized and Romanian *ab initio* firms are comparable in performance to companies in Spain. State-owned firms in Poland, and privatized companies in Romania, however, are significantly less competitive. This gives hope that, as the process of transition replaces state-owned firms with private and new companies, the competitive gap between transition countries and the rest of the EU will narrow.

Absolute performance levels in firms in Poland are below those in Spain, but above those in Romania. The survey suggests, however, that firms in Poland have been catching up; they have higher investment rates than firms in Spain, although even privatized firms in Romania do not. The survey also reveals a significant history of excess employment in both transition countries, particularly in state-owned firms.

Meeting the EU Requirements

The survey shows a considerable gap between firms in Spain and the accession countries in compliance with EU directives

and regulations. Only with equal pay is there no gap between the firms in Eastern Europe and in Spain. Firms in Spain stand out as more compliant with the working time directive, the levels of ISO certification, and emissions monitoring. Poland is somewhat better than Romania in export product certification but not according to the harsher criterion of International Organization for Standardization (ISO). The transition indicators—own-

ership and corporate governance—are not significant factors in explaining the levels of compliance in the accession countries.

Overall, firms in Poland lag behind those in Spain, but are significantly ahead of those in Romania in compliance, but all firms in Eastern Europe will experience a burden in satisfying the standards of *acquis communautaire*, especially those

standards related to emissions monitoring and product certification.

This article is based on William Davidson Institute Working Paper 224 by Wendy Carlin, University College, London, Saul Estrin, London Business School, and Mark Schaffer, Heriot-Watt University. Paper prepared for the Chief Economist's Office, EBRD.

Investment Financing in Russian Financial-Industrial Groups: Are Diversified Industrial Groups Efficient Corporate Structures in Emerging Market Economies?

by Enrico Perotti and Stanislav Gelfer

There is increasing skepticism in industrial countries about the efficiency of diversified conglomerates. Western diversified groups tend to trade at a discount. Relative to a portfolio of independent firms in comparable industries, they have on average a lower Tobin's Q. (Tobin's Q is defined as the ratio of the market value of the firm to the replacement value of its capital assets, and is therefore the shadow value of an additional unit of capital). These conglomerates tend to break up, and if that occurs, their share price significantly increases.

Looking at investment patterns of these conglomerates among the various divisions, some recent research concluded that conglomerates appeared to practice "socialist" reallocation of resources across divisions, moving funds from profitable firms in high Q industries to support investment in lower Q sectors.

Leading explanations for such underperformance have focused on the agency conflict between investors and empire-building managers. More recently, some authors have argued that internal power conflicts force an inefficient redistribution of resources to less successful divisions.

In sharp contrast, industrial-financial groups persist and often prosper in many developing and transition countries, where private sector activity is often dominated by diversified business groups. Theoretical explanations for such corporate structures point to the incentive to resolve scarcity in the capital and the intermediate product markets. Such groups may also be a function of the weak institutional environment in emerging market economies of Asia, Eastern Europe, and Latin

America. Groups may have extensive governance functions in countries with weak law enforcement, unstable regulatory systems, and vast corruption. These groups may support internal trade, ensure close monitoring of management decisions, and manage a privileged access to political favors, such as subsidized credit, favorable regulation and licensing, and access to strategic resources. In conclusion, these groups may emerge to capture scarcity rents or compensate for lack of markets, or both.

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Emergence of Russian Business Groups

In Russia, an historical reliance on implicit contracting, the oligopolistic structure of industry, and underdeveloped capital markets have given additional scope for the development of business groups. Following the onset of privatization in 1993, new Russian banks took large equity positions in the Russian industrial sector. Most groups got hold of their assets through debt-equity swap programs, government provisions, and privatization sales. Taking advantage of the limited competition offered by capital market investors, they began to consolidate holdings in controlling blocks by 1994.

The emerging corporate structure, called a Financial-Industrial Group (FIG), was sometimes officially constituted by the government, sometimes formed spontaneously. An official recognition of FIGs came in December 1993 by presidential decree. Under this decree, FIGs receive a number of benefits, such as the right to receive blocks of shares in privatized enterprises from GKI, preferential reserve requirements from the central bank, and preferential access to licenses and permits.

Given Russia's uneven history of development and its current weak market conditions, such institutions may constitute an optimal organizational structure. Weak law enforcement makes arm-length contingent contracting impossible. Russia never experienced capitalism based on reliable contractual relations. During the Soviet era the directors of enterprises relied on relational contracting to ensure supply delivery and performance. High transaction costs associated with segmented information and poor contractual enforcement in Russia suggest that centralized ownership of assets may lead to both better corporate and contractual governance. Holding companies such as FIGs may thus be an optimal construction to carry out the required reallocation of ownership and governance in Russia.

Executives of many bank-centered groups routinely claim that they and other banks play the same role in the Russian economy today as investment bankers did in the U.S. economy at the turn of the century. In this working paper we investigate this argument, with the goal of identifying useful policy recommendations.

Analyzing the Role of the Group

We start by an empirical analysis of the relationship between internal finance and investment in independent and group-affiliated Russian enterprises. We compare firms that are members of official Financial Industrial Groups, and/or are owned by a large Russian bank with a control set of large firms, categorized by dispersed ownership or management and employee control. We find that investment is sensitive to internal liquidity for the second set of firms but not for the first.

Such results can be reinterpreted as evidence of extensive financial reallocation across group firms. The interesting question, naturally, is the interpretation of this finding. One interpretation is that group firms have an internal capital market that facilitates access to finance for good projects by reallocating resources across firms. An alternative view may be that reallocation is driven by the desire of the controlling shareholders to shift resources around in order to better appropriate them—shifting them, for instance, to firms in which their equity interest is greater.

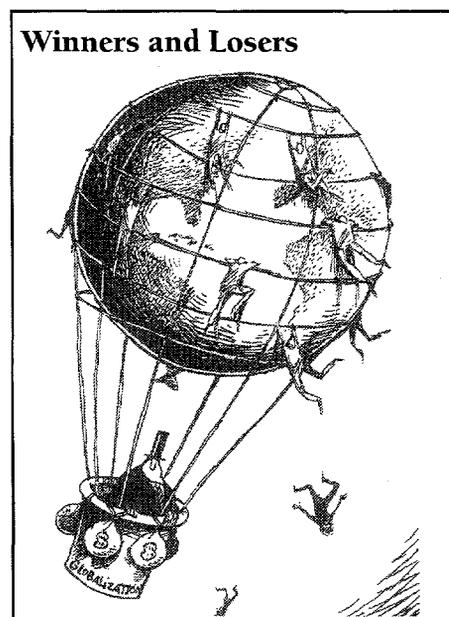
In order to test these competing views, we assess the quality of the investment process in group and nongroup firms. We do so by regressing individual firms' absolute and relative investment on our measure of Tobin's Q. The result supports the notion that firms within groups allocate capital better than independent firms.

We then distinguish between bank-led groups, which are more hierarchical, and

industry-centered groups, which may be more defensive arrangements. While investment is not significantly correlated with cash flow in industry-led group firms (unlike in independent firms), there is a significant negative correlation for bank-led firms, suggesting a more extensive financial reallocation and the use of profitable firms as cash cows. Most intriguingly, the greater sensitivity of a group firms' investment to Q is entirely to be attributed to firms in bank-led groups, where the controlling bank may have a stronger profit motive and authority to reallocate resources. Finally, independent firms with a high stock market value appear less liquidity constrained, suggesting that the Russian equity market may already provide a positive informational function.

Overall, we conclude that while the groups appear to serve a useful governance function, there are no reasons to encourage or subsidize their formation.

This article is based on a paper by Enrico Perotti, University of Amsterdam, and Stanislav Gelfer, EBRD, presented in May 1998 at a William Davidson Institute conference on Financial Sectors in Transition.



From the *World Press Review*.

Letters to the Editor

Wishful Thinking about Russia?

In the following, we publish Vladimir Brovkin's response to Ivan Szegvari's article "Who Is To Blame for Russia's Economic Woes?" (Transition, April 1999, page 26), true to our traditions to maintain a forum for transition-related views that we do not necessarily share.

Ivan Szegvari formulates eight widely held propositions, which he then goes on to disprove. I would like to argue for the validity of those propositions and challenge the arguments the author has presented.

1. Market reforms failed in Russia.

Let us leave this proposition for last.

2. The international finance institutions—and the international community in general—paid too little attention and afford too little respect to the national history, culture, and characteristics of borrower countries.

Essentially the author has nothing to say on this score except that the so-called transition economies tried to combine socialism and capitalism. And the author admits "Policymakers then sought ways of combining capitalism with a country's national characteristics, culture, history, and anything else that makes a country a place worth living in. The trouble is that nobody knows what this actually means."

What is wrong, then, with the lending approach of the Western institutions? First and foremost: they forget that culture, customs, and traditions matter a great deal. Even the language used by the participants in the discourse has different connotations. The very words *capitalism*, *socialism*, *accountability*, *responsibility*, and *integrity* have different connotations in different countries. In Russia the legacy of the Soviet past is omnipresent. Their attitudes toward property, law, government, political parties, and order have been misunderstood by Western counterparts who assume them to be similar to the West or at least to the other—lumped together—transition economies.

In Russia, for instance, *property* means physical possession. The state and the so-called "law enforcement" agencies still have not embraced the notion that their duty is to defend property rights in a court of law. Property can be alienated by an *ukaz*—an order from the President, a local despot, or a bribed official. Under these terms, Russians cannot see capitalism guaranteeing—equal property rights for all.

Because of the Soviet experience, authority in Russia has been—and still is—widely disdained and disrespected, as well as feared. Therefore, it remains a virtue to cheat the state. The immediate evidence for this is mass evasion of taxes—underestimated by Western institutions and experts advising on the transition to capitalism. The Soviet economy functioned by deceit: double accounting, barter arrangements, falsification of statistical data and revenue were the norm. This deeply held trait has remained intact and has been perfected in recent years.

The Western donor institutions have dispensed millions of dollars without adequate accounting procedures or built in mechanisms of verification and control. They continue to rely on central government institutions without a thorough understanding of Russian bureaucracy's inner mechanism—culture, traditions, and the Soviet heritage.

3. The IMF imposed its narrow-minded uniform policies on Russia, an approach doomed to failure from day one.

Indeed they were. In disapproving this statement the author argues that it was the G-7 not the IMF that made key decisions. The author asserts that "the idea that the

West in conjunction with a handful of Russian reformers imposed a skewed policy package on Russia that led to disastrous result does not have merit." I can prove that it does have merit.

The author's argument is to point out that Russia had a poor record of implementing Western recommendations. If only the reforms had been implemented, the thinking is, then everything would have been all right. No one can dispute the fact that in January 1992 Russian prices were liberalized. Yegor Gaidar pursued liberalization on the advice of official advisors of the Russian government. The idea was that free prices would generate competitive prices, thus establishing a correlation between production costs and what consumers can afford to pay. It was this so-called "shock therapy" that was claimed to have worked in Poland. No one can dispute that shock therapy was a Western product imposed on Russia by Western advisors and their Russian students, the so-called "young reformers."

What happened in real life is well known. Existing monopolies hiked up the prices and a regime of no competition prevailed. Domestic production of food plummeted and imports rose. Low tariffs on food imports stimulated more imports and Russian domestic production of food and textiles was decimated. Soviet monopolies seized the market and destroyed competitive monopolies by imports. All part of what was supposed to be a market reform.

But that is not the worst of the Western-imposed approach. What was worse for Russian economy was the governments' pursuit of a policy of macro-economic stabilization, which meant the dollar-ruble ex-

change rate became the most important economic indicator. Since most economic indicators were calculated in dollars, the exchange rate was perceived as a measure of confidence in the economy. Stable exchange rate guaranteed investments—or so it was thought. In reality, the artificially maintained stability of the exchange rate meant that imports flooded the domestic markets and domestic production declined. As a result, tax revenues declined too, and the economy as a whole kept shrinking. In other words, the success of a reform based on the stable exchange rate of the ruble meant shrinking the real economy—a direct consequence of the policy recommended by Western advisors.

But even that is not the worst. The worst was that the “reformist governments”—up to and including Kiryenko—had to cover up the ever-bigger hole in the budget resulting from the collapsing tax base. From 1993 on, they invented and used GKO—Short Term Government Treasury Bills—as a stop-gap measure. The government started financing the budget deficit by selling the GKOs at rates that the investors perceived as advantageous. The sale of GKOs was not a measure of financial stability and transition to markets but, on the contrary, a measure covering up the failure of transition to market, the de-industrialization of the country. The GKO pyramid scheme set Russia on a course of disaster by relying more and more on foreign borrowing, which was not invested into infrastructure, not invested in production, but in covering up the growing deficits to make Russia look like it was moving to a market economy. But it was a virtual economy, as one observer put it. It was an illusion for Western consumption.

4. Privatization (mainly the voucher scheme and the loans-for-shares scheme) was ill-conceived and unsuccessful in Russia.

Indeed it was. The author asserts that “voucher privatization was inevitable and

that the outcome was a success.” Only in the “loans for shares” schemes does the author admit some problems. The publicly announced intention of voucher privatization was to create a class of owners in Russia. That goal has not been reached. First, because voucher holders received nothing for their papers; second, because managers who bought up the vouchers became de facto owners of the enterprises. Because the general public regards voucher privatization as a sham, lacking legitimacy, managers don’t feel secure as owners. They are afraid that what they grabbed can be revised by the courts and taken back. Therefore they try to squeeze out as much asset from the enterprises as possible and then move it overseas. Lack of domestic investment in Russia—and an appalling flight of capital—is a direct consequence of voucher privatization and Western advice.

The loans for shares scheme was even worse—and not because of a lack of transparency and non-admittance of Western participants to auctions. The loans for shares program was a deal between the regime and a few chosen individuals to transfer huge state assets into the hands of some companies in exchange for financial support in elections. Insider trading at its worst by Western standards, this was the name of the game. For example, Oneksimbank lent money to the state and took over shares of enterprises as collateral. When the fixed auction came, collateral became their property at favorable prices.

5. The sequencing reforms the West proposed in Russia, including the precipitate liberalization of capital transactions, was ill conceived and ill advised.

Indeed it was. The author tries to debunk this proposition by defending the Western-sponsored policies in GKO borrowing. Specifically, the author argues that positive things happened; for example, access

of Western investors to the GKO market was liberalized, so Western investors were encouraged to buy Russian GKOs. Was that a good thing? The author argues it was because Western access was supposed to lower Russian interest rates and increase openness of Russian capital markets, thus imposing self-discipline. This Western strategy had worked, asserts the author: the rate of GKOs yields was only 18 per cent in October 1997.

But let’s pause for a moment to respond to this reasoning before we address the author’s explanation of what went wrong later. His argument is an excellent illustration of what went wrong with the Western approach to Russia’s economy. Liberalizing Western access to the GKO market did not lead to lower interest rates. On the contrary, it fueled a speculative rush to make a quick buck on the GKO market because Western investors were buying ever more GKOs. Buying them because Russia was paying incredibly high—20 to 60 percent—interest rates. So, instead of stabilizing Russia’s emerging market, Western investors, in their rush to make money fast, contributed to the destruction of the Russian economy, pushing it to an inevitable crash.

And there was no lending to the enterprise sector. All the money that was coming in from Western buyers of the GKOs was absorbed, in a vacuum cleaner’s fashion, by Russian banks. With such high rates of return they became unconcerned with investing in production, instead buying more GKOs from borrowed Western money.

Essentially, the reformers did nothing wrong, according to the author. It was the Asian crisis and the fall in commodity prices that rocked the Russian economy. The Russian reformers, according to the author, “renewed and strengthened their commitment to the ruble.” To shore up weakened investor confidence, they fully liberalized the exit mechanism for foreign GKO holders.

Despite the author's praise for that policy, the stable ruble was in fact the root of the problem. A stable ruble meant dependence on more GKO sales to finance the budget deficit. Stabilizing the ruble for the sake of investor confidence meant that Russia was sinking into ever-larger deficits and ever-larger foreign debt, while production and investments continued to fall. No country could sustain paying 60 percent on its Treasury bills amid collapsing domestic production.

When Kiryenko visited Washington last fall, I asked him at a public forum, "Why did you not stop the GKO pyramid scheme in June 1998 rather than increasing interest rates to 120 percent?" He mused and said, "That is a good question." Kiryenko believed that shoring up the ruble with IMF money was the right strategy for getting out of the crisis. Following this strategy, however, the crash became inevitable and billions of dollars were wasted.

6. Institutional reforms are by their nature long-term tasks, something that should have been taken into account up-front in designing policy.

The author narrows this broad question down to the problem of bankruptcy laws. He argues that Russia had the necessary legislation for bankruptcy, and that bankruptcy was a "market selection mechanism." The only problem was the political will of the authorities to implement it. The implication is that non-market forces were resistant to market reforms.

But there is no adequate bankruptcy law in Russia. More important, bankruptcy is not a regulatory market selection mechanism, as the author claims, but a tool in the hands of organized crime to obtain possession of enterprises, precisely because there are no markets or competition. How is that done? Very simply. If there is a potentially profit-making enterprise then organized crime wants to have it—and have it cheaply. The easiest way is to

bribe local officials to suffocate the enterprise into bankruptcy by taxes and regulations. Then it can be obtained cheaply. Thus, in Russia, bankruptcy is not a market selection mechanism. With no legislative framework and a political will to interfere, the assets of the chosen few are protected, either by forestalling bankruptcy or promoting it.

The larger question is, of course, about changing institutions. Surely they cannot be changed overnight. Institutions grow out of the country's history; they are not imposed by those claiming to have superior knowledge. New institutions can function only if attuned to the existing practices of a country. Otherwise they will be absorbed into the existing cultural practices and rendered useless.

7. Lack of liquidity in the system was the main problem underlying the non-payment culture and the prevalence of non-monetary transactions (barter) in Russia.

The author praises confidence in money, exchange rates, and the like as keys to success. Nobody denies that. However, barter was a direct consequence of GKO interest rates. Money transactions became expensive; as a result, barter took the place of money. Further, taxes were high and barter made it easy to avoid taxes. The tradition of duping the state, a holdover from Soviet times, played a role in reverting to barter as a way to beat the system and survive.

8. Russia has made very little progress in its transition to a market-based democratic society.

The author simply states that Russia has already built a market economy and a democratic society. But where's the beef? How can this assertion be backed?

Let us return to the first proposition:

1. Market reforms failed in Russia.

Indeed they have. If by "markets" we visualize a place where peasants sell potatoes and other produce grown on tiny plots of land as in the Middle Ages, then, yes, Russia has a market. This kind of market existed in Russia for centuries when there was nothing to transition to. However, if by "market economy," we entertain the notion of a modern system of private enterprises that are protected by the rule of law, where all citizens are treated equally, where elected representatives of the people are accountable, then Russia fares poorly. In some respects, the situation has deteriorated even further than in the Soviet period.

Large holdover enterprises from the Soviet era have remained mostly inefficient and unproductive—"loss making" as some economists assert. The ruling class of Russia is made up of entrepreneurs who either have emerged from the criminal world or from the corrupt and rotten communist nomenclatura. As a result, people have learned to dislike private property, distrust the government, and expect social services.

These problems are compounded by this fact: many governors in the eighty-nine entities that make up the Russian Federation regard large enterprises in their domain, regardless of productivity, as belonging to them. If necessary, governors join forces with managers to evade taxes and dupe the Federal State. In other cases, in order to get more revenue they are ready to confront managers who introduce administrative regulations. Many governors prevent bankruptcy procedures, prevent transparency, and prevent foreign investment because they would have less control over their enterprises in the end. Some have their own customs and export policies. Federal laws and regulations are ignored. In fact it is legitimate to ask: Is there a Russia as one country with one set of laws and one government for all? This is certainly not democracy or capitalism in the modern sense of those words.

Property is just as tenuous as in Soviet times. It can be revoked at a moment's notice by fiat. Use of public office for personal gain is certainly more, not less, widespread than in Soviet times. Organized crime controls regions of the country and segments of the economy. Women are underpaid and sexual harassment is worse than under the Soviets. The state consistently fails to provide even the most basic services to its populace and collect any taxes. The political system is inherently destabilizing and

unworkable. The people are just as deprived of their rights against arbitrariness as under Soviet rule. How can anyone liken this reality to market reform and democracy? Russia is in its deepest crisis in decades—spiritual, economic, and political.

There is no quick fix. The first thing the West should do is to stop pretending that everything is fine, stop looking for a quick fix, and acknowledge the extent of its misguided policies. Only then can it begin a

serious consideration of what can be done to help Russia help itself.

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The Race Is On: Competition for the CEE Car Market

by Ryan James Tutak

Globalization has transformed the auto industry everywhere in the 1990s, but the most dramatic changes have come in Central and Eastern Europe (CEE), including the Baltics and the 12 former Soviet Union republics that comprise the Commonwealth of Independent States (CIS). Before the Berlin Wall fell in 1989, this region comprised nine countries. Now there are 27. Since 1989 several changes have occurred in these CEE countries.

- Before the Wall came down, socialist markets were hermetically protected. Albania even banned private car ownership. Now, several of these countries embrace extreme openness in trade. For example, the Baltic countries levy no customs duties, helping Japanese cars to become best sellers, while elsewhere in Europe the same brands incur punitive import taxes.
- Before 1989 national governments in CEE controlled all 23 car manufacturers. Now they control only five.
- Hungary didn't mass produce passenger vehicles before 1989—not even major car parts. Now, Suzuki has an assembly plant, Volkswagen (VW) manufactures engines, and Audi makes sports cars, and a new GM plant has been built—all new auto manufacturing in Hungary. Before 1989 Poland built only Fiats or Fiat-designed

models. Now, it boasts the broadest range of auto factories in the world—more than Brazil or India.

But the transition countries still have a long way to go before their markets mature. In 1998 estimated per-capita sales of new cars in CEE totaled a mere 0.005, compared with 0.039 in Western Europe. In effect, 414 million people bought 2.2 million cars in Central and Eastern Europe, while 370 million people bought 14.3 million models in Western Europe.

European Union (EU) aspirants—Poland, the Czech Republic, Estonia, Hungary, and Slovenia—already enjoy close ties with the EU, which grants them annually expanding duty free export and import quotas for motor vehicles.

Slovenia sold 72,000 cars in 1998 and had the highest per-capita sales (0.036) of new cars in CEE—near par with Western Europe. But in volume this figure is less significant, as the country's population is barely 2 million. Last year an estimated 850,000 new cars were sold in Russia, 565,000 in Poland, 157,000 in the Czech Republic, 139,000 in Romania, and 127,000 in Hungary. In all other countries of the region new car sales didn't reach 100,000.

Rush to Poland's Market

In Poland, per-capita sales are still small (0.014), but with a growing population that is already more than 39 million, the potential is great. In many other CEE countries the population is stagnating—even shrinking. In Poland the population's average age is significantly younger than in the Czech Republic or Hungary. In the 1990s, car sales in Poland have grown faster than anywhere in Europe, making it the eighth-largest car market on the continent—ahead of Belgium and just behind the Netherlands. The demand for new cars and other light vehicles in Poland is increasing. Between 1992 and 1998 demand has grown at an annual rate of 17.6 percent. Over the next five years, car sales in Poland are expected to increase annually by 8 to 10 percent. By the time the country is scheduled to enter the EU in 2003, annual car sales could approach the current demand in Russia, which has a population four times larger.

Remarkably, not less than thirty brands of cars, buses, and trucks from 13 countries are now assembled or manufactured in Poland, the Czech Republic's Avia and Skoda; France's Citroen, Peugeot, and Renault; Germany's Audi, Mercedes-

Benz, Opel, and VW; Italy's Fiat and Iveco; Korea's Daewoo, Hyundai, and Kia; Romania's ARO; Spain's SEAT; Sweden's Scania and Volvo; Ukraine's Tavia; the United Kingdom's LDV; the United States's Chrysler and Ford; and Yugoslavia's Zastava. Native manufacturers are also present: Autosan, Jelcz, Lublin, Polonez, Star, Tarpan, and Zuk. Poland's share in CEE's total sales of new light vehicles in 1998 increased to about 25 percent—or, excluding countries of the former Soviet Union, to more than 40 percent.

Fiat intends to invest more than \$2 billion in Poland; the Daewoo Group, more than \$1 billion. GM plans to invest over \$900 million, while VW recently embarked on a major expansion that could boost its Polish commitment to about \$500 million. Isuzu Motors Ltd of Japan recently started making diesel engines in Tychy, southern Poland, at a site that may later build the company's medium trucks. This is the second Japanese investment in CEE to build vehicles—Suzuki Motor Corp started making mid-sized cars in Hungary in 1992. Toyota could begin to build cars there as well.

Forbidden Fruit; Russia

While all of Poland's carmakers had privatized by 1995, Russia declined to privatize its auto industry and thereby attract foreign investment in this sector through guarantees and incentives. Instead, confusing regulations and punitive tax rates are block car production progress in Russia. According to preliminary figures, car production has fallen nearly 20 percent in 1998, from a post-Soviet high of 982,000 in 1997, and could drop another 20 percent in 1999.

Russia's per-capita car ownership is among the lowest in Europe. On average, 1,000 people own 110 cars—compared with 420 cars in France and 400 cars in Germany per 1,000 people. This gap between actual and potential motorists tantalizes foreign automakers, who

still view Russia as one of the final frontiers for investment. Fiat, GM, Renault, and VW's Skoda Auto have ambitious plans in Russia, despite the fact that in this country of 150 million people, no foreign automaker has succeeded in building a manufacturing base that produces more than 25,000 cars annually. VW, however, recently agreed to assemble Skoda models in Russia at PA IzhMash, a conglomerate best known for its Kalashnikov assault rifles.

Economic mismanagement and stagnation have similarly hampered Romania's car production. Romania, home to 23 million people is CEE's biggest market after Poland. Romania has struggled for years to privatize its indigenous carmakers—ARO and Dacia. Renault eventually may buy Dacia this year. The only foreign manufacturer here, Korea's Daewoo, has pledged to invest roughly \$1 billion, but at present even Romania's existing capacities are not utilized properly.

No foreign automakers are present in the Baltics, whose population is only 7.7 million. In the eight countries of Central Asia, only Uzbekistan attracted a foreign auto maker—Daewoo—to make an investment. The only international player in the war-torn Balkans is VW, which has re-opened a factory in Bosnia-Herzegovina that it had closed earlier following the onset of armed conflict in former Yugoslavia. The plant will also assemble the Skoda model.

VW, Daewoo, Fiat Ahead

Only a handful of automakers dominate the entire region. Nearly 55 percent of sales in 1998 accrued to three companies: VW, Daewoo, and Fiat (in descending order). No other automakers sold more than 100,000 units in 1998, with the exception of Romania's Dacia, which sold most of its cars domestically.

VW, the region's top-selling auto group since 1996, has built its lead on a broad

presence in the countries of CEE. The German company's major activity is Skoda, in the Czech Republic, but it also assembles models in Poznan, in western Poland. VW produces gearboxes and assembles cars in Slovakia, and has manufacturing bases in Hungary, Bosnia and Herzegovina, and Russia.

While VW's sales have remained strong, Fiat's have slipped. Between 1993 and 1995 the Italian conglomerate had the highest sales in the region, but its one-sided strategy struck back: the Italian company maintains a large car-making complex in Poland, but produces no light vehicles elsewhere in CEE. The only exception is a new venture in Russia, but that has started slowly, due to the economic crisis there. Poland has been a goldmine for Fiat, as its models were the only mass-produced cars in this market until 1994. But in the past five years, foreign manufacturers eroded the company's market share, slipping last year to 28 percent from 49 percent in 1993. If Renault buys Dacia, the French automaker could challenge Fiat's present third place behind Korea's Daewoo in market share.

In four years, Daewoo has become the region's most ambitious player, buying seven state-owned auto plants: four in Poland, one each in the Czech Republic, Romania, and Ukraine. The Uzbek plant is the latest. Daewoo plans to invest more than \$5 billion with the aim of building between 500,000 and 1,000,000 light vehicles in the region by 2005. In 1998, the Korean conglomerate halved VW's sales lead—and snuck past Fiat into second place in market share. In 1999 Daewoo could overtake VW, if Romania overcomes recent labor unrest and sustains the upswing in car demand.

Both the Daewoo and the Hyundai Group from Korea saw a golden opportunity to fill a gaping hole in CEE's markets by offering decent-quality cars at decent prices. They were ready to offer a third option for budget-conscious consumers

wary of buying another Lada, yet unable to afford a VW. The Koreans exposed the limits of the existing options of low-priced, low-quality cars from Central-Eastern Europe and high-priced, high-quality cars from Japan, the United States, and Western Europe.

The "Korean blitz" of CEE, including Hyundai Group's recent push into Russia, is vigorous. Daewoo chose great locations for expansion and experimentation, and the company has acquired assets of immediate value, especially large sales-and-service networks of state-owned automakers. But Daewoo may have committed too much too quickly, and it has tried to offload some holdings to GM, although will likely retain its plants in Poland. Daewoo is closing in on Fiat as the market leader in Poland—a place that the Italian company has dominated more than 75 years.

In contrast to the Big Three of VW, Daewoo, and Fiat, several major automakers from Western Europe enjoy only meager sales in Central and Eastern Europe, largely because they manufacture no cars in the region. These include BMW, DaimlerChrysler, GM's Saab Automobile, Peugeot Citroen, and Volvo. Most of these companies suffer from overcapacity at existing plants and believe that their sales in CEE will increase once the EU expands eastward and import tariffs disappear.

In the next five years, sales should rise on average 8 to 10 percent annually in CEE's most developed markets—Poland, the Czech Republic and Hungary. But Slovenia, near a saturation of demand, might see growth rates of only 1 to 3 percent. Increases will vary wildly in the still-evolving markets of Croatia, Estonia, Latvia, Lithuania, Romania, and Slovakia.

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New auto sales, Central-Eastern Europe, 1998

	% Share 1998	% Share 1997	Units 1998	Units 1997	% Change 1998/1997
REGION TOTAL	100.0	100.0	1237840	1153915	7.3
MARKETS:					
Poland	45.7	46.1	565098	532281	6.2
Czech Republic	12.7	16.6	156813	191788	-18.2
Romania	11.2	9.7	138974	111575	24.6
Hungary	10.2	8.4	126588	96972	30.5
Slovakia	6.2	6.0	76394	69055	10.6
Slovenia	5.9	5.7	72607	65275	11.2
Croatia	5.0	4.9	61399	55979	9.7
Estonia	1.0	1.1	12573	12836	-2.0
Bulgaria	1.0	0.7	12196	7792	56.5
Latvia	0.7	0.5	8674	5559	56.0
Lithuania	0.5	0.4	6524	4803	35.8
AUTOMAKERS:					
Volkswagen AG	20.8	23.0	257458	264871	-2.8
Skoda	13.0	14.8	160329	170847	-6.2
VW	5.3	5.3	65404	61225	6.8
SEAT	2.0	2.3	24976	26193	-4.6
Audi	0.5	0.6	6749	6606	2.2
Daewoo Group	17.7	16.1	218690	185680	17.8
Daewoo	13.7	9.4	169286	108628	55.8
Polonez	2.8	5.4	34479	61986	-44.4
Lublin / Zuk	1.1	1.2	13514	14017	-3.6
Tavria	0.0	0.0	566	217	160.8
Ssangyong	0.0	0.0	562	557	0.9
LDV	0.0	0.0	250	212	17.9
Avia	0.0	0.0	33	63	-47.6
Fiat SpA	15.8	18.0	195599	207751	-5.8
Fiat	15.2	17.6	187756	202980	-7.5
Alfa Romeo	0.4	0.2	5072	2105	141.0
Iveco	0.1	0.2	1696	2135	-20.6
Lancia	0.1	0.0	1073	523	105.2
Maserati	0.0	0.0	2	1	100.0
Ferrari	0.0	0.0	0	7	-100.0
SC Automobile Dacia SA	8.4	8.5	104565	97761	7.0
General Motors Corp	7.2	7.1	88986	81670	9.0
Opel	7.1	7.0	88357	81283	8.7
Saab	0.0	0.0	574	307	87.0
Chevrolet	0.0	0.0	39	55	-29.1
Cadillac	0.0	0.0	5	2	150.0
Pontiac	0.0	0.0	4	13	-69.2
GMC	0.0	0.0	3	9	-66.7
Oldsmobile	0.0	0.0	2	1	100.0
Buick	0.0	0.0	1	0	-
Saturn	0.0	0.0	1	0	-
Renault SA	5.6	4.9	68882	56712	21.5
PSA Peugeot Citroen	5.3	4.7	65604	54220	21.0
Citroen	2.8	2.4	34373	27971	22.9
Peugeot	2.5	2.3	31231	26249	19.0
Ford Motor Co	4.8	4.9	59855	56929	5.1
Ford	4.8	4.9	59751	56824	5.2
Jaguar	0.0	0.0	85	95	-10.5
Lincoln	0.0	0.0	18	6	200.0
Mercury	0.0	0.0	1	4	-75.0
Suzuki Motor Corp	2.5	1.8	30981	20821	48.8
Suzuki	2.5	1.8	30981	20782	49.1
Maruti	0.0	0.0	0	39	-100.0
Toyota Motor Corp	2.3	1.8	27866	20633	35.1
Toyota	2.2	1.8	27507	20448	34.5
Daihatsu	0.0	0.0	316	172	83.7
Lexus	0.0	0.0	43	13	230.8
Hyundai Group	2.2	1.8	27591	20325	35.7
Kia	1.1	0.7	13922	7798	78.5
Hyundai	1.1	1.1	13663	12510	9.2
Asia	0.0	0.0	6	17	-64.7
Honda Motor Co Ltd	1.6	1.5	19823	17321	14.4
Honda	1.6	1.5	19823	17319	14.5
Acura	0.0	0.0	0	2	-100.0
Nissan Motor Co Ltd	1.5	1.5	18782	17199	9.2
Nissan	1.5	1.5	18764	17178	9.2
Infiniti	0.0	0.0	18	21	-14.3
DaimlerChrysler AG	1.1	1.1	13771	13146	4.8
Mercedes-Benz	1.0	1.0	12107	11889	1.8
Chrysler	0.1	0.1	1340	1002	33.7
Jeep	0.0	0.0	272	221	23.1
Dodge	0.0	0.0	43	22	95.5
Plymouth	0.0	0.0	8	11	-27.3
Eagle	0.0	0.0	1	1	0.0
Mazda Motor Corp	1.0	1.0	12417	11478	8.2
BMW	0.6	0.6	7117	6956	2.3
Others	1.5	1.9	19853	20442	-2.9

NOTE: Data cover new vehicles not over 5.0 tonnes gross weight. Source: RJT Information Services

World Bank/IMF/EBRD Agenda

World Bank and IMF Resume Lending to Ukraine

The World Bank has decided to disburse to Ukraine the last \$100 million tranche of its \$300 million Second Enterprise Development Adjustment Loan (EDAL-II). Gregory Jedrzejczak, World Bank resident representative in Ukraine, said the Bank made its decision after the IMF's board of directors approved the disbursement of a \$115 million tranche to Ukraine on June 30, under a \$2.6 billion Extended Fund Facility. The IMF stressed the "need to maintain fiscal discipline in the months leading up to the presidential elections at end-October, including by strengthened efforts to collect revenues and by timely clearance of expenditure arrears." IMF Deputy Managing Director Stanley Fischer urged Ukrainian authorities to accelerate the structural reforms envisaged under the program.

(*The Financial Times* reported that the IMF is using Ukraine as a test case to force the first-ever default on international bonds. A \$155 million bond issue fell due on June 9, but no repayment was made. A default on the bonds, arranged last August by ING Barings, could trigger a cross-default on more than \$1 billion in outstanding international bonds. A Fund official in Washington categorically rejected the charge that the Fund was seeking a default, but did point out that Ukraine faces an unsustainable debt burden and "it is obvious that without the assistance and forbearance of the private sector, a solution cannot be found. The official community is speaking very loudly and very clearly that it will not pick up the burden.")

World Bank May Help Develop a Low-cost Aids Vaccine

Alarmed by the relentless spread of the HIV virus, the World Bank is proposing

the creation of a global health insurance program to enable it to underwrite the search for affordable anti-AIDS drugs. The Bank is seeking a partnership with pharmaceutical firms to end the industry's reluctance to invest in developing countries that lack the means to pay for the vaccine. A special Bank task force has expressed a willingness to kick-start research aid and, in collaboration with the WHO and other international bodies, guarantee a market for the vaccine in developing countries. According to expert estimates, between 500 million and 1.5 billion people would benefit from a vaccine—a market that could be worth \$50 billion to the big drug firms. The Bank believes that an outlay of up to \$5 billion might be enough to encourage the drug industry to begin research.

\$325 Million World Bank Support to Romania

On 10 June the World Bank approved a \$300 million loan to Romania to promote private enterprises and banks (a Private Sector Adjustment Loan) and another \$25 million for technical assistance in private sector institution building. These loans will provide support in the following areas:

- Restructuring and privatizing state-owned banks, strengthening supervision capacity of the National Bank of Romania, and developing a secondary market for government securities. An Asset Resolution Agency will be set up for quick and effective bank restructuring.
- Accelerating the privatization and divestiture of large state-owned enterprises and small and medium firms.
- Changes in key legal areas where private business is currently most impaired, including a secured transaction law, a comprehensive tax reform, and the introduction of international accounting standards.

Since 1990, commitments to Romania have totaled \$3.5 billion for 24 projects.

\$300 Million to Transform Poland's Ailing Coal Mines

Poland's coal sector provides more than 60 percent of the country's total primary energy consumption and accounts for almost 4 percent of GDP. But in recent years it has suffered huge losses and failed to adjust to shrinking domestic demand with sharply declining export sales and prices. The World Bank's \$300 million coal loan (see also page 33) approved on 10 June, will help the country transform this industry into a competitive and profitable sector. It will enable the government to do the following:

- Address the needs of miners leaving the industry, ensure adequate funding for social support, and help unemployed workers find jobs.
- Fully or partially close unprofitable mines. By 2002 coal production will be reduced by 25.5 million tons annually. Most financing will come from the state budget, whereas partial mine closures will be financed from a company's own resources.
- Reschedule or forgive coal companies' liabilities to the government and its institutions, including environmental funds. Liabilities to private businesses would remain.
- Equip mining companies with the proper legal and regulatory framework to operate in an independent, autonomous, and increasingly competitive manner.
- Draft a privatization strategy for the sector and privatization action plans of each company.
- Conduct environmental assessments identifying environmental priorities and appropriate mitigation measures.

Since 1990, when Poland resumed borrowing from the World Bank, the Bank's commitments to the country have totaled approximately \$5 billion.

1999: EBRD Invests \$400 Million in Poland

Horst Koehler, president of the European Bank for Reconstruction and Development, said in mid-May that EBRD will invest 370 million euro (\$390 million) in Poland this year. The EBRD is to focus on projects promoting small- and medium-size enterprises. It will also support restructuring processes in economically promising giants such as the Sendzimir and Katowice steel mills, LOT airlines, Nafta Polska, and the PKP state railways. Since 1991 the EBRD has allocated 1.3 billion euro for 83 investment projects in Poland.

World Bank Study on Big Tobacco

According to the World Bank study "Curbing the Epidemic: Governments and the Economics of Tobacco Control" released in mid-May, countries can prevent millions of premature deaths and much disability if they adopt measures to control the demand for tobacco—especially prevalent among children, adolescents, and the poor.

To effectively reduce tobacco demand, governments can raise cigarette taxes (a 10-percent price increase would reduce average demand by about 8 percent in low- to middle-income countries), ban the advertising and promotion of tobacco products, and provide information on the health risks of smoking directly or through research. Countries can also increase access to nicotine replacement therapy to help those willing to quit smoking. The report outlines current global trends in tobacco use:

- About 1.1 billion people smoke worldwide. By 2025 the number is expected to rise to more than 1.6 billion.

- With current smoking patterns, about 500 million people alive today will eventually be killed by tobacco use.

- Every day about 80,000 to 100,000 young people become regular long-term smokers, most of them in the transition and developing countries.

- By 2030 tobacco is expected to be the single largest cause of death worldwide, accounting for about 10 million deaths per year. Half of these deaths will be in middle age (35-69), a loss of 20 to 25 years of life.

Since 1991 the World Bank is not lending aid for tobacco production and encourages tobacco control.

World Bank Supports Ownership Change in Bosnia and Herzegovina...

Three IDA credits for Bosnia and Herzegovina totaling \$134 million will support structural reform measures targeted for putting the economic system on a private-based, competitive footing: enterprise and bank privatization with \$50 million, reform of fiscal management with \$72 million, and strengthening banks and enterprises with \$12 million. Since Bosnia and Herzegovina joined the Bank in 1996, commitments have totaled \$694 million for 29 projects.

...Land Registration in Slovenia...

A \$15 million loan to Slovenia will go toward improving the country's land registration, housing finance, mortgage, and property ownership systems; developing first-time registration of apartments; establishing a market-based property tax; and monitoring agricultural land-use monitoring. Since joining the Bank in 1993, Slovenia has been granted a total of \$151 million for four projects.

...Private Farming in Bulgaria...

The \$75.76 million loan to Bulgaria will support a comprehensive reform of agricultural policies aimed at developing a competitive,

market-based sector that will include privatization, development of rural and agricultural finance, and land market. Since Bulgaria joined the Bank in 1990, commitments have totaled \$1.27 billion to 18 projects.

...Improved Water Service in Kazakhstan...

A \$16.5 million World Bank loan to Kazakhstan will strengthen the capacity of Vodocanal water and wastewater enterprise in the city of Aytrau to provide reliable and safe drinking water and disposal of sewage.

...Dam Safety in Armenia...

A \$26.6 million loan for Armenia will finance a five-year program for improving the safety of 20 priority dams and for establishing an effective system for monitoring the safety of all dams in Armenia.

...Farming and Education in Tajikistan...

A \$20 million IDA credit will support the privatization of farms in Tajikistan, \$5 million will improve access to high quality education and will raise learning achievements of students, and \$6.7 million will be used to strengthen the country's public sector management capacity through consulting services, training, and office technology.

...Agriculture and Historic Monuments in Azerbaijan...

A \$30 million loan to Azerbaijan will aid private family and group farms and other private rural entrepreneurs, to begin to register land transactions and provide information and advisory services, as well as credit to expand investment in their farms and other rural businesses.

...Rural Credit System in the Kyrgyz Republic...

A \$15 million IDA credit for the Kyrgyz Republic will support the strengthening of

the rural financial system to enable it to lend to small-scale entrepreneurs and farmers, including those who do not have adequate physical collateral but have proposals for viable economic activities, or social collateral.

...Utility Privatization in Moldova...

\$40 million will go to Moldova for two tranches of a structural adjustment credit (SAC) aimed at promoting privatization of the country's agricultural, industrial, and energy sectors. Another \$11.1 million will go toward implementing pension reform and developing an efficient social protection system. Since Moldova joined the Bank in 1992, total commitments have reached \$344 million for 14 projects. (Moldova's National Agency for Energy announced on 25 June that gas prices will increase by 45.1 percent, electricity by 19 percent, and heating by 23.3 percent as of 1 July. The hikes were necessitated by the devaluation of the leu by almost one-third since prices were adjusted in December 1998).

...Reforms in Georgia ...

A total of \$114.9 million IDA credit for Georgia will finance four projects in Georgia: structural reforms, including privatization (\$60 million); public sector reform, including health care (\$16.5 million); investment in the energy sector (\$25 million); and judicial reform (\$13.4 million).

...and Urban Development in Vietnam

In mid-June, the World Bank approved a \$80.5 million IDA credit to Vietnam for improving public health and increasing economic development in three key urban areas—the cities of Da Nang, Haiphong, and Quang Ninh Province (Halong City and Cam Pha). World Bank Country Director Andrew Steer pointed out that the credit will help reduce the incidence of waterborne disease, environmental degrada-

tion, and the effects of flooding and poor sanitation that particularly affect the urban poor.

Latest IFC Investments in Transition Countries

● **Medicover Health Care, Poland.** As its first regional health care investment in Eastern Europe, IFC in mid-May granted \$7 million credit to a Warsaw-based company that, since 1995, has operated a network of outpatient centers offering preventive and ambulatory care and occupational medicine under a prepaid, comprehensive private health care system. Medicover also operates outpatient centers in Romania, Hungary, Estonia and serves approximately 30,000 members, primarily from the corporate sector. Medicover's major stockholder is ORESA Ventures, a Swedish venture capital company.

● **Georgian glass bottle plant.** Together with the EBRD, \$17.6 million in financing has been committed to Saaktsio Sazogadoeba MINA (Ksani). This joint financing will help Ksani to increase exports, enhance energy efficiency, and raise environmental practices to international standards. The EBRD and IFC are each making a \$2.5 million equity investment and a \$6.3 million, 6.5-year secured loan. The total costs of the project are estimated at \$27.4 million.

● **Bulgarian American Credit Bank (BACB)** has received a five-year loan of up to \$5 million for long-term on-lending to private small- and medium-sized enterprises. IFC has an option to acquire an equity stake of up to 20 percent in the bank.

● **DCRH Hungarian credit rating company.** IFC will make a 20 percent equity investment of up to \$100,000 in DCRH, which will use internationally accepted standards to provide all types of credit rating services for the Hungarian market. IFC's partners are the Chicago-based Duff & Phelps Credit Rating (DCR), which has offices in 26 countries around the

world; HVG Publisher, publisher of the leading Hungarian economic news magazine HVG; and PlanEcon, a consulting company specializing in economic and industrial analysis in transition economies.

● **Ceskoslovenska Obchodni Banka (CSOB)** will be the first of the three remaining large state-owned Czech banks to be privatized. With an equity investment of approximately \$75 million for a 4.3 percent shareholding, IFC will undertake the largest equity investment it has ever taken in any bank. CSOB's transfer to new management and ownership is the cornerstone of the government's reform plan for the financial sector. The strategic investor is KBC Bank N.V. of Belgium, which will invest about \$1.1 billion for a 65.7 percent stake.

Mongolia's Reform Program Gets \$320 Million

International donors on June 22 pledged a total of about \$320 million to support Mongolia's efforts to transition to a market economy. The commitments—which will cover Mongolia's financing needs over the next eighteen months—come at a critical time for this country, which has suffered a number of setbacks to its reform program over the past year. A terms-of-trade shock was triggered by the sharp fall in the international prices of Mongolia's key export commodities: copper, gold, and cashmere. Copper exports alone, which had accounted for a quarter of GDP and 15 percent of tax receipts, virtually halved in 1998, widening the fiscal deficit to more than 11 percent of GDP. Also, foreign direct investment (FDI), particularly from other East Asian countries affected by the regional financial crisis, dropped sharply. Donors stressed the need for a substantial overhaul of the banking system, including privatization of state-owned banks. Donors expressed concern that the overall level of poverty, while not rising, remains 35.6 percent. Participants decided that future assistance group meetings will

transform to a Consultative Group (CG) format, chaired by the World Bank, with the venue rotating among Paris, Tokyo, and Ulaanbaatar. The next meeting will be held in Paris in eighteen months.

World Bank Lends more than \$1 billion to China in Five Weeks

In the final weeks of fiscal year 1999 (which ended on June 30), the World Bank unloaded more than \$1 billion to China, either as concessionary IDA credits or normal IBRD loans. Standard IDA terms include no interest rate, 35-40 years repayment period, and a 10-year grace period. As of 1 July, China is not eligible to any of these credits, having reached a higher stage of economic development. (The number in parentheses is the date of World Bank approval.)

- (May 26) **\$250 million** to increase the incomes of poor farmers and agricultural production in China: \$80 million loan and \$20 million IDA credit for irrigation improvement in Guanzhong; \$50 million IDA credit; \$100 million for the second Loess-plateau watershed rehabilitation project.
- (June 3) **\$30 million IDA credit and a \$16 million loan** will help more than 3 million people in the Anhui, Fujian, Guizhou, and Hainan provinces enjoy the benefits of clean, safe water and improved sanitation and health conditions. Despite recent progress, more than 450 million rural Chinese continue to draw water from unsafe sources or endure insufficient supplies.
- (June 8) From a **\$100 million loan and a \$35 million Global Environment Facility (GEF) grant** about 1 million people in rural China will be connected for the first time to electricity generated by solar power and wind, while millions of others will be able to switch to electricity generated without greenhouse gas emissions.
- (June 17) A **\$350 million loan** will finance the construction of the 300-kilometer Wuhan-Changsha expressway, the

central section of the highway linking Beijing to Hong Kong.

- (June 17) With a **\$150 million loan and a \$2 million IDA credit**, six million low-income urban people in the cities of Chengdu, Deyang, Leshan, Luzhou, and Zigong, in Sichuan Province, will receive assistance. Sichuan Province, with over 82 million residents, is the most populous province in China. Citizens will enjoy the benefits of cleaner, safer water and a healthier environment.

- (June 24) A **\$200 million loan** was given for the construction of the 140-kilometer Zhangzhou-Zhao'an Expressway, a key section in the coastal corridor of China's National Trunk Highway System between Fuzhou in Fujian Province and Shenzhen in Guangdong Province.

- (June 30) A **\$5 million IDA credit** will help deepen enterprise reform in China. Methods will be tested through pilot implementation in four pilot cities—Changsha, Shenyang, Wuhan, and Wuhu—and successful experiences will be disseminated to officials in central and local government.

Qinghai Component of World Bank's China Loan Delayed

A sweeping majority of the World Bank's Board of Executive Directors on 24 June approved a **\$100 million IDA credit and a \$60 million loan** designed to benefit 1.7 million poor in China who live in the Inner Mongolia Autonomous Region of Gansu and Qinghai. The Board also agreed that no work be done and no funds be disbursed for the \$40 million Qinghai component of the program—which involves the resettlement of 57,750 people and had been criticized by environmental and Tibetan groups—until the Board decides, pending on the results of the Independent Inspection Panel's review. The review was requested by two NGOs.

The Qinghai component—involving the voluntary move of farmers from heavily

eroded hillsides in the east of the province—will begin with a small pilot phase if the government proceeds to implementation after the Inspection Panel review. The pilot phase will involve only about 200 households and will allow close monitoring to ensure that the environmental issues, irrigation systems, and health and education services achieve their stated goals before any further investment in the project is made. The pilot phase will also require evidence that the overall status of the ethnic groups is protected and preserved in the new surroundings.

The Western Poverty Reduction Project, as it is called, provides significant health, education, employment, and farming benefits to people in remote and inaccessible villages. The current average incomes is between \$25 and \$60 a year. This money will support farmers by providing seeds, fertilizers, forestry development, irrigation and land improvement, road construction, safe drinking water, basic health and education services, and credit to nonstate rural enterprises. The partnership between China and the World Bank has helped to reduce the number of people in China living in poverty from 280 million to 80 million.

IFC Lends \$20 Million to Lithuania's Leading Bank...

The IFC lent \$20 million to Vilniaus Bankas, the largest private bank in Lithuania. Vilniaus Bankas will use the funds to finance lending to small- and medium-sized businesses and increase its lending for residential mortgages.

...and World Bank Supports Municipal Development

The World Bank's \$20.1 million loan to Lithuania, approved in late May, will help accelerate municipal development through technical assistance to local governments and municipal enterprises it will fund municipal credits to viable local investments and provide municipal infrastructure grants.

Albania's Donors Pledge \$200 million for 1999

24 countries and 15 organizations participating in the Emergency Joint G24/Consultative Group meeting for Albania in late-May pledged \$200 million to cover external financing requirements in 1999. This financing will allow Albania to continue its program of economic reform and cover costs incurred by the Kosovo crisis. The meeting was co-hosted by the European Commission and the World Bank.

The Kosovo conflict and the surge of refugees have placed extraordinary demands on Albania's public sector to provide basic infrastructure and public services. In June the World Bank approved three IDA credits worth \$57 million: on June 3 a \$45 million Structural Adjustment Credit (SAC) and \$24 million for irrigation and drainage rehabilitation; on June 22 a \$12 million microcredit project that will improve the availability of financial services to rural farmers and entrepreneurs, as well as urban micro entrepreneurs and self-employed workers.

In mid-June the IMF released \$12.9 million to Albania under the three-year Enhanced Structural Adjustment Facility (ESAF), which had been augmented to \$60.6 million. Having concluded the Article IV consultation with Albania, the IMF points out that growth could continue at 8 percent this year, while inflation should stay below 7 percent. "The Kosovo crisis apart, Albania still faces tremendous development problems. Despite rapid growth in the early years of transition, per capita GNP is only about \$800. Basic structural deficiencies in the economy run deep. The financial system is rudimentary, the tax base is inadequate, communications are hampered by a weak infrastructure, and waste and inefficiency are considerable in the public utilities. Corruption and organized crime are recognized problems and administrative capacity is weak. The internal and exter-

nal security situation undermines investor confidence," reads the IMF statement. (See IMF website: <http://www.imf.org/external/>)

World Bank Reopens Minsk Office

After an absence of some 10 months, the World Bank will re-establish a permanent representative in Belarus, Paul Siegelbaum, World Bank Country Director for Ukraine and Belarus, announced on 18 June. On 21 June Serhiy Kulyk, a Ukrainian national and career diplomat, took up the position, discontinued by the World Bank last September.

G8: IMF Interim Committee Renamed...

Leaders of the G8 (Group of seven leading industrial states and Russia) held their annual summit this year in Cologne, Germany, in June and decided to rename the IMF's policymaking Interim Committee to the International Financial and Monetary Committee. The committee will retain its original constituency structure, which means that its 24 participants represent fully the 183 member countries of the Fund. It will also meet regularly at deputies (or senior official) level and hold occasional joint meetings with the Development Committee of finance and development ministers, which considers issues relevant to poorer countries arising in both the IMF and the World Bank. World Bank President James Wolfensohn will be given a privileged position in the new committee. The Interim Committee, which was formed in 1974, meets twice a year—in spring and in autumn—but it only in an advisory capacity. Day-to-day decisions—including dealing with international financial crises—are taken by the IMF's Executive Board, made up of the permanent representatives of the main IMF shareholders.

...Will Set Up New "Talking Shop"...

The G8 also proposed a new talking shop of selected industrial and emerging market economies. Dubbed GX until its mem-

bership is decided, this informal body, comprising the G8 and selected emerging market nations, will discuss the architecture of the international financial system.

...and Released Statement about Russia's Debt Rescheduling

Further rescheduling of Russia's debt depended on its carrying out economic reforms under an agreement with the IMF and World Bank, the G8 leaders said in a statement. "Once an IMF agreement is in place, we encourage the Paris Club [of creditor governments] to act expeditiously to negotiate a debt rescheduling agreement with Russia." The leaders called for more cooperation with Russia in areas such as small business development, regional development, health care, offsetting the social impact of economic transformation, fighting organized crime, and money laundering.

Three-year Aid Package for Bosnia and Herzegovina

During their fifth donor conference for Bosnia and Herzegovina in Brussels in late May, 45 countries and 30 organizations pledged \$1.05 billion (992 million euro) for covering the country's need in 1999. Preparations started for a three-year aid package up to 2003, focusing on economic growth and industrial development rather than infrastructure. The World Bank-led reconstruction program for war-torn Bosnia and Herzegovina, estimated to require some \$5.1 billion, was mainly focused on infrastructure recovery for the period 1996–1999. Since the war, some \$4.25 billion in grants and soft loans have been given to rebuild power systems, housing capacity, transport, waterworks, and de-mining, as well as for industrial revitalization. The International Monetary Fund (IMF) approved an augmentation of \$23 million and an extension—through end of April 2000—of Bosnia and Herzegovina's \$81 million stand-by credit.

Milestones of Transition

Continued from page 15

Bulgaria

Liquidation of loss-making state companies. Bulgaria has sold 40 percent of its state assets and met the IMF-set deadline for selling or closing 41 large loss-making companies as part of its market reform program. Finance Minister Muravei Radev announced on 30 June. Under the terms of a 1997 three-year stand-by agreement for a \$800 million loan, the companies had to be closed to cut losses in the public sector. Of the 41 companies, 30 have been sold, including the national carrier Balkan Air. Radev said that 7,000 jobs were cut and there will be another 6,000 layoffs by year's end if none of the nine remaining companies slated for closure is sold.

Minimum wage raised, energy prices hiked. The cabinet on 24 June decided to raise the minimum monthly wage by 9.8 percent. The government also hiked energy prices. Prices for electricity went up 10 percent for domestic consumption and 1.1 percent for industrial consumption. Heating prices were raised by 12 percent and the price of briquettes for household use increased by 30 percent.

Czech Republic

Real GDP fell by 4.5 percent year-on-year in the first quarter of 1999. The 1999 first-quarter result was the worst quarterly economic performance since the establishment of the Czech Republic in 1993. While the country is expected to emerge from its recession in the second half of this year, prospects for sustainable growth remain uncertain. In the fourth quarter of 1998, real GDP fell by 4.1 percent year-on-year. During the first quarter of 1999, however, the FDI inflow amounted to \$583 million, while the year-end figure is expected to exceed \$3 billion. After selling the fourth-largest bank, Ceskoslovenska obchodni banka (CSOB), to the Belgium-

based KBC bank for 40 billion koruny (\$1.1 billion), sale of the country's two largest banks, Komerčni banka and Ceska sporitelna, is also expected by the end of 2000. Restructuring and privatization of the country's largest industrial conglomerates should be resumed. (*Oxford Analytica*).

Poland

Lower income taxes. Personal income rates will be reduced from the current 19, 30, and 40 percent to 19, 29, and 36 percent next year and replaced by two rates—18 and 28 percent—in 2001. The corporate income tax will be reduced from the current 34 to 30 percent in 2000, while subsequent yearly reductions by two percentage points will lower it to 22 percent in 2004. Finance Minister Leszek Balcerowicz, the chief promoter of reduced taxes, said the plan is a "victory for the taxpayers," adding that the "struggle for lower taxes is not ending." The tax reduction plan is subject to parliamentary approval.

Coal mining digs up more losses. From January to May 1999, Poland's coal-mining sector chalked up losses of some 900 million zlotys (\$230 million), Deputy Economy Minister Jan Szluzak said on 28 June. The total debt of Polish coal mines amounted to 17.6 billion zlotys at the end of May. Declining demand and falling prices for coal were the main reasons for this year's poor results. Szluzak added that some 30,000 miners will leave the sector this year—two-thirds of whom will take advantage of benefits offered under a special social package.

Ten-year economic strategy. Finance Minister Leszek Balcerowicz said on 22 June that the government has adopted a strategy for public finances and economic development from 2000 to 2010. Two major goals of the strategy—which focuses on job creation—are to balance the budget by the year 2004 and to bring

inflation to below 4 percent. The rate of economic growth is already projected to increase significantly the next year, reaching 5.6 percent. The forecasted economic growth in 1999 is 4 percent. According to Balcerowicz, 3 to 4 million jobs are needed in the coming few years to defuse hidden unemployment and the demographic boom that is now entering its working age.

Romania

Poll: Life was better under Communists. More than 60 percent of Romanians believe living standards were better under communism and almost 90 percent want the state to lower unemployment and prices, according to an opinion poll published early-June, released by the Open Society Foundation. According to the survey—based on polling 2,000 people across Romania—66 percent were worried that the country was moving in the wrong direction, with three-quarters dissatisfied with living standards. (80 percent of a Romanians' income is spent on essentials). But 85 percent of those surveyed were still in favor of a market economy, although 88 percent believe the market economy benefits only high-ranking officials, like former communist party activists and "dishonest persons." Three years of economic contraction and massive layoffs have caused 74 percent of the respondents to distrust the government and 77 percent to lose confidence in all political parties.

CIS

Common Central Asian economic space? The presidents of the four member states of the Central Asian Union—Kazakhstan's Nursultan Nazarbaev, Kyrgyz Republic's Askar Akaev, Uzbekistan's Islam Karimov, and Tajikistan's Imomali Rakhmonov—met outside Bishkek on 24

June. The four presidents agreed on strengthening economic cooperation between their countries and on taking practical steps to form a common Central Asian economic space that would include a free trade zone and a common market for goods, services, and capital. They also granted Georgia and Turkey observer status in the union.

Belarus

Tight money? Addressing the National Assembly last week, Finance Minister Mikalay Korbust said his ministry is unable either to pay wages or finance the purchase of medicines. National Bank Chairman Pyotr Prakapovich told the National Assembly the same day that owing to a lack of foreign credits the bank issued 50 trillion Belarusian rubles (some \$200 million) in the first half of 1999 "to ensure economic growth."

Kyrgyz Republic

Cabinet discusses economic situation. During a government meeting in Bishkek on 26 June, Finance Minister Marat Sultanov characterized the current economic and social situation as "very serious." Sultanov said the government will be able to pay wage and pension arrears only after it receives new loans or grants from abroad. The internal debt is currently about 500 million soms (some \$12 million). Muraliev urged the government to speed up privatization of the three largest state-owned companies—Kyrgyztelecom, the Kyrgyz national airline, and the Kyrgyzenergo energy company.

Moldova

Premier says economic security endangered. In an article published in the daily *Moldova suverana* on 30 June, Prime Minister Ion Sturza said the country's economic security is in danger and speedy, far-reaching reforms are the

only solution to that situation. Sturza said Moldovan GDP has shrunk by 60 percent since the country became independent and per capita annual income is \$500, thus making poverty "the number one problem" for the government. The cabinet on the same day approved a number of draft laws targeted for accelerating reforms, including legislation on guaranteeing against the expropriation of property.

Russia

Decisive actions in banking sector?

The Central Bank on 29 June announced it is withdrawing the licenses of four large banks—Mezhkombank, Mosbiznesbank, Oneksimbank, and Promstroibank. Oneksimbank was one of Russia's top ten banks and its chairman Vladimir Potanin was considered one of Russia's oligarchs, but the bank's debt has reached an estimated \$2 billion. In mid-May the Central Bank revoked the licenses of 12 failing banks, including Menatep, which before last August's devaluation of the ruble had the country's seventh largest assets. Other banks stripped of their licenses were Derzhavnii, ELKOM-Bank, Interbiznesbank, Kontakt, Krasnodarbank, Kurgansotsbank, MV, Nizhnevartovsk Commercial Innovation Bank, Slaviya, Unibest, and Unikombank.

Sidanko bankruptcy. A Moscow court on 18 May declared Sidanko, Russia's sixth-largest oil company, bankrupt. A 12-month external administrator will be appointed at the court's next hearing of the case, scheduled for 23 July.

Russia's budget is half the budget of Texas. The draft federal budget for 2000—just under \$24 billion—targets for 1.5 percent economic growth, 18 percent inflation, a 32 ruble=1 dollar exchange rate, and a budget deficit of just 1.5 percent of gross domestic product. Russia is set to spend 42 percent of its 2000 budget on debt servicing.

Focus on investors, not ruble-economists. Russia must focus on enticing investors rather than supporting the ruble or balancing its budget if it wants to attract this major capital resource, suggests German economist Paul Fischer, an independent economist who has worked on technical assistance programs to Russia. Russia's wrong choice—the macroeconomic route—brought only a few billion dollars of direct investment to the industry since the fall of the Soviet Union—slightly more than Vietnam. Russia should be aiming for \$10–\$15 billion per year, claimed the economist. Better conditions for investment might also bring back some of the \$120 billion Russia has lost in capital flight. Fischer said Russia needs a legal environment that includes a better tax system, land ownership, and free economic zones near city centers. Investors needed information systems and consulting services. Russia, he said, also needs to put its financial services in order for industries to borrow.

Poisoned land. About 44 percent of the Russian population—65 million people—live in cities that exceed the government's strict limits on air pollution, quoted the *Washington Post* on the latest government report on the environment. Most major rivers and their tributaries are heavily polluted. The government admitted it cannot guarantee the quality of the drinking water. Even the kitchen gardens, which many Russians depend on for food, may be unsafe. More than 13 percent of the soil tested in Russian cities is contaminated with heavy metals, oil, pesticides, or other harmful substances. "The environment is an abandoned child," said Vladimir Tsirkunov, senior environmental specialist with the World Bank.

Ukraine

Borrowing needs. Finance Minister Ihor Mityukov told a government-sponsored conference in Kyiv on the 2000 budget that the government needs 15.3 billion hryvni

(\$3.9 billion) to repay its debt obligations in 2000. To reach this, Ukraine must borrow 11.1 billion hryvni. On 28 June Leonid Kuchma signed 13 economic decrees to generate budget revenues and cut expenditures—including the privatization of the UkrTeleKom communications giant, the promotion of foreign investments, and new taxes on tobacco, real estate transactions, and mobile phones. Money generated by the decrees will be used to pay wage and pension arrears and to compensate the elderly for their savings losses. The Economy Ministry predicts a 2 percent in-

crease in GDP in 2000—the first projected economic growth year in independent Ukraine's history.

Asia's Reforming Economies

China

Import tariffs to be slashed in 2000. China will cut import tariffs on industrial products from 17 to 15 percent next year, Deputy Minister for Foreign Trade and Economic Co-operation Sun Zhenyu announced. By 2005 the tariffs could be reduced to 10 percent. China

plans to import \$1.5 billion worth of technology, equipment, and products in the next seven years. China will open up banking, insurance, and telecommunications industries in gradual steps to foreign businesses. Investment in agriculture, high-tech industries, infrastructure, construction, the environmental sector, and export-oriented industries are also being encouraged. By the end of last year, foreign firms from more than 170 countries had made a cumulative contractual investment of \$522.52 billion in China, of which \$267.45 billion was put into use, according to figures from the ministry.

Conference Diary

For the Record

Collective Action and Corruption in Emerging Economies

May 14, 1999

Sponsor: The IRIS Center, under an agreement with the U. S. Agency for International Development.

This conference addressed the proposition that fundamental flaws in the design of the state are a primary source of high corruption in many poor societies. The presentations focused on ways in which institutions (state and non-state) undermine collective action in support of effective governance. In the absence of a framework for collective action at the political level, narrow and informal methods of coordination play the preeminent role in the public sphere, thus intensifying rent seeking and corruption. These failures can be attributed to a combination of over-centralization, disjuncture between social norms and formal institutions, social and ethnic fractionalization, and unplanned or unsupervised methods of devolution. In short, the conference addressed an important dimension of governance failure not emphasized in principal-agent models and bribery studies. In doing so, it pro-

posed a necessary complement to mainstream anti-corruption activities presently being pursued by international financial and donor agencies.

Some papers presented include "Cooperating against Corruption: Governance, Collective Action, and Jurisdictional Design in Plural Societies," by Patrick Meagher, IRIS Center; "Ethnic Fractionalization, Corruption, and Institutions in Africa," by Samson Kimenyi, University of Connecticut; "Asian Business Networks and Forms of Economic Organization: A Psychological Game-Theoretic Approach," by Peter Huang, University of Pennsylvania and Janet Landa, York University; and "Decentralization in Russia: Impact for the Quality of Governance," by Leonid Polishchuk, IRIS Center.

Information: To receive a conference packet, which includes all of the papers presented, contact Alison Gramann at the IRIS Center, tel: 301-405-3060, email: alison@iris.econ.umd.edu, The Center for Strategic and International Studies, Floor B1, Room B, 1800 K St., NW, Washington, DC 20006. In order to cite any of the papers in the packet, the author's permission must be granted, as the papers are still being revised.

Upcoming Conferences

CTI/Industry Joint Seminar on Technology Diffusion in Eastern Europe

July 14–16, 1999, Bratislava, Slovakia

Co-sponsors: European Commission Directorate General XVII—Energy, NEDO, Japan, U.S. Department of Energy, and U.S. Agency for International Development, in cooperation with the United Nations Framework Convention on Climate Change Secretariat.

Topics: The United Nations Framework Convention on Climate Change and Technology Diffusion and Transfer; Ministerial Roundtable on Technology Needs and Barriers; Private Sector Perspectives on Climate-Friendly Technologies; Overcoming Financial Barriers and the Role of Multilateral and Financial Institutions; Donor Country Perspectives and Strategies to Encourage Climate-Friendly Technology Market Development; Technology Needs Assessments: Methodologies and Approaches; Lessons Learned from Existing Projects in the Region; and Roundtable Discussion to Identify Practical Steps to Promote, Facilitate, and Finance Transfer of and Access to Environmentally Sound Technologies and Know-How.

Information: Mr. Michael Rucker, Climate Technology Initiative, International Energy Agency, 9, rue de la Fédération, 75739 Paris Cedex 15, France, tel: 331-4057-6522, fax: 331-4057-6759, email: rucker@iea.org.

International Capital Mobility and Domestic Economic Stability

July 14-16, 1999, Australia

Organizers: Australia National University, Bankers Trust Foundation, and the World Bank.

Information: Mr. Marc Uzan, Executive Director, Reinventing Bretton Woods Committee, 157 East 37 Street Suite 4F New York Nyork 10016 USA, tel. 212-685-1308, fax 212-685-1057, email MDU@aol.com, Internet: <http://www.RBWF.org>

Second Annual Central and East European Finance Director's Forum

October 13-14, 1999, Budapest, Hungary

Organizer: The Economist Intelligence Unit. Information: Gerlinde de Leonardis, The economist Conferences, Schwarzenbergplatz 8/7, A-1030 Vienna, Austria, tel. 431-712-4161, fax 431-712-4165, email: gerlindedeleonardis@eiu.com.

Ten Years after Transition and Growth in Post-communist Countries

October 15-16, 1999, Warsaw, Poland

Organizer: (CASE) Center for Social and Economic Research.

Topics: Transformation: Taking Stock of Ten Years' Experience; What Are the Chances of Catching Up with the EU?; Globalization, Openness, and Macroeconomic Stability; The Role of Economic and of Political Institutions; The Post-Communist Welfare State—Inequality Question and the Challenge of Growth; The Quest for Modern Solutions: Pension Reforms in Transition Economies; Political Challenge of Transition.

Information: Dr. Jarek Neneman, email: neneman@kryisia.uni.lodz.pl

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: 202-676-0581, email: books@worldbank.org, Internet: <http://www.worldbank.org> or <http://www.worldbank.org/html/dec/Publications/Workpapers/tranecon.htm>, or visit the World Bank bookstore in the United States, at 701 18th Street, NW, Washington, DC, or France, at 66, avenue d'Iena, 75116 Paris.

Working Papers

<http://www.worldbank.org/html/dec/Publications/Workpapers/home.html>

Martin Ravallion and Michael Lokshin, **Subjective Economic Welfare**, WPS 2106, April 1999, 39 pp.

Current household income compared with a poverty line can only partially explain how Russian adults perceive their economic welfare. Other factors include past income, individual income, household consumption, current unemployment, risk of unemployment, health status, education, and relative income in the area of residence. Healthier and better-educated adults with jobs perceive themselves to be better off. The unemployed view themselves to be worse off, even with full income replacement. Relative income also matters. Living in a richer area lowers perceived economic welfare, even assuming unchanged income.

To order, contact Patricia Sader, room MC3-632, tel: 202-473-3902, fax: 202-522-1153, email: psader@worldbank.org. The authors may be contacted at

mravallion@worldbank.org or mlokshin@worldbank.org.

William Easterly, **When Is Fiscal Adjustment an Illusion?**, WPS 2109, May 1999, 32 pp.

William Easterly, **Life during Growth: International Evidence on Quality of Life and Per Capita Income**, WPS 2110, May 1999, 31 pp.

Improvements in a country's quality-of-life indicators (health, education, individual rights and democracy, political instability and war, transport and communications, inequality across class and gender) possibly depend as much on rising world income as on the growth of the country itself. Longer life expectancy in a country, for example, may reflect technical breakthroughs in antibiotics associated with world economic growth. Changes in quality of life, as income grows, are surprisingly uneven.

To order both papers, contact Kari Labrie, room MC3-456, tel: 202-473-1001, fax: 202-522-1155, email: klabrie@worldbank.org. The author may be contacted at weasterly@worldbank.org.

Stefano Paternostro and David E. Sahn, **Wage Determination and Gender Discrimination in a Transition Economy: The Case of Romania**, WPS 2113, May 1999, 32 pp.

Romania's labor code stipulates equal pay for equal work. In reality, gender discrimination is found in both urban and rural labor markets. While the observed bias in urban areas is comparable with that found in other Western countries, in rural settings gender discrimination is much greater than in the West.

With the adjustment to market forces, as less-skilled workers face increasing difficulties in the region, women's relative wages may be expected to decline further. Discrepancy in pay also directly affects the level of pensions, unemployment benefits, and other means-tested benefits to workers. *To order, contact Nadege K. Nouviale, room J7-269, tel: 202-473-4514, fax: 202-473-8466, email: nnouviale@worldbank.org. The authors may be contacted at spater_nostro@worldbank.org or david.sahn@cornell.edu.*

Simeon Djankov and Bernard Hoekman, **Foreign Investment and Productivity Growth in Czech Enterprises**, WPS 2115, May 1999, 24 pp.

Foreign direct investment had a greater positive impact on total factor productivity in firms in the Czech Republic over a four-year period than joint ventures did, suggesting that parent firms transferred more know-how to affiliates than joint venture firms got from their partners. Firms without any foreign partners experienced negative spillover effects, finding it difficult to absorb and benefit from the diffusion of state-of-the-art know-how.

To order, contact Rose Vo, room MC9-622, tel: 202-473-3722, fax: 202-522-2031, email: hvo1@worldbank.org. The authors may be contacted at sdjankov@worldbank.org or bhoekman@worldbank.org.

Soamiely Andriamananjara, **On the Size and Number of Regional Integration Arrangements: A Political Economy Model**, WPS 2117, May 1999, 37 pp.

Will the current wave of regional integration arrangements lead to the world being divided into competing inward-looking trading blocs? Or will it lead to a more open multilateral trading system? Using a multicountry political economy model, and after having shown that global free trade is optimal, Andriamananjara investigates the possibility of achieving a trading system

through regionalism. An outsider country considering entering a trading bloc must weigh the tradeoff between the costs of opening its own market to more foreign competition and the gains from getting better access to the bloc's preferential market.

The gain of access is always larger, so an outsider would always want to apply for membership in the existing bloc. If the bloc policy is open membership, its expansion would result in global free trade. But if member countries can accept or reject new members, expansion of the bloc is unlikely to yield global free trade. Even if blocs form and merge simultaneously, yielding progressively larger symmetrical blocs, they would fail to converge in a single bloc unless the external tariffs were low enough. In other words, global free trade could be achieved through bloc expansion if trading blocs lowered their external tariffs when abolishing their internal tariffs.

To order, contact Lili Tabada, room MC3-333, tel: 202-473-6896, fax: 202-522-1159, email: ltabada@worldbank.org. Policy Research Working. The author may be contacted at soamiely@wam.umd.edu.

Anne O. Krueger, **Developing Countries and the Next Round of Multilateral Trade Negotiations**, WPS 2118, May 1999, 33 pp.

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Ian Parry and Antonio Bento, **Tax Deductions, Environmental Policy, and the "Double Dividend" Hypothesis**, WPS 2119, May 1999, 39 pp.

To order, contact Roula Yazigi, room MC2-533, tel: 202-473-7176, fax: 202-522-3230, email: ryazigi@worldbank.org. The authors may be contacted at parry@rff.org or abento@worldbank.org.

Bernard Hoekman and Kym Anderson, **Developing Country Agriculture and**

the New Trade Agenda, WP S2125, May 1999, 23 pp.

To order, contact Lili Tabada, room MC3-333, tel: 202-473-6896, fax: 202-522-1159, email: ltabada@worldbank.org. Bernard Hoekman may be contacted at bhoekman@worldbank.org or kanderson@economics.adelaide.edu.au.

Bartlomiej Kaminski, **Hungary's Integration into European Union Markets: Production and Trade Restructuring**, WPS 2135, June 1999, 28 pp.

Hungary has achieved impressive results in reorienting both its production and trade. Between 1989 and 1992, as the former CMEA markets collapsed and Hungary liberalized imports and the exchange rate regime, exports to the European Union (EU) expanded, with manufactured exports redirected largely to Western (mostly EU) markets. In a second phase of expansion (in 1994–97), driven by restructured and rapidly changing export offers, exports again registered strong performance, their value increasing by 132 percent. There was a dramatic shift from an export basket—dominated by resource-intensive, low-value-added products—to one driven by manufactures, with a rapidly accelerating growth of engineering products. Machinery and transport equipment rose from 12 percent of exports to the EU in 1989 to more than 50 percent in 1997.

The shift from natural resource and unskilled-labor-intensive products to technology- and capital-intensive products in EU-oriented exports suggests the potential for integration higher in the value-added spectrum. The rapid pace of Hungary's turnaround seems to reflect the emergence of second-generation firms, mostly foreign-owned. Foreign-owned firms tend to be more export-oriented. Hungary has been one of the more successful transition economies because its economy was receptive to foreign direct investment from the outset. Between 1990 and 1997, Hungary absorbed roughly half of all foreign capital invested in Central Europe.

To order: Lili Tabada, room MC3-333, tel: 202-473-6896, fax: 202-522-1159, email: ltabada@worldbank.org. The author may be contacted at bkaminski@worldbank.org.

Andrés Solimano, **Globalization and National Development at the End of the 20th Century: Tensions and Challenges**, WPS 2137, June 1999, 14 pp.

Globalization offers developing countries the opportunities to create wealth through export-led growth, to expand international trade in goods and services, and to gain access to new ideas, technologies, and institutional designs. But global business cycles can reinforce macroeconomic volatility at the national level. Policymakers should also be concerned about how globalization exacerbates job instability and income disparities both within and across countries. Development policy agendas need to articulate traditional concerns with growth, stability, and social equity with new themes such as transparency and good governance at national, regional, and global levels.

To order, contact Diana Cortijo, room 14-050, tel: 202-458-4005, fax: 202-676-0720, email: dcortijo@worldbank.org. The author may be contacted at asolimano@worldbank.org.

Bernard Hoekman and Kamal Saggi, **Multilateral Disciplines for Investment-Related Policies**, WPS 2138, June 1999, 29 pp.

Is there a strong case for developing countries to support the creation of a multilateral agreement on investment? Probably not. Existing agreements offer ample scope for liberalizing foreign direct investment in the area that matters most to developing countries: services.

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Steven J. Matusz and David Tarr, **Adjusting to Trade Policy Reform**, WPS 2142, July 1999, 58 pp.

A survey of more than 50 empirical papers shows that the adjustment costs of trade liberalization are small relative to the benefits, because

- These costs are typically short term and end when workers find a job, but the benefits grow as the economy does.
- Unemployment doesn't last long, especially where workers' pay was not substantial in the original job.
- Normal labor turnover often exceeds job displacement from trade liberalization.

Moreover, studies that examine the impact of trade liberalization on employment in developing countries find there is little decline—and usually an increase—in manufacturing employment in developing countries one year after trade liberalization. A uniform tariff would minimize special-interest lobbying for protection since it diffuses the benefits of protection. Available data suggest that trade liberalization reduces poverty.

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World Bank Country Studies

Czech Republic: Capital Market Review, 1999, 194 pp.

Weak protection of minority shareholder rights and the absence of other important elements of internal governance proved to be important obstacles to sound management and active restructuring of Czech enterprises. Weaknesses in the external mechanisms of governance also created room for abuse by large shareholders and managers.

Estonia Country Economic Memorandum: Implementing the EU Accession Agenda, 1999, 148 pp.

Estonia's case for accession is built, to a large extent, on a record of sound economic management. Indeed, since regaining independence in 1991, Estonia has successfully implemented a broad agenda of stabilization and structural reform policies. However, at present, Estonia is experiencing a sharp economic slowdown as a result of two major external shocks: the Asia and Russia crises.

There is a major overlap between the accession agenda and measures to strengthen economic management—by upgrading financial sector supervision and strengthening budget management, modernizing public administration, adhering to EU quality standards, and completing of land reform. Adopting the EU's Common Agricultural Policy (CAP) and complying with EU environmental standards entail a fundamental change in Estonia's trade policy regime. Trade has high compliance costs.

World Bank Technical Papers

Non-Payment in the Electricity Sector in Eastern Europe and the Former Soviet Union, No. 423, 1999, 132 pp.

Csaba Csaki and John Nash, **Regional and International Trade Policy: Lessons for the EU Accession in the Rural Sector**, World Bank/FAO Workshop June 20-23, 1998, Budapest, Hungary, No. 434, 1999, 112 pp.

Roy Prosterman and Tim Hanstad (eds.), **Legal Impediments to Effective Rural Land Relations in Eastern Europe and Central Asia: A Comparative Perspective**, No.436, 1999, 330 pp.

Csaba Csaki, Michel Debatisse, and Oskar Honisch, **Food and Agriculture in the Czech Republic: From a "Velvet" Transition to the Challenges of EU Accession**, No.437, 1999, 112 pp.

Overcoming Obstacles to Liberalization of the Telecom Sector in Estonia,

Poland, the Czech Republic, Slovenia, and Hungary: An Overview of Key Policy Concerns and Potential Initiatives to Facilitate the Transition Process, No. 440, 1999, 48 pp.

Other World Bank Publications

Guy Pfeffermann, Gregory Kisunko, and Mariusz Sumlinski, **Trends in Private Investment in Developing Countries**, IFC Discussion Paper #37, 1999, 49 pp.

1997 was a record year for private capital formation in developing countries. Public investment as a share of GDP fell to its lowest point in 25 years. This paper, produced by the IFC Economics Department, includes the results of a country-by-country survey of the views of company executives on the obstacles to doing business in 74 developing, transition, and industrialized economies. Unpredictable courts and lack of financing emerged as major factors that discourage private capital formation.

Website: <http://www.ifc.org/DEPTS/OPS/ECON/PUBS/dp37.pdf>.

Project Finance in Developing Countries, IFC Series: Lessons of Experience No.7, 1999, 102 pp.

Project finance in emerging markets took a beating during the recent financial turmoil, but the method of financing projects through their own revenues and assets will rebound in an environment of the stronger markets, fairer regulations, and more inviting business policies being introduced in many developing countries. In the past decade IFC has invested in more than 230 projects, valued at more than \$30 billion. This book draws on that experience to describe the major international trends in project finance, significant risks in project structuring, and key ingredients of successful project financing.

James N. Tooley, **The Global Education Industry: Lessons from Private Education in Developing Countries**, Studies in

Education No. 7, IFC-Institute of Economic Affairs (IEA), UK Publication, 1999, 136 pp. To order, contact IEA, 2 Lord North Street, Westminster, London, SW1P 3LB, United Kingdom, tel: 44171-799-3745, fax: 44171-799-2137, email: iea@iea.org.uk, Internet: <http://www.iea.org.uk>.

Changes in private education could have a dramatic impact on the lives of millions of people worldwide. Drawing on examples from Romania, Russia, and other countries, the author gives a snapshot of private education that may surprise many readers: contrary to expectations, the private education sector is large in the countries studied, it is innovative, and it is not the exclusive domain of the wealthy. He challenges the conventional wisdom that private education fosters greater social and economic inequality; he points out that such education often provides creative social responsibility programs, subsidized places, and student loan schemes.

Harry G. Broadman (ed.), **Case-by-Case Privatization in the Russian Federation: Lessons from International Experience (Russian edition)**, World Bank Discussion Paper No. 385R, 1999, 104 pp.

John Nellis, **Time to Rethink Privatization in Transition Economies?**, IFC Discussion Paper No. 38, 1999, 40 pp.

This paper looks at what happens when the shift to private ownership gets ahead of the effort to build the institutional underpinnings of a capitalist economy. What went wrong and why—and what, if anything, can be done to correct it? Proposals include renationalization and/or postponement of further privatization, accompanied by measures to strengthen the managerial capacities of the state. Neither approach seems likely to produce short-term improvements. Governments that botch privatization are equally likely to botch the management of state-owned firms. For institutionally weak countries, the reason-

able short-term course of action is to push ahead more slowly with case-by-case and tender privatization in accordance with the international assistance community.

Jia Wang, Dean T. Jamison, Eduard Bos, Alexander Preker, John Peabody, **Measuring Country Performance on Health: Selected Indicators for 115 Countries, Health, Nutrition, and Population Series**, 1999, 368 pp.

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Luis M. Valdivieso, **Macroeconomic Developments in the Baltics, Russia, and Other Countries of the Former Soviet Union, 1972–97**, Occasional Paper No.175, 1998, 30 pp.

Andrew Berg, Eduardo R. Borensztein, Ratna Sahay, and Jeromin Zettelmeyer, **The Evolution of Output in Transition Economies—Explaining the Differences**, WP/99/73, 81 pp.

What are the relative roles of macroeconomic variables, structural policies, and initial conditions in explaining the large differences in output performance across transition economies? Using a sample of 26 countries, the results point to the preeminence of structural reforms over both initial conditions and macroeconomic variables. For more information, contact eborensztein@imf.org

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Assar Lindbeck, **Lessons from Sweden for Post-Socialist Countries**, Discussion Paper No. 50, November 1998, 53 pp.

What are the main implications for post-socialist countries to be drawn from the Swedish case? Strongly interventionist policies in Sweden, especially generous welfare-state arrangements, accomplished important social goals such as income security, income equality and limited poverty. But these policies burdened productivity and economic growth, and became unsustainable by the 1990s, partly due to negative macroeconomic shocks. These costs would be more serious in post-socialist countries, given the relative low level of per capita income and the more competitive international economic environment of today.

Post-socialist countries should be aware that Sweden has experienced considerable macroeconomic disruption because of mistakes in the sequencing of reforms. The most important effects came from deregulating domes-

tic capital markets prior to tax reform and the removal of foreign exchange controls.

Stephan Haggard, Robert Kaufman, and Matthew Shugart, **Politics, Institutions and Macroeconomic Adjustment: Hungarian Fiscal Policy-Making in Comparative Perspective**, Discussion Paper Series No. 51, November 1998, 56 pp.

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6610, fax: 431-533-6610-50, Internet: <http://www.wiiv.ac.at>.

Leon Podkaminer, **Three Essays on Inflation**, No. 252, January 1999.

Raimund Dietz, **Exchange Rates and Relative Prices in Central and Eastern European Countries: A Systems and Transactions Cost Approach**, No. 254, March 1999, 41 pp.

The size of the East-West price gap is extremely large. Low relative price levels in the Central and Eastern European (CEE) countries are in stark contrast to the degree of their industrial development and to the geographical and historical neighborhood of Western Europe. The price gap for the Eastern CEE countries—Bulgaria, Romania, Ukraine, and Russia—is more pronounced than for the Western CEE countries—Slovenia, Hungary, Poland, the Czech Republic, and Slovakia.

The higher the undervaluation of a currency, the more the price structure of the country differs. The stronger the purchasing power parity (PPP) undervaluation, the lower are wages and incomes measured in the same currency. The precipitously wide gap in nominal GDP per capita more or less parallels the nominal wage gap. Once institutions and transaction costs are taken into account, the argument on the causes and consequences of PPP undervaluation changes considerably.

A currency must be undervalued in order to generate a sustainable current account. As institutions and systems catch up, currencies may appreciate in real terms without jeopardizing a country's external equilibrium. Vice versa, when financial or other crises affect the exchange rate, the general price level will be reduced, which will affect the whole price structure of a country.

Other Publications

Shangquan Gao, **Two Decades of Reform in China**, World Scientific Publish-

ing Co., Ltd., Singapore, Summer 1999, 300 p.

From the *Foreword*, written by World Bank President James D. Wolfensohn:

"Professor Gao is an insider. During much of the past twenty years, since the beginning of China's market reforms in 1978, he was in senior government positions, guiding the reform effort as one of China's prominent economists and reformers. It was an uncharted course. The Chinese had to learn by doing; 'crossing the river while feeling the stones,' as Deng Xiaoping put it. This book explains the enormous obstacles that had to be overcome in facing economic and financial challenges. It also records the astonishing progress that has been made during the past 20 years, not least in the reduction of poverty, and sets out the agenda for difficult reform tasks that still lie ahead.

Most of this book was written while Professor Gao worked in the World Bank, as participant of the Visiting Research Fellows Program, from April through December 1998. The question, why China has been less affected by the crisis than most other countries in East Asia, was the subject of much discussion and analysis. Part of the answer lies in the fact that China had not yet liberalized its capital account. But the book also reveals that the macroeconomic reforms China undertook in the years preceding the crisis, contributed much to the country's monetary stability and its considerable external economic strength at the time the crisis struck. Nevertheless, the social and financial challenges facing China as a result of the current slowdown in domestic and in export demand are extremely serious. The critical importance and the urgency of deepening China's state-owned enterprises and financial sector reforms are underlined in Professor Gao's analysis."

William H. Meyers, Natalija Kazlauskienė, and Marcelo M. Giugale (eds.), **Lithuania's Accession to the European Union: Successes and Challenges for a Rural**

Economy in Transition, Iowa State University Press, United States, 1999, 220 pp. To order, contact Iowa State University Press, 2121 South State Avenue, Ames, Iowa 50014, United States, tel: 800-862-6657, fax: 515-292-3348, Internet: <http://www.isupress.edu>.

Axel Siedenberg and Lutz Hoffman (eds.), **Ukraine at the Crossroads: Economic Reforms in International Perspective**, Physica-Verlag Heidelberg, New York, 1999, 437 pp. To order, contact Dr. Axel Siedenberg, Deutsche Bank AG, Grobe Gallusstrasse 10-14, D-60311 Frankfurt am Main Germany, or Dr. Lutz Hoffmann, President, DIW, German Institute for Economic Research, Konigin-Luise-Strasse 5, D-14195 Berlin, Germany.

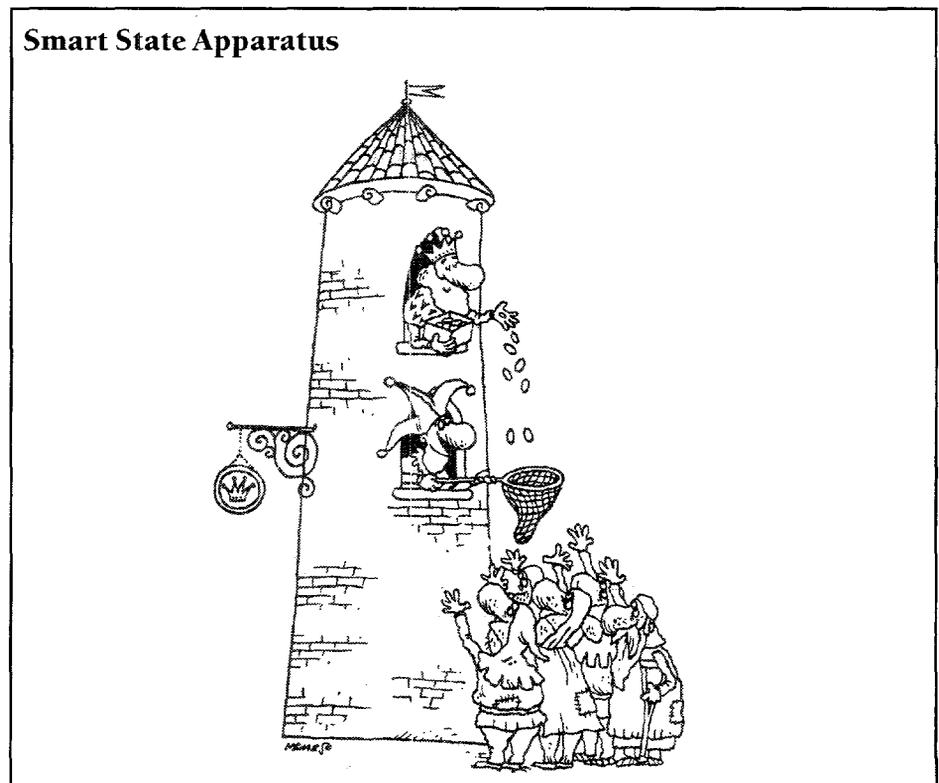
Paul J. J. Welfens, **Economic Aspects of the Eastern Enlargement of the European Union**, July 1999, 30 pp. To order, contact Bundesinstitut für Ostwissenschaftliche und Internationale

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Yanrui Wu (ed.), **Foreign Direct Investment and Economic Growth in China**, Edward Elgar Publishing, 1999, 256 pp. To order, contact Marston Book Services Ltd, P.O. Box 269, Abingdon, OXON OX14 4YN, United Kingdom, tel: 44 1235-465500, fax: 44-1235-465555, email: direct.order@marston.co.uk.

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