TRANSITION

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Socialist Economic Reform Unit • Country Economics Department • The World Bank

Angola: The Economic Challenge of Peace

The news of a peace agreement in Angola between the MPLA-led government and the U.S.-supported opposition, UNITA, is encouraging. A peace agreement does not mean, however, that economic reforms will be implemented quickly to improve living conditions and guide the country toward sustained development. On the contrary, it could be argued that peace will exacerbate some of the economic policy dilemmas, making reform even more difficult. Peace becomes, indeed, a major challenge.

Beyond the peace agreement are several issues that deserve examination: foremost (i) the economic and political difficulties of consolidating the peace process; (ii) the appropriate sequencing of economic and political reforms; and (iii) the speed of the reform process.

Consolidating the process

The war has been a tragedy, but peace, too, will be expensive. The country will likely be able to save part of the expenditures that formerly went toward war materiel (perhaps more than $600 million per year, or 6 percent of GDP). But it will need to integrate two armies, and some soldiers will become redundant as a result. Meanwhile, the number of soldiers will increase at the beginning of the process as the regular army absorbs the UNITA army. This increase could expand the Angolan army from about 140,000 to an estimated 210,000.

Security in the interior will not occur automatically, since a whole generation has grown up with weapons and amidst violence. More expenditures **on internal security will likely be necessary to make the interior safe.**

When soldiers — and other employees — are fired, they will need a social safety net. A tentative estimate of the cost of a safety net to cushion military

What's inside...

demobilization is $250 million, or 3 percent of GDP. On the whole it is unlikely that savings in military or security expenditures will occur in the first years of the transition process; such expenditures might even increase.

Moving decisively toward a secular, open society, the MPLA Government had made progress toward political reform even before the peace agreement existed. The MPLA repudiated Marxism as the official ideology, endorsed democracy and a multiparty system, and separated the army from the political party. These reforms were important for generating discussions that resulted in the peace agreement.

Nevertheless, achieving peace is but one of the steps in Angola's political transition. Laws must change, elections must be held, and the whole institutional fabric of the country must undergo change. The first free elections in Angolan history will not be held for more than a year, however. The MPLA could lose the elections — although not necessarily to UNITA — and the elections are likely to be heavily contested.

Timing of reforms

In this context, will the present government start economic reform before the elections? This will depend on the government's assessment of the political costs and gains of reform in the first year, although the general benefits of the program are unlikely to be obvious that soon. No doubt some government supporters will lose out as a result of reform.

Even if the government initiates a reform program, a neutral institution (such as the World Bank) might develop second thoughts about the actual commitment of a government seeking re-election and therefore implemening only measures that are popular with the electorate. A reform program endorsed and executed by the competing political parties in a power-sharing arrangement would seem to be the only way to initiate economic reform parallel to the introduction of peace and democracy. However, this arrangement seems extremely difficult in a country that has only known dependence and war.

Waiting until the elections are over might not be a feasible alternative because some aspects of reform cannot wait that long. Recent indications are that if Angola does not undertake massive devaluation, price liberalization, and remonetization of formal sector wages, the situation will deteriorate further and fast. Last September the government tried to mop up 95 percent of the excess money supply. Angolans received 5 new kwanzas for every 100 they surrendered. (The official rate of the kwanza, the Angolan currency, is 60 to the dollar; the parallel market rate is about kwanzas 1,200 to the dollar.) But the price drop on the unofficial market did not last long; the state-run stores could not meet demand, and parallel market prices soared again.

"There is no beaten path, 'tis walking makes it so"

Social demands initially encouraged by the new political freedom could become uncontrollable (there are already signs of this). If internal conditions deteriorate, the expected political settlement could become unattainable. Moreover, under the prevailing economic distortions it is virtually impossible for the international community to deliver external assistance, other than urgent relief, because hardly anything works in the present environment.

The role of the international community in promoting power sharing — whereby the political costs and benefits of reform are assumed by all competing parties before the elections and are continued by the new government afterwards — is a legitimate one. A country $6 billion in debt and with more than $1 billion in arrears, with its social and physical infrastructure in ruin, cannot initiate a democratic process on its own. It will need the international community.

The government has been improvising responses to the crisis. The failed monetary reform of September 1990 is an example of an *ad hoc* response. But it is clear that anything short of well-synchronized measures, implemented by qualified technical staff with broad political support, will fail.

Crash program or gradualism

Not only the timing but the speed of the reform program needs to be determined. On the one hand, shock treatment could stimulate inflation if the policy managers are not fully in control of the changes. Granted, this is always the case during periods of reform, but it is magnified in Angola by the degree of distortion. Moreover, a number of operational questions are so far unanswered even though they will be crucial in the first stage of the program: for example, how to handle an incomes policy if the necessary adjustment in wages, which will accompany the expected devaluation, turns out to be extremely large. What happens if the initial adjustment proves to be excessive? These are justifiable questions in view of the enormous difference between official and parallel prices. Management of the reform process, more precisely of the monetary realignment process, will be crucial.

On the other hand, the impact of a more "gradualist" approach might not be felt in view of the large distortions. Such lack of impact could discredit the whole reform process — certainly the monetary realignment — which is what happened with monetary reform.

Given the deterioration of the economy the need for bold measures appears to be gaining acceptance. Although external technical support is absolutely necessary to start the reform process, Angola will have to find for itself the answers to many of its problems and implement the most urgent reforms, particularly realignment of prices and incomes. After all, "there is no beaten path, 'tis walking makes it so".

Carlos Elbirt, AF6CO, World Bank
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Treuhand in Action: the Privatization of East Germany

In the past nine months, Treuhandanstalt has built, virtually from scratch, a large and effective holding corporation with a staff of 2,500. It is now the world's largest industrial holding, and has more than 3 million employees in its subsidiary companies. It completes about 300 larger privatization transactions every month. During the first quarter of 1991, more than 15,000 smaller commercial and service establishments were privatized. About 900 industrial establishments were privatized as of end-March, including about 600 manufacturing firms and many companies in the energy sector. It is expected that privatization of the commerce and service sectors will be completed by the end of July. By comparison, British privatization involved only 25 large state enterprises over a period of 10 years.

Balance sheet

In Germany some 350,000 industrial jobs and 150,000 commercial and service jobs have been secured through privatization. Pledged investments total about DM50 billion, including DM30 billion in the energy sector and DM15 billion in manufacturing. Sales proceeds are about DM6 billion, although they do not yet cover Treuhand's current expenditures (debt service on behalf of enterprises, retained social and environmental liabilities, etc.). Liquidation and bankruptcy proceedings have been initiated for 300 unviable companies. Since Treuhand is the sole owner of the enterprises, it usually prefers an informal private liquidation to a formal bankruptcy proceeding. A recent agreement with the unions guarantees severance pay of four months' salary for employees of companies in liquidation.

With the exception of the commercial sector, where competitive bidding has been used, privatization transactions have relied mostly on individually negotiated sales to private investors. However, as Treuhand receives information about its enterprises, it is promoting direct sales more actively. As a first step, it has published a catalog of all enterprises under its control and has invited competitive bids for relatively standardized assets, such as publishing companies, printing establishments, as well as commercial properties, small enterprises, and land.

Treuhand will use investment banks and advisers as agents more extensively to prepare sales prospectuses for enterprises, search for buyers, and conduct negotiations. Investment banks and consulting firms have expressed an interest in participating in the process, and some firms will receive exclusive mandates for 3-6 months.

About 2,000 sales proposals are currently under consideration. Treuhand's work has also begun on splitting large enterprises and conglomerates into smaller businesses for which buyers can be more easily found. Smaller firms are pursuing management buy-outs and partnerships with venture capital firms. None of the enterprises fulfils the conditions for stock market listing and stock flotation yet.

Initial difficulties

The accomplishments of the Treuhandanstalt must be seen against the enormous difficulties it faced originally. Although it had existed for a few months as a state property agency, Treuhand received its privatization mandate and began its organizational buildup only in the summer of 1990. A critical mass of experienced managers was in charge only by late 1990, mostly seconded from German industry. Other constraints involved the following:

- Due to a poor and unreliable information system, revamping the information base was Treuhand's first job.
- Property restitution to former owners also created problems, as property claims were uncertain. A recent investment law makes it possible for Treuhand to sell properties to investors regardless of whether restitution claims are pending. Former owners will be compensated once their claims are resolved.
- Privatization has also been hampered by long-term agreements that were arranged between enterprises and Western partners prior to the German economic union. Many agreements were unfavorable and had to be renegotiated or terminated — a time-consuming process.
- The sudden opening of the economy created considerable difficulties for many enterprises. To alleviate the shocks, Treuhand provided liquidity credits (actually credit guarantees) until conditions settled. While liquidity credits initially were extended without much conditionality, they are now predicated on submission of a viable business plan.
- Finally, the inherited poor communications facilities exacerbated other problems. Foreign investors have sometimes been put off by the jammed lines to Treuhand.

Company setup

Treuhand's supervisory board is the highest decisionmaking body and also provides some insulation from political pressures. It has 20 members and includes representatives of industry, unions, federal and state governments, and the public. It appoints the president and other members of the executive board and approves management decisions — with far-reaching financial or economic implications (for example, debt restructuring and privatization or liquidation of very large enterprises). Each member of the nine-member executive board has a functional responsibility (privatization, finance, reorganization, liquidation, etc.), and most of them have operating responsibility for a group of enterprises or subsidiaries.

Treuhand's head office in Berlin is directly responsibility only for the largest enterprises — those with more than 1,500 employees, plus subsidiaries of large firms and enterprises in special sectors (utilities, financial institutions, state farms, department stores). All other enterprises (two-thirds of the total) report to the 15 regional subsidiaries, and a further shift toward the subsidiaries is being considered. Managers have full ownership responsibilities for their enterprises or subsidiaries and can negotiate sales although special subsidiaries handle privatization of commercial and service establishments and real estate marketing.

One of Treuhand's first tasks was to convert all state enterprises into companies. This took place automatically on July 1, 1990, when the economic laws of the Federal Republic of Germany were extended to the former German Democratic Republic. However, since the state enterprises could not fulfil the new registration requirements, they remained in a provisional commercial status until they could meet the requirements (specifically, provide financial statements, meet minimum equity requirements, and show that management and a board were in place). A new "opening balance sheet law" facilitates the transition to Western accounting standards and other requirements of German company law.

Larger companies are being converted into joint-stock corporations (AG), and smaller companies and most subsidiaries into private limited liability companies (GmbH). Treuhand has appointed the chairmen for the supervisory boards of the 500 largest companies. They, in turn, appoint the other members (in large companies, some of the supervisory board members are elected by employees). In most cases, existing management has remained, but on short-term contracts, to ease management transfer.

Germany's law on companies provides for considerable independence of top management in joint-stock corporations. While Treuhand, as sole owner, can freely sell the companies under its control, it cannot issue *ad hoc* operating instructions to management, for example to modify production, sell off particular assets, or lay off personnel. Such instructions can come only via the company's supervisory board and only on management's initiative. Similarly, Treuhand cannot directly sell the subsidiaries of the larger companies under its control — this is a management prerogative.

Since many enterprises and conglomerates are heavily indebted, most need some debt relief. This gives Treuhand an opportunity to restructure large companies or holdings (about 10 percent of firms have managed to survive without credit guarantees). The required debt restructuring and recapitalization provide the legal leverage.

East Germany . . . now has a "big brother" to underwrite the costs of transition

To give conglomerates an incentive to divest, the balance sheet law includes provisions that require more equity capital for conglomerates than for independent companies. Financial incentives also contribute to the release of valuable land not required for productive purposes. This is supported by a new law that supports the splitting of former state enterprises into separate companies.

Some technical details

External investors are buying most of the larger enterprises. Many employee buy-outs have taken place in the commerce sector. Treuhand is considering how to promote management and employee buy-outs for industrial companies or engineering firms. (The planned separation and spin-off of business units from larger state enterprises will facilitate these transactions.) If management buy-out proposals are comparable to the terms for external investors, Treuhand will assist with the financing, through delayed payments or loan guarantees, and in the search for external partners such as venture capital firms.

Considering the uncertainties of selling industrial firms, the normal valuation method — which is to derive the capitalized value of future profits — is in most cases not possible. A more useful approach can be to determine a "partial reconstruction" value, that is, comparing the required incremental investment costs with the costs of an expansion or "green-field" investment elsewhere. This gives the investor a rough estimate of the opportunity costs, which might be the best indicator of value.

Privatization of trade establishments and energy utilities will be completed soon, but only about 10 percent of manufacturing firms have actually changed ownership. As the larger firms split into more manageable and attractive units, the number of firms to be privatized can rise. Indeed, despite the sale of some 900 larger companies, 9,500 firms are still under Treuhand's control, compared to about 8,000 a year ago.

Privatization remains the principal objective and legal mandate of the Treuhandanstalt. However, although the Treuhand has to consider broader economic objectives, such as varying investment and the employment consequences of various privatization options, it cannot pursue a regional industrial policy. This is clearly a responsibility of the state governments and needs to be financed through government budgets.

Germany vs "the others"

East Germany, unlike the countries of Central and Eastern Europe, now has a "big brother" willing to underwrite most of the costs of the transition. This implies several key advantages for privatization:

- the eastern half of Germany is now an integral part of a richer and more productive country;
- the eastern part of the country has adopted another political and economic system, lock, stock and barrel;

• privatization in east Germany can rely largely on sales to west German firms that are already successful in European and international markets; and

• the shared language, culture, and history make it easy to introduce people to the new system and more acceptable to import key managerial and technical personnel from the western part of the country.

These features also have drawbacks — which are sometimes overlooked. Political integration has meant that labor is fully mobile. At "equilibrium" wages this would have created large-scale migration, depriving eastern Germany of some of the most entrepreneurial people and creating a housing shortage and employment problems in the west. Avoiding large-scale migration has meant setting east German wages far too high relative to present productivity levels, even though wages are less than half the west German levels. The result is that most German industrial firms have become uncompetitive and are making losses. The adjustment problem for industrial firms in the east is thus more severe and widespread than in the East European countries.

The adoption of another political and legal system has eliminated political risks and reduced legal uncertainties for German and foreign investors. Nevertheless, in the interim, it involves some difficulties. German civil, commercial, and company laws work well to support a functioning market economy but are far less adaptable to radical transition Although shortcuts to speed up investment are being devised, people in the east are not used to the system, and their unfamiliarity is delaying the tranformation and consequently resulting in higher unemployment. These short-term costs are outweighed, however, by the benefit of introducing a proven, functioning system.

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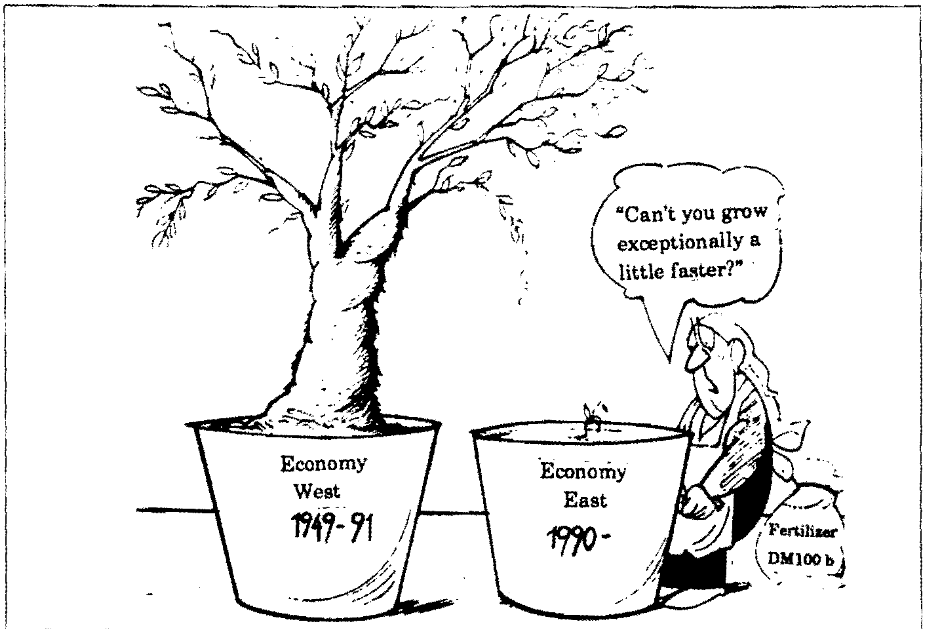
The article is based on a discussion among senior officials of privatization agencies in Central and Eastern Europe, held in Berlin on May 6-7, 1991, and organized by the World Bank and the Treuhandanstalt.



The Gap: A View from London

Most experts have underestimated the deficiencies of the east German economy and overestimated the speed with which these could be put right. Treuhandanstalt, responsible for both privatization and management of the assets it controls, is under constant political pressure to subsidize unviable enterprises.

The DM55 billion that has been earmarked for investment in privatized companies in eastern Germany appears high, but it will be stretched over a number of years. Furthermore, investment goods orders will probably benefit west German industries rather than local ones. As most of the east German firms are small or medium-sized, the overall macroeconomic impact of their privatization is not likely to be strong enough to induce a turnaround of the eastern states' economy.

The principal grievances of east Germans are the rise in unemployment and the inequality of income compared to their west German cousins. Unemployment could reach 20 percent, and in some places 40-50 percent, by the end of the year. Income differences reflect lower productivity in the eastern part of the country — roughly one-third of the productivity level of the western part — which is becoming less bearable as prices approach western levels. The east has the added burden of an inadequate infrastructure and an underdeveloped service sector. Its industries are concentrated in "rust-belt sectors:" steel, chemicals, heavy engineering, shipbuilding and textiles, where there is worldwide surplus capacity.

These economic frustrations have led to polarization between the populations of the east and west. Many west Germans feel that eastern Germany is a bottomless pit into which they are throwing their money. Expenditures in the east will account for about 60 percent of Germany's 1991 public sector deficit .

In turn, according to recent opinion polls, more than 80 percent of the people in the east German states feel they are treated as second-class citizens, subject to political or managerial decisions over which they have no control. Unions and employees are demanding establishment of publicly-financed employmen firms to absorb dismissed workers. According to a suggestion by Tyll Necker, the former president of the Association of German Industry, the Treuhandstalt should contribute social security benefits to workers in distressed companies, a policy that would amount to a wage subsidy of roughly 25 percent.

Based on reports of the London Research Group, Oxford Analytica.

Milestones of Transition

On May 17, **Poland's** zloty was devalued 14.4 percent against the U.S. dollar and pegged to a basket of currencies subject to daily change along international parities. In the first quarter of 1991 the foreign trade deficit reached $300 million. Industrial producer prices increased by 54 percent over the same period last year while the zloty remained at 9,500 to the dollar. This implied a large appreciation of the real zloty-to-dollar exchange rate. According to Poland's planning office, the trade deficit could widen to $2.1 billion by the end of this year.

A recent U.S. intelligence report on the **Soviet** economy indicates that if the confrontation between the central and republican governments over economic policy continues, real GNP would probably decline by 10-15 percent, and annual inflation could easily exceed 100 percent in 1991. According to the report, 1991 will likely be much worse for the Soviet economy than was 1990.

Meanwhile, Grigory Yavlinsky, a leading Soviet economist, has been negotiating with U.S. economists on a program for radical economic reform in cooperation with the West. Jeffrey Sachs of Harvard, Robert Blackwell of the Kennedy School of Government, Graham Allison, a former dean of the Kennedy School of Government, and Stanley Fischer of MIT are among those working with Yavlinsky. The plan, known as the Grand Bargain, envisions that the USSR would receive incremental help as it moves toward a market economy and democracy. The proposal calls for an unprecedented role for Western governments and for massive aid, described by Allison as being of Marshall Plan proportions — $10-$30 billion a year. Yavlinksy is believed to have the support of Soviet President Mikhail Gorbachev, claims the *Wall Stree Journal.*

In **Albania,** a general strike that started in mid-May and involved 350,000 employees has spread to all branches of industry and the press. The strikers have rejected a 50 percent pay offer, holding out for 50-100 percent rises. The economy is on the verge of collapse. GNP, initially estimated at 800 dollars per capita, is likely to fall below 500 dollars this year. Agricultural output has already fallen by 35-50 percent this year, raising the specter of famine. Manufacturing output fell 11-13 percent in 1990. Energy shortages have crippled the extraction and processing of oil, gas, chromium, copper, and nickel. Budget revenue has dropped below the 1989 level, resulting in savage cuts in all sectors. Inflation is currently running at about 30 percent per year. The current account deficit reached $100 million in 1990, and foreign debt is about $500 million and could exceed $1 billion by 1991, according to the Oxford Analytica.

Mongolia's government has begun its privatization program by auctioning shops and some service companies to citizens and non-state organizations. The planned auctions, an experiment as part of general privatization, do not signify a departure from the government's policy of disposing of state assets by distributing coupons to Mongolian citizens, according to official reports.

Foreign investment in Eastern Europe is beginning to take off, albeit cautiously, reports the Financial Times. Investment is strongest in **Hungary** where liberal foreign investment laws went into practice more than two years ago. Foreign direct investment in Hungary was between $750 million and $1 billion in 1990 — a fraction of the foreign investment taken in by southern European or southeast Asian countries.

Romania has passed a resolution allowing the National Bank and the Ministry of Economy and Finance to borrow up to $2 billion in the first half of 1991 to cover fuel, energy and raw materials imports. The government will guarantee the loans and will make monthly reports to parliament on the status of the loans, their terms of repayment, and interest rate levels.

Czechoslovakia faces a jump in unemployment — up to 10-12 percent of the population — and a 15 percent drop in industrial production this year, Labor Minister Petr Miller said recently in Prague. However, the inflation rate dropped to 4.7 percent in March, down from 25 percent in January. The foreign trade deficit in the first quarter equaled $300 million, against a projected $900 million, and foreign exchange reserves increased to $1.65 billion from $1.2 billion in January. The exchange rate of the koruna, the national currency, has stabilized, at least in the short term, and devaluation is not expected. On May 20, the Czechoslovak parliament pass a law that mandates return of land seized by the communist regime to potentially 3.3 million former owners or their heirs.

Despite the country's political instability, **Yugoslavia's** federal government is seeking $4.5 billion from international financial institutions to carry out economic reforms and bolster its political authority. In addition, it is asking the Paris Club to reschedule $640 million in outstanding debt. Much depends on negotiations with the IMF, says Foreign Minister Budimir Loncar. The balance of payments deficit is expected to reach $1.5 billion this year, $400 million above last year. Industrial output fell by 20 percent in 1990 and nearly 18 percent in the first quarter of 1991. The country is expected to lose at least $2 billion in tourist revenue this year as well. According to Prime Minister Markovic, about 60 percent of all bank loans are non-performing, due to the "soft credits" obtained by these enterprises, writes the *Financial Times.*

Economic Transformation: Issues, Progress, and Prospects

The World Bank has recently completed a retrospective study on the transformation of the economies of Central and Eastern Europe (CEE). The analysis divides the task into four main categories:

- macroeconomic stabilization;
- price, market and trade reform;
- private sector development, privatization, and enterprise restructuring; and
- changes in the role of the state.

Because of the tight links among the various components of system transformation, reform measures need to be introduced in complementary packages, rather than in a linear sequence, and carried out simultaneously (see graph).

All the CEE countries have taken major steps toward system transformation in the past 18 months. Hungary, Poland, and Yugoslavia led the way beginning in late 1989, and Bulgaria, Czechoslovakia, and Romania followed in late 1990-early 1991. All have adopted strict stabilization measures, implemented major price reforms, devalued their currencies (with varying degrees of currency convertibility), significantly opened their economies to international trade, and revised their legal frameworks to allow most forms of private ownership while trying to create a level playing field for private entrepreneurs. Although privatization of small-scale trade and services is proceeding rapidly, the countries have made less progress with restructuring and privatization of large enterprises or with development of the institutional capacity to implement the new legal frameworks effectively.

Despite substantial progress, the widespread initial euphoria has been replaced by a sober assessment of the task ahead. Many aspects of the transformation, including privatizaton and institutional change, are inherently slow, and setbacks are likely. However, because the events in Central and Eastern Europe are first and foremost a historic political revolution, any setbacks should not be interpreted prematurely as failure of the entire reform process.

Stabilization: costs and benefits

The experience of Poland and Yugoslavia shows that stabilization measures can reduce high inflation, at least in the short run. From March through August 1990, Poland experienced inflation of 4 percent, compared to 30 percent in the last months of 1989. Yugoslavia's inflation fell from 64 percent in December 1989 to 10 percent for the entire period from March through August 1990. Stabilization measures typically include tight fiscal and credit policies and currency devaluation, sometimes supplemented by measures to defuse the inflationary pressure of excessive stocks of money. Administrative controls on wages and interest rates are also needed because market controls are lacking.

Failure to pursue the transformation vigorously would have high costs in both policial and economic terms. However, reforms also entail high short-term costs in terms of lost output, unemployment, bankruptcies, and price instability. Poland's official measure of output fell 14 percent in 1990, Yugoslavia's fell 3 percent, and Hungary's fell 6.5 percent, with further declines expected in 1991. While official measures may somewhat overstate the drop in output because they do not fully account for the vibrant growth in private sector activity (albeit from a small base), most observers believe that the fall in output in 1990 was precipitous. Initial projections suggest that simply recovering from the contractions of 1989-91 could take 5-10 years in Poland, Hungary, and Czechoslovakia, and even longer in the southern countries. To reach the per capita income levels of industrial countries is likely to take decades.

The costs of the transformation appear higher because of the difficult external environment. In particular, the dissolution of the CMEA trade and payments regime is expected to result in a significant terms of trade loss vis-à-vis the USSR. This, plus the problematic economic situation in the USSR and the virtual loss of the East German market, may lead to a contraction in trade among former CMEA members of 50 percent or more in 1991 alone [see box *After the Fall,* page 12]. The experience of Hungary, Poland, and Yugoslavia in 1990 suggests that trade liberalization combined with devaluation and tight expenditure-switching measures can stimulate a rapid increase in exports to Western markets. Access to these markets is critical to the success of the economic transformation.

Exchange rate dilemma

The level of the exchange rate affects both the cost of stabilization and the speed (and resulting short-term cost) of adjustment. On the one hand, Poland's experience shows that a large devaluation, perhaps helpful in achieving external balance, may raise the short-term costs of stabilization while leaving a protective "cushion" for domestic firms and thus slowing adjustment. On the other hand, East Germany's experience shows that the combination of an overvalued, fixed exchange rate and immediate opening of an economy to international competition leads to an enormous short-term decline in output and employment.

In Poland, stabilization measures, and in Germany pressures for rapid adjustment, were the root causes of the short-term decline in output. Yugoslavia's experience was between these two extremes, combining the stabilization pressures of fiscal and credit contraction with the adjustment pressures of more open international trade. Firms were squeezed immediately, and the absence of "breathing space" put early pressure on the government, which relaxed monetary and credit policy after June 1990. This high cost of stabilization and adjustment results in part from the absence of effective factor markets, which prevents macroeconomic pressures from being translated rapidly into efficiency improvements.

Liberalizing prices and markets

Stabilization is unlikely to be sustainable without underlying structural change. The development of markets and the introduction of true competition are essential; this means free entry and exit of producers, freedom for buyers and sellers to negotiate market-clearing prices, and "hard" budget constraints for firms. As noted earlier, price and distribution controls on tradable goods have been lifted to varying degrees in all CEE countries. Price reforms for traded commodities, as well as some degree of protection against domestic monopolistic practices, can be introduced quickly by establishing currency convertibility and opening the economy to foreign trade. This is proceeding apace in these countries.

Experience shows that freeing prices and allowing free entry and distribution can immediately and dramatically increase the availability and variety of goods in the market. In the space of a month or two after price reform, much of the retail trade in Warsaw moved from government shops to the less formal curbside market, often operating out of trucks parked on main streets. Queues had practically disappeared, and government shops, progressively supplemented by private retailers, started to offer a wider variety of goods for sale. Direct interfirm transactions increased at the expense of the previous distributors, both domestically and internationally.

Countries have moved slower with price reform for nontraded goods — including housing and certain services such as medical care, child care, and education. These have long been considered entitlements, and major price adjustments may need to be compensated by raising cash wages, effectively shifting a larger part of consumption onto a market basis.

Goods' markets can be liberalized quicker than factor markets. While steps can be taken early to adjust wages and interest rates to realistic levels, labor and financial markets should not be fully liberalized until a country has reasonable macroeconomic stability, "hard" budget constraints for firms, an effective social safety net, and prudential supervision of financial institutions. While continuing to control wages in public enterprises for macroeconomic stability, CEE countries are beginning to reduce other controls on labor markets and establish the principles of collective bargaining.

In the case of financial markets, CEE governments have broken up monolithic banking structures into two-tiered systems (consisting of a central bank and several commercial banks) and are drafting central and commercial bank legislation and prudential regulations. However, developing fully-functioning and independent banks requires extensive training and technical assistance in complex areas, many of which are new for the countries concerned. Banks' portfolios must also be restructured and their capital bases restored, a process that is integrally linked to enterprise restructuring. Although all CEE countries recognize the importance of starting early with financial sector reforms, these reforms are necessarily limited by developments in the underlying real sectors of the economy.

Enterprise reform

The autonomous growth of new private business — supported by changes in public policy — is likely to be the main engine of structural change over the long run, more important even than privatization of the great bulk of assets now in state hands. For example, as the CEE countries lifted their highly restrictive controls over private sector activity in 1990, thousands of entrepreneurs registered sole proprietorships in Hungary, Poland, and Czechoslovakia. The share of workers employed in the private sector in Hungary has risen from 0.1 percent to an estimated 10 percent. Private sector activity continues to be constrained, however, by burdensome regulations, limited credit, legal and political uncertainty, and the *de facto* preferences that public sector firms continue to enjoy. There is a strong case for broad measures to encourage private firms until public enterprise dominance is eliminated.

Revitalizing the enterprise sector will also require restructuring and privatizing of many existing public enterprises, whether small or large, industrial, agricultural, or service-oriented. Experience over the past 10 years suggests that the two are intertwined — successful restructuring will require extensive privatization. Yet ownership reform is proving to be perhaps the most contentious challenge of the entire reform process. Privatizing small-scale firms (particularly in trade and services) through auction by local governments is relatively easy — about half of Poland's state-owned shops were transferred to private hands in 1990 — but privatizing large firms is complex, imperfect, and time-consuming.

Three means of privatizing —"spontaneous privatization"(or sale of firms or their assets "from below"), public sales (directed "from above" and possibly combined with liquidation), and mass transfer — are all likely to play a role, although with a different mix in each country. Each has drawbacks:

- Spontaneous privatization has been discredited by the perception of abuse and inequity resulting from the wave of such privatizations in 1989 and 1990.
- Public sales are hampered by the inherent difficulties of valuation, the shortage of domestic capital, concern about equity, and the sheer number of firms.
- Mass transfer is inhibited by fiscal concerns (i.e., the loss of sales revenue) and by the fear that efficient corporate governance would be sacrificed through such widespread ownership.

Hungary and Yugoslavia plan to rely primarily on public sales and controlled spontaneous privatization, while Czechoslovakia, Poland, and Romania plan to combine public sales with mass transfers through voucher schemes. Whatever the means chosen, some restructuring will be required prior to privatization, even if only to "prepare" enterprises. For example, governments need to break up large monopolies, tackle sector-wide issues of excess capacity, and address the politically-tricky problem of mass redundancy. Experience in east Germany, where thousands of west German experts are available to help with restructuring, shows that the process will be long and hard even in the best of circumstances and suggests that many firms will have to be closed.

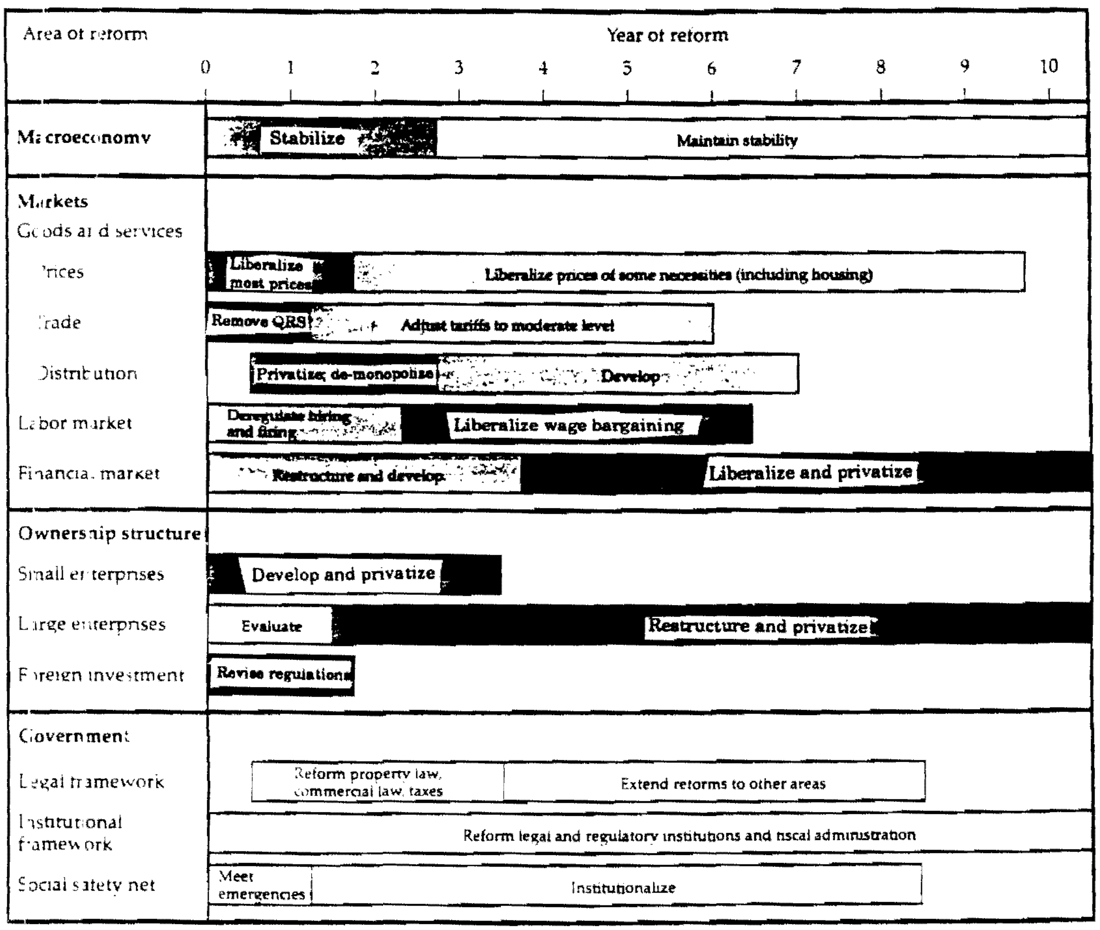
A new role for the state

One of the most pressing challenges for reforming economies is to redefine the role of the state, "unbundling" its former all-encompassing role into separate ownership, financing, and regulatory roles, and reducing the first two while strengthening the third. The task is daunting; not only must countries alter the administrative structure of their governments, but in many cases they need to reduce its overall size, retrain the remaining civil servants, and maintain, and if possible, augment the small cadre of well-qualified policy analysts and decisionmakers. They must also face the politically touchy question of devolving power to regional and local levels.

Three of the immediate substantive challenges include (i) designing a legal framework for market activities, (ii) reforming tax and expenditure systems to reflect the changing role of the state and stimulate private sector development, and (iii) deploying a social safety net in response to the unemployment and poverty that will occur during economic restructuring. Most of the reforming economies have started to address these challenges. In the longer run, they need to improve the quality of the social services and the infrastructure that are so crucial to the functioning of market economies.

Cheryl Gray, CECSE, The World Bank
For a fuller account, see **The Transformation of Economies in Central and Eastern Europe: Issues, Progress, and Prospects**, *by Alan H. Gelb and Cheryl W. Gray, to be published in June, 1991, by the World Bank.*

The Phasing of Reform



Note: Shading indicates intensive action. QRs = quantitative restrictions.

Quotation of the Month: "Prudent sale may be riskier than giveaways"

The Economist Surveys East European Privatization Schemes

"The **Czechoslovak** scheme proposes to distribute 40-50 percent of the equity in 1,000 to 2,000 enterprises through auctions beginning next January. Some 70 percent of the country's 4,800 state-owned firms are required to come up with a privatization plan. Those that cannot find a foreign partner or buyer will have to consider selling shares through the voucher scheme.

Vouchers will be offered to all citizens over 18 years of age for a nominal sum; but to use the vouchers at the auctions, citizens will have to pay to register them. The registration fee will probably determine how many citizens take part. A fee of 500 korunas ($17) would mean 4 million participants. A fee of 2,000 korunas, half the average monthly industrial wage, will probably produce 1-2 million participants. The purpose of the fee is to make the scheme more manageable and more credible: those participating will be risking something and so will take an immediate interest in their shares.

Shares in specific companies will be auctioned to voucher-holders in four or five lots throughout next year. Shares which attract too few bids will be offered again in later auctions. As the auctions proceed, demand for information about companies and the desire of the voucher-holders to trade shares will help the stock market, brokers, auditors, business press, and all the other paraphernalia of western capital markets, to spring up quickly — predict advocates of the scheme. Many individuals in the scheme will find they own a chunk of nothing: by some estimates, 70-80 percent of Czechoslovak enterprises are technically bankrupt. Participants will be warned of this from the start.

[In **Poland**] some time next year, every Pole will be given vouchers as his portion of the national patrimony, meaning a free distribution to 20-40 million people, depending on whether children are included. Everyone will be required to put his voucher into one of several "privatization funds" that will be formed this autumn. These funds, run by experienced, western investment managers, will act as investment bank, mutual fund, venture-capital manager, auditor, and consulting firm rolled into one. Initially about 30 percent of the equity of 100 large firms will be allocated to voucher-holders. The privatization funds will use the vouchers to bid for shares of state-owned companies or will exchange them for shares allocated to the funds. And the privatization funds will also manage many of the stakes retained by the government.

It is hoped that the funds' managers, with their pay pegged to the performance of their funds, will be active owners, the primary agents for restructuring many of Poland's industries. They will be able to buy and sell shares, organize joint ventures with foreign investors, and put companies into bankruptcy. After a period yet to be decided, individual voucher-holders will be able to trade their shares in the funds, thus imposing market discipline and incentives for the funds themselves. Meanwhile, individuals will be free to buy shares of individual companies, with cash.

(In both Poland and Czechoslovakia, most other forms of privatization will be pursued alongside the voucher schemes: joint ventures or outright sales to foreigners, management buy-outs, liquidation of enterprises, sale or lease of assets, and piecemeal disposal of companies.)

[In June, **Lithuania**] is due to give vouchers to all its citizens to buy state assets. People over 35 will get vouchers worth 5,000 rubles, down a sliding scale to 1,000 rubles for those under 18. Vouchers can be exchanged for all state property except farmland, which will be distributed separately. They will be used in two ways. First, shares will be issued by companies and offered for sale by subscription. Second, some small businesses, mainly shops and restaurants, will be sold at auction.

Vouchers will not be tradable. Total face value of all vouchers will be about 8 billion rubles, one-fifth of salable Lithuanian assets. To stop rich Lithuanians from snapping up too many shares, citizens will only be allowed to buy shares, with cash, in the same amount as the face value of their vouchers. Hemmed in by all these restrictions, most vouchers will probably be used to buy flats.

Hungary avoids vouchers altogether. Hungarians believe they can sell most of their large companies to foreigners or to the companies' own managers or to the country's emerging class of businessmen. By 1993 the country hopes to privatize 500-600 firms; and by 1996, 50-60 percent of state-owned assets are supposed to be in private hands. Such an agenda looks difficult if not impossible for the one small agency given the task of privatizing and liquidating all state-owned companies. Eventually Hungary may also have to consider some sort of give-away scheme or lower its hopes of shrinking its state sector. Giving away enterprises is fraught with risks. But a "prudent" sale of the ruins left by the communists may be even riskier."

On the World Bank/IMF Agenda

IDA Support to Henan Province

Parts of China's Henan Province will benefit from a $110 million IDA credit in support of an agricultural development project to increase crop, fish, and livestock production. About 630,000 poor farm families are expected to double their incomes as a result. To date in FY91, World Bank lending approved for China totals $1.1 billion in loans and credits for eight projects.

Assistance to the CEE

The World Bank expects to lend Central and Eastern Europe $2.5-$3 billion annually over the next three to five years, providing other lenders join the effort, said Bank vice president Willi Wapenhans. "We cannot be the only financiers. We need to promote co-financing and we have to see others commit themselves." He estimated that Eastern Europe will need $22-23 billion annually in gross external financing over the next couple of years. According to IMF Managing Director Michel Camdessus, who spoke recently at the Austrian National Bank seminar in Baden, Austria, the Fund plans to disburse about $5 billion to the region in 1991.

World Bank Program for Poland

In April the World Bank approved a $120 million loan to improve Poland's antiquated telephone network (see *TRANSITION*, April, 1991). The loan would enable the national telephone company to connect 70,000 new subscribers to the system in the next two years. The Bank is also considering a loan of about $300 million for privatization and industrial restructuring, as well as about $300 million for heat supply and conservation projects. About $500 million in loans is being considered for development of financial institutions, employment promotion, and agriculture and health services.

Camdessus on Viet Nam

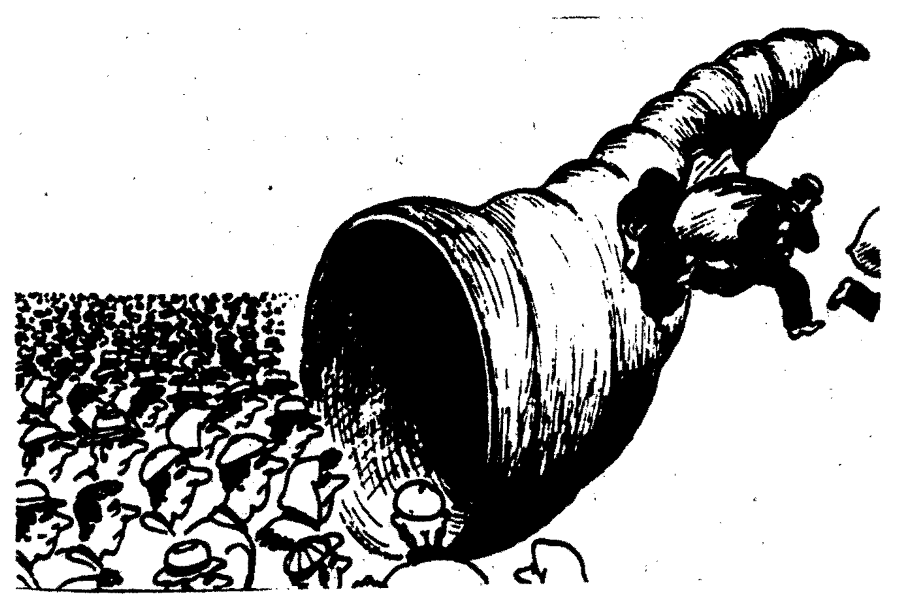
The Fund has good relations with Viet Nam, IMF Managing Director Michel Camdessus told reporters during the Interim Committee meeting in April. He added that the country is implementing an economic recovery program that is exemplary in many respects. Camdessus said the Fund hoped to normalize relations with Viet Nam completely. The IMF had been working with the Vietnamese on a program that would lead to a market-based economy; the first results have been encouraging, according to Camdessus. Despite its efforts, Viet Nam continued to have vast problems, including interrupted Soviet financing, he added.

Helping Madagascar

An IDA credit of $19.8 million will help promote livestock production for both domestic consumption and export. The credit will support institutional reforms and institution-building measures as well. The project is also expected to reduce pressure on natural rangeland and improve the sustainability of mixed farming systems in highly populated areas.

Nicaragua Will Clear Arrears

The Consultative Group for Nicaragua, representing 21 countries and nine international organizations, among them the IMF and the World Bank, has pledged $360 million to clear the country's arrears to the IBRD and the Inter-American Development Bank. During its mid-May meeting at the World Bank's Paris office (the USSR sent observers), the group praised Nicaragua's economic reform program and said that the clearance of arrears would pave the way for the resumption of lending by these institutions. Arrears are expected to be cleared by August 1991, with $225 million provided as bridge loans from Colombia, Mexico, Spain and Venezuela, and $135 million in contributions from Canada, Denmark, Finland, France, the Republic of Korea, the Netherlands, Norway, Sweden, Switzerland, and the United States. In addition, Germany and Japan have agreed to co-finance a planned World Bank economic recovery credit, and Austria has agreed to provide balance of payments support.



From the Soviet weekly Krokodyl

After the Fall

Dissolution of the Council for Mutual Economic Assistance — or in popular terms, COMECON — will take effect 90 days after the remaining nine members sign the termination agreement on June 28. The Soviet Union, Poland, Czechoslovakia, Bulgaria, Hungary, Romania, Vietnam, Mongolia, and Cuba are still divided over a successor organization, however. European members want to exclude the non-European members from the envisaged loose consultative body, to be called the Organization for Economic Co-operation, while Moscow is wavering on the issue.

This is a small problem compared to the task of reviving trade between the Soviet Union and the five European member countries. The Soviet Trade Bank claims that trade with Eastern Europe in the first quarter of 1991 was only 10 percent of the 1990 level. Since the switch to hard-currency trading in January, the Soviet Union has continued to sell oil and gas to Eastern Europe but has had no hard currency to import the food and consumer goods traditionally supplied by Eastern Europe.

Hungary has announced that it will no longer provide domestic enterprises with credit to cover exports to the Soviet Union. In the first two months of 1991, Hungarian firms lost $800 million from unpaid contracts with the Soviet Union. Stockpiles of commodities, resulting from such unfulfilled contracts, were estimated at $360-400 million at the end of March.

Czechoslovakia contends that Soviet payment problems have resulted in the Soviet share of trade with Czechoslovakia falling from 44 percent in 1989 to 23 percent in 1990. Czechoslovakia will continue to receive natural gas from the Soviet Union until 2003 in payment for its contribution to COMECON integration projects.

The trade problem has been made far worse by the rapid deterioration in the Soviet economic performance. The worst trade and payments estimates for the Soviet Union anticipate a hard currency trade deficit of $8.7 billion and a services deficit of $6 billion for 1991. After netting off the projected receipts from gold sales of over $3.6 billion, the Soviet Union ought to have a financing requirement of $27.1 billion in 1991. Identified sources of finance may provide up to $16.9 billion, leaving a payments shortfall of $10.4 billion.

Growing payments difficulties have forced Soviet authorities to recentralize trade and payments and place new restrictions on enterprise trade. In contrast to previous COMECON practices, this has a direct impact on trade with Eastern Europe:

- *Soviet enterprises are now required to surrender most convertible currency earnings to the Bank for Foreign Economic Relations (Vneshekonombank), which reserves this income for essential imports and debt servicing. Enterprises therefore have no hard currency for imports from Eastern Europe.*
- *Similarly, East European imports are not high in Vneshekonombank's priorities. Furthermore, the Soviet authorities have prevented enterprises from entering into barter agreements with East European firms, principally to save goods that could be used to obtain hard currency for the central authorities. Soviet enterprises thus are having trouble obtaining spare parts for machinery manufactured in Eastern Europe.*

The need to find an alternative method of financing trade among the former COMECON countries has become critical. East European finance ministers are considering a Hungarian proposal to establish a Central European Payments Union. This system would allow trade surpluses between countries to be cleared in hard currency. However, the free-market Czechoslovak finance minister, Vaclav Klaus, has dismissed the proposal as a "poor man's club" that would hinder the development of more orthodox trade financing and slow the integration of East European economies with Western Europe. Nevertheless, the central banks of Poland, Czechoslovakia, and Hungary are supporting proposals from the Soviet Gosbank and the West European Ecu Banking Association to adopt the Ecu banking payments system for intra-COMECON trade.

Meanwhile, the head of the USSR's foreign economic relations committee recently announced that moves are underway to raise imports from Eastern Europe by restoring trade in national currencies and lifting Soviet restrictions on barter trade.

Based on Oxford Analytica *and the* Financial Times.

Letter to the editor

[A response to the John Hardt-Laszlo Csaba discourse in the March issue of Transition*]*

The dramatic collapse of the CMEA aggravates the economic costs and social problems of the transition to a market economy and may threaten its success. Some proposals suggest strengthening regional cooperation in Central and Eastern Europe parallel to, or as a precondition for, the region's integration into the world economy.

For several decades, most regional integration among developing countries was seen as a step toward international competitiveness and as a way to access the external markets. But narrow and underdeveloped regional markets, a low level of intraregional trade, modest resources to finance bilateral trade imbalances, similar export and import patterns, and lack of efficient infrastructure impeded the implementation of these goals. In fact, countries focusing on regional cooperation usually lost market shares in international trade. Countries that strengthened their links with developed economies became increasingly competitive in world markets and in intraregional trade. The general experience suggests that the successful sequence was not from regional to global competitiveness but from global success to a higher level of intraregional cooperation. Brazil's increased role in Latin-American trade in the 1970s relied on world market-oriented strategies and not on the priority of regional cooperation; this is the case as well with ASEAN's currently increasing intraregional cooperation.

In contrast, the share and volume of intra-CMEA trade were much higher than expected, considering the development level of the member countries. In addition, distorted exchange rates exaggerated the importance of intra-CMEA trade. Thus, the dramatic decline of CMEA trade in the total trade of Central (and partially Eastern) European countries is a return to normal. What is unusual is the unprecedented speed of change, not the size of change.

To add to Laszlo Csaba's comments, economic and political motives are behind the lack of enthusiasm for revitalizing regional cooperation. Intraregional trade among CMEA countries cannot proceed according to market-economy criteria as long as there is no sign of fundamental transformation in the core country of the region — the Soviet Union. More important, the lack of solvent demand in the USSR may reduce trade flows far below the desired level. Financing high export surpluses runs against the basic macroeconomic objective of strengthening economic stability through tight fiscal and monetary controls. Moreover, it could preserve structural rigidities, inefficient production, and, as a consequence, help strengthen anti-reform lobbies. In this way, stronger intraregional cooperation could easily become counterproductive. The political future of the Soviet Union is unpredictable. As a result, quick damage limitation and reorientation away from Soviet trade should be on the agenda for its former trading partners, particularly the small and dependent countries. Central and Eastern European countries are clearly already oriented toward Western Europe, which has become the economic gravity center giving off a strong demonstration impact.

Certainly more economic cooperation among reforming economies is highly welcome in the short term. But with better access to the EC and other OECD markets, a free trade area covering Poland, Czechoslovakia, and Hungary makes sense rather than new forms of regional integration. The economic potential for longer-term intraregional cooperation will depend on how soon integration into the global economy occurs. Meaningful regional cooperation is the result of, and not a substitute for, efficient global division of labor.

Andras Inotai, CECTP
World Bank

Conference Diary

Eastern European Economies in Transition
May 23, Washington DC

One-day conference sponsored by the Society of Government Economists (SGE). Keynote address delivered by Peter Murell, University of Maryland, on evolution in economics, shock therapists vs gradualists. Other lectures included labor market readjustment, economic challenges of privatization and foreign investments (Paul Welfens, University of Muenster, Germany) economics of social safety nets (Kalman Rupp, U.S. Health Department), macroeconomic policy problems in Hungary (Janos Horvath, Butler University/ Hudson Institute), health care financing (Richard Scheffler, University of California, Berkeley).

Privatization and Entrepreneurship: The Dynamics of Growth in Eastern Europe
June 6, IMF Visitors' Center, Washington DC

Discussion organized by NEC-IMF, with panelists: Klaus Friedrich (IIF), Barbara Lee (World Bank), Peter Murell (University of Maryland), and Jan Van Outen (IMF); moderator: Barry Wood, (VOA)

Econometrics of Short and Unreliable Time Series - Model Building of Economic Transition in Eastern Europe
June 14-16, Institute of Advanced Studies, Vienna, Austria

Problems and constraints of empirical studies under the non-standard conditions of serious deficiencies in available databases. Topics include: pitfalls of traditional econometrics in the case of short and unreliable time series; current state of econometrics and statistics for model building, estimation and forecasting in terms of short and unreliable time series; current efforts to model and forecast the economic transition in Eastern Europe.

Interdisciplinary Approaches to the Study of Economic Problems
June 16-19, Stockholm, Sweden

Organized by the International Association for Research in Economic Psychology and the SASE. The program for June 19 will be devoted to the economic and social transition of Eastern Europe.

Seminar on Macroeconomic Management: Managing Inflation in Transition Period
June 24-28, Hanoi, Vietnam

Organized by the World Bank's Economic Development Institute and the National Economics University, Hanoi, to provide policymakers with better understanding of macroeconomic policy alternatives, with special emphasis on the management of inflation in the period of transition.

The Transformation of Socialist Economies
June 26-28, Kiel, Germany

Organized by the Kiel Institute of World Economics. Focus will be on policy strategies for transition, in particular the necessary changes in institutional infrastructure, to assess ways to privatize firms and restructure the economies; timing and sequencing of privatization; macroeconomic stabilization; microeconomic deregulation; and external liberalization; economic integration of Germany and the policy options for the individual East European countries.
Information: Kiel Institute of World Economics, Duesternbrooker Weg 120, PO Box 4309, D-2300 Kiel 1 Germany, Fax: 431/85853

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

Hosted by the Southern Conference on Slavic Studies. Some highlights:
Nov. 22: Roundtable discussion on the year in Russia after Yeltsin. Discussions of recent economic changes and reform prospects [in the USSR]; Yugoslavia in the 1990s; Is Latin America the future of Eastern Europe?
Nov. 23: East Central Europe today: continuity and change; Company laws and property rights: a comparative analysis.
Nov. 24: Beating the system: borrowing, earning, and spending rubles; A roundtable on current Soviet economic development.
Nov. 25: Demonopolization and international competitiveness in Eastern Europe.

Books and Working Papers Briefs

Paul Hare and Gordon Hughes
COMPETITIVENESS AND INDUSTRIAL RESTRUCTURING IN CZECHOSLOVAKIA, HUNGARY AND POLAND
CEPR Discussion Paper Series No.543, London, 1991, 59 p.

The paper presents a methodology for ranking enterprises and industries in post-socialist economies according to their long-term viability and competitiveness. The methodology aims at removing the effects of distortions from monopolies, subsidies on production, and trade-related taxes. Such distortions may result in closure of the wrong firms or expansion of far less profitable firms, once their input and output are assessed at world prices. Traded goods were valued directly at world market prices, and non-traded goods in terms of their primary factor inputs, that is, indirectly at world prices. The authors also calculated the cost of domestic resources, such as capital and labor (using 1988-89 data on inputs, outputs, and exchange rates).

A poor correlation was found between value added at domestic and world prices. About 20-25 percent of manufacturing production had negative value added at world prices, so these firms might be regarded as "value subtractors." Various industries and enterprises in the three countries have made major contributions to national income (valued at world market prices relative to the input of required domestic resources).

Much of the food industry appears to be unprofitable in all three countries. Additionally in Czechoslovakia, building materials, household chemicals, and car production register negative value added. In Hungary, iron and steel, fertilizers, canned food, milk products, and in Poland, basic chemicals, cement, and non-ferrous metallurgy are the least competitive industries. Nevertheless, several industrial branches are competitive, as measured by domestic resource costs: several engineering sectors in Czechoslovakia; footwear, textiles, chemicals, instrument engineering, and pharmaceuticals in Hungary; and machine tools, food concentrates, and paper products in Poland.

Center for Economic Policy Research, 6 Duke of York Street, London SW1Y 6LA. Tel:(44 71) 930-2963. Paul Hare may be contacted at Heriot-Watt University, Economic Dept., Ricarton, P.O.Box 807, Edinburgh EH 14 4AT, Scotland. Tel:(44 31) 449-5111 x4792. Gordon Hughes' address: Edinburgh University, Economics Dept., 50 George Square, Edinburgh EH8 9JY, Scotland. Tel: (44 31) 650-8359.

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George S. Tolley
URBAN HOUSING REFORM IN CHINA: AN ECONOMIC ANALYSIS
World Bank Discussion Paper No.123, Washington DC, 1991, 93 p.

The present housing policy in China, where urban households spend about 1 percent of their cash income on housing, is unsustainable and leads to ever growing distortions and large-scale subsidies, asserts the author. To illustrate the depth of the crisis: in 1985, 30 percent of urban households had less than 4 square meters of living space (living room plus bedroom space) per person.

To raise rents to their economic level requires ending the present interlocking combination of low cash wages and artificially low rent levels. Experiments carried out in 11 small and medium-size cities indicate that the existence of a rationed rental market fundamentally affects the privatized housing market; for example, low rents reduce the price people are willing to pay for a house.

The suggested immediate reform includes: charging market rents, with income adjustment (and reducing negative windfalls to acceptable levels); making available sound mortgage instruments; and codifying property rights. In the long run, however, fundamental housing reform is needed. This might mean spinning off all housing into newly-created companies that could sell or rent the apartments they manage. An alternative solution is for ownership of a dwelling to be transferred to the present occupants. Their wage increases should cover future maintenance costs.

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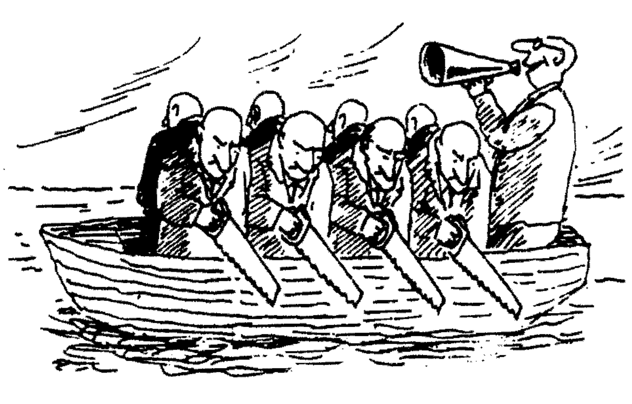
Susan M. Collins and Dani Rodrik
EASTERN EUROPE AND THE SOVIET UNION IN THE WORLD ECONOMY
Policy Analyses in International Economics No. 32, IIE, Washington DC, 1991

Emerging market economies (EMEs) in Europe could double their share of world trade over the next 10 to 20 years if the industrial countries provide market access for their products, conclude the authors. The share for Eastern Europe in the European Community's trade could rise to 12 percent from the present 4 to 5 percent over the next few years. The



From the Soviet weekly New Times

main trade losers vis-à-vis the EMEs will be middle-income developing countries that have their labor-intensive exports displaced.

Net capital inflows to the region are likely to range between $30 to $90 billion per year for the next five years, but this assessment includes capital flowing to the eastern part of Germany. A survey of private investors shows that the region's share in their investment portfolios will remain substantially below the 2 percent level despite the considerable interest the EMEs generate. However, increasing capital flows to Central and Eastern Europe could result in a reduction of investment to the developing countries and an increase in interest rates, claim the authors.

Institute for International Economics, 11 Dupont Circle, NW, Washington, DC 20036, tel: (202) 328-9000.

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George Kopits
FISCAL REFORM IN EUROPEAN ECONOMIES IN TRANSITION
IMF Working Paper, No.43, Washington, 1991, 33 p.

In the GDP of most Central and East European countries the share of government operations is considerably higher then in member states of the European Community. (In the second half of the 1980s, general government operations in Hungary, Bulgaria, and Czechoslovakia accounted for about 60 percent or more of the GDP, as against less than 50 percent in the EC.) Quick convergence in size and structure of the two groups' government finance is doubtful. New demands on the budget of postcommunist economies (to finance social safety nets, environmental cleanup, enterprise restructuring, etc.) could swell government outlays while tax revenues stagnate or decline. Authorities should endeavor to maintain a precautionary fiscal stance — if necessary supported by contingency measures, such as reduction of government employment and increases in excise taxes —to ensure macroeconomic equilibrium during this critical period, argues the author.

New Books and Working Papers

Mathias Dewatripont and Gérard Roland
The Virtues of Gradualism and Legitimacy in the Transition to a Market Economy
CEPR Discussion Paper Series No.538, London, 1991, 14 p.
Center for Economic Policy Research, London. Tel: (44 71) 930-2963

Daniel Cohen
The Solvency of Eastern Europe
CEPR Discussion Paper Series No. 539, London, 1991, 35 p.

Michael Landesmann and Istvn Székely
Industrial Restructuring and the Reorientation of Trade in Czechoslovakia, Hungary and Poland
CEPR Discussion Paper Series No. 546, London, 1991, 50 p.

Michel Burda
Labor and Product Markets in Czechoslovakia and the ex-GDR: A Twin Study
CEPR Discussion Paper Series No. 548, London, 1991.

Gordon Hughes
Foreign Exchange, Prices and Economic Activity in Bulgaria
CEPR Discussion Paper Series No. 549, London, 1991.

Commentary and Draft—USSR Foreign Investment Law
Geonomics Global Policy Report, No. 3. Middlebury, VT, 1991, 24 p.
Contact Nancy Ward, The Geonomics Institute, 14 Hillcrest Ave., Middlebury, VT 05753. Tel: (802) 388-9619.

John Williamson
The Economic Opening of Eastern Europe
Policy Analyses in International Economics No. 31, Washington, 1991,
Contact Institute for International Economics, Washington D.C. Tel: (202) 328-9000

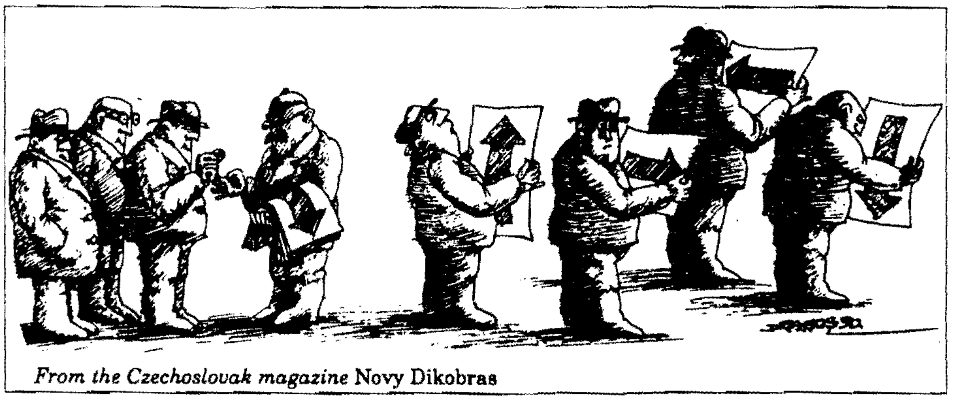
Tony Killick and Christopher Stevens
Economic Adjustment in Eastern Europe: Lessons from the Third World
Working Paper, Overseas Development Institute , London, 1991, 45 p.
Contact ODI, Regent's College, Inner Circle, Regent's Park, London NW1 4NS. Tel: (44 71) 487-7413; fax: (44 71) 487-7590.

Jozef M. Brabant
The Planned Economies and International Economic Organizations
Cambridge University Press, New York/London, 1991, 318 p.

Oliver Blanchard et al
Reform In Eastern Europe
MIT Press, Cambridge, MA, 1991, 98 p.

David Bachman
Bureaucracy, Economy and Leadership in China: The Institutional Origins of the Great Leap Forward
Cambridge University Press, Cambridge/New York, 1991, 262 p.

Tadao Horie
Marx's Capital and One Free World
St.Martin's Press New York, 1991, 240 p.



From the Czechoslovak magazine Novy Dikobras

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