A Changing Development Landscape: Globalization and Localization


by Shahid Yusuf

World Development Report 1999/2000: Entering the 21st Century explores the avenues for institutional change and catalogues the major issues confronting the world in the early 21st century. These issues include macroeconomic instability resulting from openness, decentralization, rapid urbanization, and climate change. Both globalization and localization will shape the development landscape in the early 21st century. Both forces have a long, albeit somewhat fitful history. The response of nation-states to these two forces will determine whether incomes in low-income countries converge with those of industrial countries and whether efforts to eliminate poverty from tomorrow’s world are ultimately successful.

Globalization entered the development discourse in the early 1980s. Now it is common currency and denotes the integration of markets for goods and factors of production, along with the increasing commonality of standards and consumer tastes. Starting in the 1980s many countries began dismantling controls on the movement of capital and adopting a more favorable stance to foreign direct investment (FDI). Declining transport costs and advances in communications and information technology tightened the integration of goods and capital markets.

Getting Global . . .

The Uruguay Round in 1994 significantly lowered trade barriers and enlarged the gambit of trade liberalization to include services, intellectual property rights, agricultural commodities, and textiles while anchoring the new rules of the game in the World Trade Organization (WTO). The adoption of common rules to regulate banking and financial reporting lent further momentum, as did the creation of the World Wide Web and an international movement toward product standards like the ISO 9000.

Greater receptivity toward FDI and the ease of transactions over long distances induced companies to reorganize their activities, slice up the value-added chain, and distribute production facilities across markets. This spatial diffusion and the widening of markets are behind the proliferation of production networks, which allows firms to specialize, focus their research efforts, and leverage their scarce managerial and marketing skills. Cross-country production networks have reinforced the impulse released by the liberalization of trade and the removal of barriers to capital mobility.

Even with these changes, globalization might have remained a weak force were it . . .
not for a seismic shift toward market-
based economies and democratic forms
of government symbolized by the tearing
down of the Berlin wall. This rise of politi-
cal participation also feeds centrifugal
pressures within nation-states.

Membership in the WTO increased from
102 countries in 1990 to 134 in 1998. Trade
in goods and services rose twice as fast as gross domestic product (GDP)
during the 1990s. By 1998 FDI in devel-
oping and transition economies reached
a net $155 billion—16 times larger than in
1990. International trade that flows through
global production networks is now one-
third of total trade. One dark side of glo-
balization, however, is the rapid spread of
harmful substances and pollutants.

... and Local at the Same Time

Nation-states increasingly focus on supra-
national issues such as globalization, which
circumscribe their choices. Simulta-
aneously, localization is forcing states to
take note of subnational dynamics and
accommodate demands coming from the
local level.

Localization demands autonomy and a
political voice for regional and community
needs. It has many motives, including:

• Dissatisfaction with the state’s ability to
deliver on development promises.

• Strength of local and ethnic identity, re-
  inforced by education, better communica-
tions, and the rising concentration of
people in urban areas.

• Desire to deepen the sense of belong-
ing somewhere in a world in which global-
ization levels cultural differences.

• Sharpening competition among
  subnational units in an open environ-
  ment, along with the reluctance of richer
  entities to share their resources with less
  well-off neighbors.

The pull of local identity is manifested
through the following developments:

• Nation-states multiplied from 96 in 1980
to 192 in 1998.

• The process of political and functional
decentralization—pointing toward partici-
patory democracy—is continuing in large
and small states. Half the countries that
decentralized also devolved major func-
tional responsibilities. In many countries
of Eastern Europe and Central Asia
subnational governments evolved follow-
ing the collapse of the earlier autocratic
regimes.

• Urbanization is continuing by leaps and
  bounds. At the turn of the 21st century half
the world’s population will be living in ar-
eas classified as urban. As recently as
1975 this share was just over one-third; by
2025 it may rise to almost two-thirds. While
the rate of urbanization has passed its
peak in the higher-income countries of
Eastern Europe, the transition is just be-
ginning in Asia and Africa. An increase of
almost 1.5 billion people is expected in
urban populations over the next 20 years.
While the public sector is likely to remain
the key player in planning urban develop-
ment and providing basic services, part-
nerships between the public sector,
nongovernmental organizations (NGOs),
and private entities have become an im-
portant source of capital, skills, manage-
ment, and initiative throughout the world.

Gains and Risks

Globalization and localization promise in-
creased availability and more efficient al-
location of resources, freer circulation of
knowledge, more open competition, and
improved governance. But there are down-
sides and risks as well. Globalization en-
tails greater exposure to external shocks
and capital volatility—recently highlighted by
the East Asian crisis—along with numer-
ous environmental consequences. Mea-
ures to decentralize in order to satisfy local
demands can lead to macroeconomic in-
stability and lack of fiscal prudence. On the
other hand fiscal rules can buttress politi-
cal autonomy by assigning revenue bases,
responsibilities, and prescribing revenue
sharing arrangements between the center
and localities. Efforts to raise urban living
standards could prove elusive if policies
cannot prevail over the spread of poverty,
violeuce, and squalor.

Recent strides in development thinking have
begun to define a pragmatic agenda of insti-
tution building and policies that exploit the
gains and contain the risks from these two
forces. For example, rules for fiscal decen-
tralization can establish the sharing of respon-
sibilities between central and subnational
governments. All change courts risk. The
downside of globalization and localization is
starkly apparent from the East Asia crisis and
the state-induced fiscal crises in Brazil. These
forces are generating much of the stimulus
behind development. Minimize the risks and
ensuring that development is stable and sus-
tainable are the objectives to strive for. As this
report shows, the road to such a desired fu-
ture is paved with good institutions.

Excerpted from an article to be published
in the IMF's Finance and Development.
Shahid Yusuf is staff director of the World
Banks’ DECWD team, in charge of prepar-
to be published in mid-September.
home.htm; Email: world_development_report@worldbank.org.
What Went Wrong with Foreign Advice in Ukraine?

by Vira Nanivska

Reform in Ukraine has been greatly hampered by its government's lack of institutional capacity for policymaking. The reform process was conceived, designed, and guided by donors. So what went wrong? Somehow the political will to go the "Western way" did not manifest itself in concrete policy decisions. The government lacked the institutional capacity to make radical political choices. To fix what has already gone wrong, Western technical assistance must be reassessed and shifted to enable Ukrainians to initiate their own institutional capacity building.

After Ukraine gained independence in December 1991, the general view was that it had great economic potential. Already blessed with well-educated people, abundant natural resources, relatively well-developed industry and agriculture, Ukraine's geographical location in the heart of Europe was also advantageous for world trade.

Lowering High Expectations

Instead of reaching this great potential, however, Ukraine endured one of the world's worst depressions in modern history. Even among the struggling countries of the former Soviet Union, Ukraine stands out as having one of the longest and deepest periods of economic decline—one lasting for nearly nine years and with a contraction in GDP of more than 60 percent.

The effect of this economic downturn on the people has been severe. Most Ukrainians live on less than half the income of a few years ago. At least 30 percent—and perhaps up to 75 percent—of families now live below the poverty line. Sickness from preventable causes is rising, death rates are climbing, life expectancy is falling, and the population is shrinking.

Poor policy decisions and the lack of a sound economic strategy have exacerbated the economic decline in Ukraine. While the president and government have articulated a clear, medium-term economic policy, its implementation bears little resemblance to its vision. As a result, Ukraine has stumbled from one crisis to another, and the government has been bogged down in putting out fires.

While reformists did not have the necessary skills, experience, or resources to defend their course, well-organized opposition groups rapidly attracted financial resources and retained social support by successfully using familiar Communist slogans.

Burden of the Soviet Legacy

The international community tends to believe that lack of political will by Ukraine's president and government is the unique cause of the inadequate reforms and economic strategy. This ignores the other reason: the gap between the design of foreign technical assistance programs and the institutional reality in countries of the former Soviet Union.

For a long time international donors believed that the post-Soviet Ukrainian government had both the mandate and the capacity to make reform decisions. Donors believed that once the Ukrainian government was advised it would take the lead in reforming economic and social institutions. They further believed that once state control was removed and Ukraine had been given the right recommendations, civil society would automatically become active and independent, and enterprises would cooperate with foreign investors following generally accepted business rules. Given these assumptions, donors saw their role solely as advising the government on reforms and supporting the transition financially. However, the government lacked the skills needed to fulfill its new role in a market economy.

During the Soviet period the Ukrainian government did not have any real governing responsibilities; rather, it was fully engaged in the distribution of resources and the direct management of a huge, country-sized production line. No policy formulation was necessary—all decisions were made by the Central Committee of the Communist Party. The Ukrainian government's role was to execute those orders.

But after the collapse of the totalitarian regime—and in order to function properly in the new democratic arena—the Post-Soviet Ukrainian government was expected to justify its decisions, predict their consequences, and prove why they were better than the alternatives. Analytical and political justifications should have been presented to win public support. But the government machine was unable to cope with the challenges of transformation—neither substantively (what to do?) nor managerially (how to make it happen?). Even during the present reform process, no new capacities to fulfill such tasks have been developed.

The government also lacks the ability to effectively communicate reform to the Ukrainian people. The basic principles of a market economy and the rationale for reforms have yet to be explained, nor has any future prosperity been linked to the success or failure of these reforms. Voucher privatization, for example, was promoted as a liberal-socialist equity measure aiming at the "fair redistribution of state property." However, those not involved in private business—including public servants, teachers, doctors, pensioners, and sol-
Iters—did not see the benefit from the changing ownership of shops and factories and thereby did not become allies of reform. Thus there was no public pressure to introduce transparent bankruptcy procedures.

Ideally, the institutional mechanism of the Ukrainian government to carry out reforms should include:

- Employing qualified experts for professional policy analysis, especially research on the possible short- and long-term consequences of suggested decisions.
- Evaluating the public costs of ignoring those decisions and of reinforcing them, and comparing these decisions with defined goals.
- Managing change by establishing a department of reform management that is able to formulate reform strategy, differentiate process from substance, identify driving forces and opponents of reform, develop action plans, and build political support throughout the country.
- Putting organizational procedures in place to provide extensive support for government reform policies, including an officially structured system of communication with the Parliament, as well as procedures and documents that fulfill the principle of government transparency for the public.

Donors’ Miscalculations

Foreign technical assistance to date has not helped to develop Ukraine’s analytic competence inside and outside the government. Recommendations offered to the government by groups of foreign experts who conduct their own research cannot directly be used with any great or lasting effect on Ukrainian policymaking.

Why was the approach more successful in the Central European countries than in Ukraine? In Central Europe the focus has been on European integration. In these countries institutions were developed to allow integration into the European Union (EU). Together with their Western counterparts, government officials in Central Europe adjust their institutions to EU standards, which is stipulated in technical assistance projects.

In the former Soviet Union technical assistance has aimed at consulting, advising, and sharing information, not institution building. The first project of public administration reform in Ukraine started in late 1997—compared to 1991 in Poland.

Considering the overall high level of education, the Ukrainian government has few specialists with the knowledge and expertise necessary for government work in a democratic, open, and transparent society. Most public servants lack the skills needed to give strategic advice to the government.

Technical assistance in Ukraine has focused on advice rather than on teaching Ukrainians to develop and formulate policy advice. Frequently, foreign consultants do not promote the transfer of knowledge because they are expected to provide advisory service. Thus they are opposed to guiding, consulting, and supervising Ukrainians to do the same. As a result, all parties are frustrated—the foreign advisors because Ukrainians do not follow their advice, the Ukrainians because they were not helped to deal with their problems. Ultimately, the government is unable to evaluate foreign advice—let alone implement it. Like the fictional character Baron Munchhausen, the Ukrainian government is expected to drag itself by its own hair into a new role.

More Training, Less Advising

On the contrary, Ukraine has paid a high price for early democratization, which has not been matched by the government’s institutional capacity to take reform decisions in the presence of opposition and freedom of speech. Market forces, embedded in people’s vested interests, thrive in Ukraine. Private initiative is far ahead of regulatory framework, and a “shadow economy” makes up 60 percent of GDP. The problem lies in the reform design. This design did not account for the Soviet institutional legacy and for the market behavior of people who instinctively make money wherever possible and who are unwilling to wait for the proper and correct legislation or procedures to be in place.

Ukraine, therefore, needs to build on existing societal forces instead of fighting them. The international development community needs to advise on the reform process as a special policy craft, both in concept and implementation. Projects should be designed to facilitate new government functions.

Training programs must also be restructured so that Ukrainians can initiate their own development. Ukrainian participants need substantive training, including continuing study programs after returning from abroad. For now these overseas programs do little more than provide sightseeing tours. Technical aid also needs to be aimed at helping Ukrainian institutions to ask the proper questions, find the answers, and thus be self-supportive in the decisionmaking process.

Vira Nanivskar is Director of the International Centre for Policy Studies (ICPS), Kyiv. ICPS is a nongovernment research organization operationally financed by George Soros’ Open Society Institute. ICPS conducts independent research and organizes dialogue between the public, the government, NGOs, foreign experts, and the media. Its periodical Quarterly Predictions provides economic commentaries and forecasts. ICPS produces and disseminates the Russian language version of our Transition Newsletter.
How to Better Manage China’s State Owned Enterprises?
by Weian Li, Lidong Wu, and Yashuang Zhang

Beijing, a city with an unprecedented construction boom, was the location of the “4th Annual International Conference on Transition Economies” in late July, sponsored by The William Davidson Institute of Ann Arbor, Michigan, the London-based Centre for Economic Policy Research (CEPR), and the National Center for Economic Research at Tsinghua University, Beijing, in cooperation with the World Bank and the Ford Foundation. The conference covered a broad range of transition issues, including the experiences of Central and Eastern European transition economies and the lessons gained that can be useful for China’s scholars and policymakers. The following article analyzes the corporate governance dilemma of China’s state-owned enterprises. Incorporation and mixed ownership (through selling stocks to banks and other investors on the stock exchange) can create favorable conditions for introducing modern, market-driven corporate governance in China. Transition newsletter will come back to the conference debate in the future issues.

The corporate governance of China’s state-owned enterprises is gradually changing from administratively controlled to market driven. In the highly centralized planned economy, government and enterprise functions were not separated. Businesses were government affiliations, or state-owned enterprises, and lacked the necessary rights and vitality of an independent entity. As a result, enterprises were inefficient, with elusive performance responsibilities. Reforms starting in the late 1970s were not enough to cure the ailing state enterprises or to allow an efficient governance mechanism to develop.

While the means of government control changed—from physical indicators to financial regulators—the authorities were still unwilling to give up supervision of the enterprises’ activities, including investment policies, production mixes, and long-term development plans. The government, as owner, made the decisions, and the managers or factory directors executed these decisions. Managers of the enterprises’ day to day operations therefore lacked incentives for preserving and increasing enterprise value.

Who Controls Whom?

With the contracting-out system, the ownership and management of the enterprise were formally separated under formal contracts (managers gained some autonomy and became more motivated to increase production), but the administrative nature of governance did not change. The government—the external governance in this system—controls personnel affairs, appoints and evaluates management, and scrutinizes overall business performance. The internal governance in this system is a structure of checks and balances among three power centers:

- Enterprise directors or managers take charge of the daily production and management.
- The secretary of the Communist Party Committee is responsible for the personnel and the party affairs, as well as supervision of the enterprise operation.
- The Workers Council represents staff in the enterprise management.

This governance pattern is efficient only if:

- The government exercises effective supervision over the enterprise.
- The enterprise director or manager is a person of high principles.
- The party secretary and the Workers Council provide checks and balances against the power of the enterprise manager.

These prerequisites are not met, for a variety of reasons:

- During the process of broadening enterprise autonomy, the government stays out of an enterprises’ affairs and real control shifts to the enterprise managers. Due to an asymmetry of information, the government is unable to determine whether external factors or a manager’s successes or failures cause a certain outcome. Rewarding or penalizing managers is biased and inefficient at best. Supervision of enterprises needs to be made more efficient, but bringing the enterprise back under full government control is not a realistic alternative.

- Enterprise directors and managers pursue personal interests—often this means maximizing their own economic gains. Without adequate supervision, adverse selection and moral hazards are the result.

- Since the party secretary and the factory directors or managers have common interests, collusion among them is hard to avoid—often, the factory manager and the party secretary are the same person. Supervision by the Workers Council is even more ineffective since the staff depends on managers for their salaries, welfare, and promotions.
Clearly, a new governance pattern is needed in China, but it needs to be applied under the right conditions. Selected enterprises are experimenting with the shareholding system. However, two problems are already apparent. First, due to the special characteristics of listed companies in China, stocks are concentrated in the hands of state authorities or of legal entities approved by the state. Majority stock owners—with a huge concentration of shares—thus have unmatched power to dominate shareholders' meetings, boards of directors, and managers. Thus the formal separation of power is illusory. Second, enterprise governance should provide for an efficient decisionmaking process. The new system does little to improve the process, although it appears to be tightly structured and well coordinated. The shareholders' general meeting is prevented from serving its proper function by the enormous power of the board of directors, while the second-tier board of supervisors is too weak to have much influence.

**Limited Shareholders' Role**

A recent firm-level survey found that in 85 percent of state enterprises the general manager has assumed full responsibility under the direction of the board of directors (75 percent) or the board of supervisors (10 percent), while 15 percent of corporations are either run jointly by the board of directors and the party committee (12 percent)—the committee assuming responsibility for decisions—or by the general manager under the direction of the party committee (3 percent).

The survey also found that the board of directors (selected from high-level executives) overwhelmingly dominates the decisionmaking process, initiating proposals and participating in discussions. The worker directors, the board of supervisors, and the ministries have more of a supplementary function. Efforts have been made to give a greater role to worker directors and “outside” directors, appointed by the authorities, and to protect the interests of the minority shareholders. This more market-driven corporate governance structure still suffers from several problems:

- The shareholders’ control in many enterprises is rather limited. Their major role is to decide how much of the dividends should be distributed each year. Shareholders do not select members of the board of directors, which in many companies is established before the shareholders’ general meeting. Often directors are government officials who had previously managed the company from their relevant ministries. The government appoints the chair of the board of directors and the general manager. In some provinces local authorities simply remove directors and the chair if unsatisfied with them. Thus even listed corporations are controlled more by the government than by the shareholders. A standard mechanism has yet to be established.

Despite this formal system, external governance mechanism remains ineffective. The government is unable to properly supervise enterprises because asymmetric information provides ample room for insider control.

Internal governance is also weak. Most shareholding corporations have no internal supervision mechanisms. Workers lack efficient access to the management of a corporation. Supervisors come from the corporate auditing, accounting, and administrative staffs. This arrangement makes collusion with managers far more likely and nearly eliminates any chance for independent supervision. In most corporations the general manager and the chair of the board are the same person, significantly undercutting the supervisory role of the board.

We base our recommended corporate governance model on the principle of joint governance and joint decisionmaking by all the interested parties.

- Worker participation in management should be encouraged. Participation ensures the sustainable development of the enterprise, binding the future of the firm to the well-being of its employees. Likewise, the position of worker directors and their participation with the board of directors and board of supervisors should be regulated. Worker directors and worker supervisors should be selected by the Workers Council.

- Supervision of enterprises should be strengthened by introducing outside supervisors such as auditors and accountants. At present, most supervisors are chosen from the ranks of corporate managers.

- The independence of nonexecutive directors—experts, scholars, or experienced entrepreneurs—whose participation is invited by the shareholders should be reinforced.

**Needed: Capital Market**

An effective corporate governance mechanism assumes the existence of a functioning, efficient capital market. China’s capital market is rife with speculative activities due to ambiguities in regulations, loose supervision, and lack of a modern enterprise system. Strong measures must be taken to get the stock market back on the right track.

Managers are important human resources in modern corporations. The practice of having government departments appoint managers should be stopped and a market for high-level managers should be established. Intermediary companies (head-hunter firms) should be established to find individuals with management talent. Managers should be selected on the basis of fair competition and market testing.

The current banking system in China does little to improve the efficiency of corporate governance. Loans are still allocated on an administrative basis, providing little corporate discipline. Assuming that China introduces the German or Japanese model of
the main-bank system—allowing banks to accumulate part of their assets in enterprise shares—reform of China's banking system should create a new relationship between enterprises and banks and improve the effectiveness of corporate governance. This reform would require commercialization, or incorporation, of existing banks and the establishment of new banks, encouraging competition in the financial sector.

*The survey was carried out in 1997, supported by the State Committee of Economics and Trade and the International Business School of Naikai University, Tianjin Province, through random sampling of 300 of the 745 listed companies. Weian Li is Dean, Lidong Wu and Yashuang Zhang are PhD students of economics at the International Business School, Nankai University.

Corporate Governance in Eastern Europe—A Survey by Oxford Analytica

In the early years of transition, observers spoke of choosing between different models of capitalism—particularly between Anglo-Saxon stock market capitalism and the German model of more concentrated ownership that permits commercial banks to hold enterprise shares in their assets. The corporate structures that have emerged in practice borrow elements from different models of capitalism. A decade of privatization has had different effects on corporate governance. Several problems have emerged:

- **Crony capitalism.** Several countries are just beginning to unravel the webs of crony capitalism that have been built up as a result of partial privatization and political favoritism. In particular, the Czech and Slovak governments are trying to undo the work of their predecessors. By contrast, front-runners of transition—like Hungary and Poland—have relatively good corporate governance, as evidenced by the level of industrial restructuring and competitiveness. However, market supervision is still not entirely trusted by investors even in these preferred investment destinations.

- **Iron triangles.** Across Central Europe there is still much to be done to dismantle the iron triangles that have been built up among firms, banks, and the state. Soft credits have been provided to many failing enterprises through these links, even after privatization.

- **Management abuses.** Managers and boards are often reluctant to cede control, preferring to retain control of failing businesses rather than allow foreigners a chance to improve enterprise performance. Also, a general lack of transparency deters investors, especially after revelations over the past two years of the extent of the "tunnelling" used to strip Czech firms of their assets after voucher privatization. Boards are still reluctant to give out information, while local accounting standards are often well below international norms. Moreover, rules on shareholder liability are frequently unclear.

- **Interfirm networks.** Interenterprise links are a key concern in improving corporate governance, particularly among small and medium-size enterprises. At the start of transition, informal networks among firms—and among firms, banks, and parts of the state—compensated for the structural shortcomings of the formal organization of the economy, keeping the economy running in times of political paralysis. These informal networks, however, have also exacerbated structural shortcomings by bypassing regulatory controls and allowing anticompetitive links to flourish.

A prerequisite for improving corporate governance is the use of market mechanisms to force underperforming firms to change management practices and failing firms to exit the market. Although the rudiments of these mechanisms are in place across Central Europe, they have not been widely used. The number of serious takeover bids is still small. Shareholder activism looks like a distant prospect, given that supervisory boards are weak and market supervision is well below Western European standards. Regulators have been slow to respond to these problems.

Central Europe's equity markets have not recovered to a level close to the highs achieved before the Asian and Russian crises. However, some efforts are being made to improve investor confidence, such as:

- **Legal reforms are being introduced to allow hostile takeovers.** Hungary has recently introduced a takeover law, ending a situation in which firms could write "poison-pill" clauses into their statutes to ward off hostile bidders.

- **The Czech Republic is reforming its bankruptcy rules so that they can be used to force market exit.**

- **Abuse of minority shareholders is being addressed through legislative change, as in the substantial protection provisions included in this year's overhaul of Slovakia's financial regulation.**

Based on a recent report of Oxford Analytica, the Oxford-based international consulting firm. Information: Oxford Analytica Ltd, At Pasley Tyler, 42 Berkeley Square, London, England, W1X 5DB; Tel: 44171-318-0800; Fax: 44171-409-369; United States address: Oxford Analytica Inc., 1750 K Street, NW, Suite 800, Washington, DC 20006; Tel: 202-872-241; Fax: 202-429-7030; Email: client.services@oxford-analytica.com.

© 1999 The World Bank/The William Davidson Institute

TRANSITION, August 1999
Ethnic Unmixing and Forced Migration in the Transition States
by Tim Heleniak

The recent episode of ethnic cleansing and forced ethnic migration in Kosovo is, unfortunately, all too common among the transition states of Europe and Asia. The emergence of new independent states—many resulting from the breakup of the Soviet Union and Yugoslavia and the liberalization of political regimes across the region—has spawned a number of different migration streams, many of them forced. Each of the transition states has become more ethnically homogeneous since the beginning of the decade as a result of the ethnic unmixing that has been the primary, but not sole, cause of the migration.

Chaotic Unmixing

During the Soviet period a tight lid was kept on the nationalist and territorial aspirations of various ethnic groups. Suppressed ethnic grievances and territorial claims have come into the open as the result of the end of the cold war and the liberalization that contributed to the breakup of the Soviet Union, Yugoslavia, and Czechoslovakia. As new states seek to correct these grievances or assert claims, other ethnic groups are excluded. The response of many has been to migrate back to what they perceive to be their ethnic homelands. This massive, unplanned, and chaotic ethnic unmixing has had a negative impact on development and has led to increased poverty at a time when the states are also transforming their economies away from the centrally planned models they used for decades.

With most of the armed hostilities in the former Soviet Union having died down, much of international community’s attention has focused on the repatriation of 780,000 refugees and 800,000 internally displaced people and on the rebuilding of Kosovo. It should be kept in mind that the consequences of armed ethnic conflicts linger long after hostilities have ended and disappeared from the headlines. A number of potentially explosive situations remain in the former Soviet Union—and elsewhere in the region—to which durable political solutions

Glossary

**Internally displaced person (IDP):** A person in similar circumstances to a refugee with the exception of not crossing an international border. More difficult to deal with because such a person is often outside the reach of the international community.

**International Organization for Migration (IOM):** An international NGO that monitors the complex migration and refugee movements and works on governmental capacity building in areas of migration and refugee legislation.

**Irredentism:** The policy advocated by members of an ethnic group of reattaching a region that was—or that they believe should be—part of the ethnic homeland to the homeland. Usually only possible when the group is a majority in the region and the region is contiguous to the homeland.

**Nonrefoulement:** The principle that no person with a well-founded fear of persecution should be forcibly returned to the country where they fear persecution. This is the guideline under which the international community and other bodies dealing with refugees operate.

**Refugee:** A person who is outside his or her country of origin and is unable or unwilling to avail to the protection of that country or return there. Such inability or unwillingness is attributable to a well-grounded fear of prosecution, based on race, religion, nationality, membership in a particular social group, or political opinion.

**United States Committee on Refugees:** A U.S. NGO that attempts to find solutions to refugee problems partially through publicizing the plight of uprooted peoples. Compiles the annual World Refugee Survey.

**United Nations High Commissioner for Refugees (UNHCR):** The main United Nations body mandated to deal with refugees. The UNHCR and the IOM organized the Commonwealth of Independent States (CIS) Conference in 1996 to deal with consequences of the large and complex post-Soviet migration. The World Bank has played a limited role in the work on the conference that has fallen short of expectations in terms of fund-raising and other areas.
New Books and Working Papers

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

World Bank Publications


Working Papers


In bank-based financial systems banks play a leading role in mobilizing savings, allocating capital, overseeing the investment decisions of corporate managers, and providing risk management vehicles, as in Germany and Japan. In market-based financial systems securities markets share center stage with banks in getting society's savings to firms, exerting corporate control, and easing risk management, as in England and the United States. What are the relative advantages and disadvantages of each of these systems?

Analyzing newly collected data on a cross-section of roughly 150 countries, some clear patterns emerge:

- In higher income countries, stock markets become more active and efficient than banks. Thus financial systems tend to be more market-based.
- Countries with a common law tradition, strong protection for shareholder rights, good accounting standards, low levels of corruption, and no explicit deposit insurance tend to be more market-based, even after controlling for income.
- Countries with a French civil law tradition, poor accounting standards, heavily restricted banking systems, and high inflation generally tend to have underdeveloped financial systems, even after controlling for income.

To order: Kari Labrie, Room MC3-456, tel: 202-473-1001, fax: 202-522-1155, email: klabrie@worldbank.org. The authors may be contacted at ademirgucunt@worldbank.org or rlevine@csom.umn.edu.


Many developing countries have been reluctant to participate in multilateral trade negotiations although they can gain significant benefits from a broader WTO Millennium Round of negotiations once they develop proper strategies. They should embrace industrial tariffs and trade-related aspects of intellectual property rights, trade-related environmental issues, and government procurement. Liberalization of their own trade with realistic transition periods and technical assistance to address constraints on their institutional capacity in exchange for improved access to the markets of their trading partners is the only way to maximize benefits from multilateral trade negotiations.

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


Few Russians expected rising living standards in the 1990s, most expected a decline, so there was strong demand for redistribution, even among those currently well off but fearful of the future. Some 72 percent of the 7,000 adults surveyed in October 1996 favor government action to reduce incomes of the rich. But the other 28 percent were not only the currently "rich."
Women tend to favor redistribution more than men do.
To order: Patricia Sader, tel. 202-473-3902, fax: 202-522-1153, email: psader@worldbank.org. Martin Ravallion may be contacted at mravallion@worldbank.org.

Francisco Ferreira, Giovanna Prennushi, and Martin Ravallion, Protecting the Poor from Macroeconomic Shocks, WPS 2160, August 1999, 24 pp.

To minimize the harmful impact of macroeconomic shocks on the poor, governments and civil society need to be prepared for a flexible response well ahead of the crisis, primarily setting up an effective permanent safety net, combining a workfare program with targeted transfers and credit. Once a crisis has happened, the following should occur:

• Macroeconomic policies should aim to achieve stabilization goals at the least cost to the poor. Temporary reduction in aggregate demand is inevitable but as soon as a sustainable external balance has been reached and inflationary pressures have been contained, macroeconomic policy should be eased (interest rates reduced and efficient public spending restored, to help offset the worst effects of the recession on the poor). A fiscal stimulus directed at labor-intensive activities (such as building rural roads) can combine the benefits of growth with those of income support for poor groups.

• Key areas of public spending—especially investments in health care, education, rural infrastructure, urban sanitation, and microfinance—should be protected.

• Efforts should be made to preserve the social fabric and build social capital.

• Sound information should be generated on the welfare impacts of the crisis.
To order: PREM Advisory Services, Room MC3-825, tel: 202-458-7736, fax: 202-522-1135, email: premadvisory@worldbank.org. The authors may be contacted at fferreira@econ.puc-rio.br, gprennushi@worldbank.org, or mravallion@worldbank.org.

To order: Maria Kasilag, Room MC3-321, tel: 202-473-9091, fax: 202-522-1159, email: mkasilag@worldbank.org. The author may be contacted at mschiff@worldbank.org.

Estelle James, Coverage under Old-Age Security Programs and Protection for the Uninsured—What Are the Issues? WPS 2163, August 1999, 21 pp.

The shift toward social security systems with a tighter link between benefits and contributions will make such systems more fiscally sustainable. But to protect the uninsured and underinsured, such programs should be complemented by better social assistance programs for low-income groups, primarily workers who spend much of their lives in agriculture or the informal sector (often self-employed or in small firms) and women who, having worked mostly in the household, expect to be supported by a family system that may fail them in old age.
To order: Marianne Leenaerts, Room G2-030, tel: 202-458-4264, fax: 202-676-0961, email: mleenaerts@worldbank.org. The author may be contacted at ejames3@worldbank.org.


While authors welcome the relative success of reform in majority of 10 regional capitals along the Volga River, they point out that a major difficulty facing Russian cities is the cost of subsidies to housing and utilities. Real estate constitutes a major expenditure category for local government rather than, as in most western cities, a major source of revenue. With the credibility of Russia’s federal government at an all-time low, foreign investors have to rely on the competence and reliability of local leaders, especially mayors and governors. They will be looking for evidence of accountability in the form of the rule of law and transparency in the form of reliable public information.
To order: Hedy Sladovich, Room MC2-609, tel: 202-473-7698, fax 202-522-1154, Internet address: hsladovich@worldbank.org. The authors may be contacted at rhanrott@erols.com or gur.ofer@yale.edu.


Analyzing a sample of 49 developing (Latin American), transition, and industrial economies, the authors conclude that ineffective and discretionary administration of tax and regulatory regimes, as well as corruption, are responsible for increases in the size of the unofficial economy—not just higher tax rates. And countries with a larger unofficial economy tend to grow more slowly.

Wealthy OECD economies and some Eastern European economies find themselves in the “good equilibrium” of relatively low regulatory and tax burden (not necessarily low tax rates), sizable revenue mobilization, good rule of law and control of corruption, and a small unofficial economy. Several countries in Latin America and the former Soviet Union exhibit characteristics consistent with a “bad equilibrium:” the discretionary application of heavy regulatory and tax burdens, the weak rule of law, heavy bribery, and an active unofficial economy.
To order: Diane Bouvet, Room G2-136, tel: 202-473-5818, fax: 202-334-8350, email: dbouvet@worldbank.org. The authors may be contacted at dbouvet@worldbank.org or pzoidolobaton@worldbank.org.


---

Edward Elgar Publications

To order, contact Edward Elgar Publishing, 136 West Street, Suite 202, Northampton, MA 01060, United States, tel: 800-390-3149, Internet: http://www.e-elgar.co.uk or Glensanda House, Montpellier Parade, Cheltenham, Glos, GL50 1UA, United Kingdom, tel: 44-1242-226934, fax: 44-1242-262111, email: info@e-elgar.co.uk


Transformation often is treated in a cookbook manner rather than as a game of chess—that is step-by-step procedure with action, evaluation, and feedback. Consequently, during transition the institutional and economic conditions of the target model are not clear. Economic institutions with formal and informal rules and norms were devised to shape human interaction and help solve economic problems. The essays in this book show a variety of approaches to underpin economic analysis of transformation from a microeconomic point of view.


Governments of the Czech Republic, Hungary, and Poland have experienced problems in implementing economic reforms,
which have had to be weighed against increasing inequalities, growing unemployment, poverty, and the discontent of the public. Electorates in Hungary and Poland turned their backs to the liberal democrats and national conservatives in the mid-1990s and brought to power the socialists, initially reform communists. Four years later, right-of-the-center parties formed the government in both countries. In the Czech Republic the liberal-conservative coalition gradually split up and the social democrats were able to form a minority government. These countries cannot afford to pay the high cost of social support structures and are attempting to reform pension, health, and other social support reforms. This is the most important "unfinished business" of the transformation process.


Privatization investment funds are the key feature of mass privatization programs in transition economies. This book surveys mass privatization programs in the Czech Republic, Poland, and Slovenia, complemented with extensive empirical analysis.


Successful macroeconomic stabilization in Central and Eastern European countries has encouraged inflows of foreign capital badly needed to promote economic development. Strikinglly, these countries have found capital inflows in their various forms to be a mixed blessing, with its adverse effects on inflation, the exchange rate and the current account, and difficulties to contain disturbances resulting from reversals of the flows. This book investigates recent experiences in Central and Eastern Europe and contrasts those with experiences from Latin America and East Asia. It concludes that several features are similar. However, certain unique characteristics such as data limitations and the fragility of the banking and financial systems compound the problems faced by policymakers in Central and Eastern Europe.


The first part of the book presents case studies on the transition process as experienced in eleven countries. It outlines the role of monetary policy in macroeconomic stabilization, the characteristics of banking systems, the transfer of corporate ownership through privatization, the dynamics of exchange-related trading, and the importance of international funding. In the second part the authors present an in-depth analysis focusing on specific issues including market efficiency, financial risk, a comparative assessment of central bank independence, foreign debt settlement, and the privatization process.


Comprehensive analysis of the impact of privatization in Bulgaria, Estonia, Hungary, and Poland, the book sheds new light on the achievements and shortcomings of that process. The strongest financial standing and the fastest growth has been recorded by foreign-owned companies, although in most cases those were the flagship, state-owned companies before privatization. Government officials were less efficient "agents" at selling companies than managers of the firms were. Privatization with the ESOP-type privatization is mixed. In most larger companies workers could not function as owners so the companies went bankrupt or were sold to the managers.

Tony Verheijen (ed.), *Civil Service Systems in Central and Eastern Europe, Civil Service Systems in Comparative Perspective series*, 360 pp.

A comprehensive comparative analysis of the emerging civil service systems in nine Central and East European states provides insight into the emerging patterns of administrative development in the region.


At the beginning of the 1990s the first encouraging results on GDP growth combined with the fulfillment of international requirements led many to believe that Albania was a shining star of economic development in Central and Eastern Europe. But in 1997 this progress was reversed by unprecedented institutional, political, and social turmoil leading to a spiral of violence and chaos. The author provides a comprehensive economic analysis on Albania and identifies the major reasons for the 1997 explosion. The collapse of the pyramid scheme was just the last drop—the breakdown of the industrial production, failure of mass privatization, paralysis of the banking system, and rampant poverty fueled discontent to breaking point.

Publications of Federal Institute for Russian, East European and International Studies Cologne, Germany, Berichte
des Bundesinstituts für Ostwissenschaftliche und Internationale Studien (BIOSt) (In German, with English summaries)

To order, contact BIOSt, Lindenbomstr. 22, D-50823 Köln, Germany, fax: 049-221-5747-110, email: administration@biost.de, internet: http://www.biost.de/biopubl.htm.


SIGMA Publications

To order, contact Head of Publications Service, OECD, 2 rue André-Pascal, 75775 Paris Cedex 16, France, tel: 331-4524-7900, fax: 331-4524-1300, email: sigma.contact@oecd.org, Internet: http://www.oecd.org/puma/sigmatweb.


The Royal Institute of International Affairs Publications

To order, contact The Royal Institute of International Affairs, Chatham House,


University of Leicester Publications

To order, contact Faculty of Social Sciences, Department of Economics, University of Leicester LE1 7RH, United Kingdom, tel: 0116-252-2892, fax: 0116-252-2908.


Cornelia Scutaru and Adrian Ghita, Chaos and Order in Transition: Social Costs (Inflation, Unemployment) and Exchange Rate Policy. Case of Romania, No. 99/9, April 1999, 18 pp.


Constantin Ciupagea, Rigidities of the Labor Market in a Transition Economy: The Case of Romania, No. 99/6, April 1999, 44 pp.


****

Other Publications


To order: Ashgate, Old Post Road, Brookfield, Vermont 05036, United States, tel: 800-535-9544, fax: 802-276-3837, email: info@ashgate.com.


To order: De Paul University, Department of Management, 1 East Jackson Boulevard, Chicago, Illinois 60604-2287, fax: 312-362-6973.


To order: Ashgate, Old Post Road, Brookfield, Vermont 05036, United States, tel: 800-535-9544, fax: 802-276-3837, email: info@ashgate.com.


To order: Greenwood Publishing Group, Inc., 88 Post Road West, P.O. Box 5007,
Financial groups increasingly shape rules, institutions, beliefs, and norms at home and globally. The book provides a comprehensive overview of the formation and governance of financial groups in Poland. State monopolies were the old monsters; since their weakening and demise in the early 1990s, financial groups are replacing them. They are neither completely private nor public. As to their scale, concentration, historical heritage, connections with the government, and control of their own activities, they markedly differ from their western counterparts.

Maria Romanowska's paper, "Financial Group Strategies in Poland," explores the dangers of recreating the old monopolistic monsters into new formations. Poland should set up lobby groups representing various branches of Poland's industry in order to influence decision-making bodies in the European Union, argues Krzysztof Popowicz in his essay, "Polish Financial Groups in Negotiations with the European Union." Wiesław Grudzewski and Helena Hejduk in their study "The Holding Company as Instrument for Restructuring Key Industry in Poland" challenge the idea of restructuring major Polish enter-

pries into holding companies. Reviewed by Maria Aggestam, School of Economics and Management, Lund University Sweden, email: maria.aggestam@fe.klu.se


Part I, a macroeconomic review of the transformation process, provides a comprehensive overview of economic development in the East European and CIS transformation countries. John Odling-Smee and Oleh Havrylyshyn identify three country categories: sustained growth, artificial growth, and zero growth, with Ukraine belonging to the latter. Part II covers issues that have been neglected for too long in the transformation debate: institutional change as a precondition for any reform. Part III addresses structural change in what is the key institution for any capitalist market economy—the financial sector. Part IV is dedicated to agriculture, and Part V covers reform of the energy sector, sometimes perceived as the Achilles' heel of the Ukrainian economy.

Whatever the macroeconomic figures, the major transformation still confronting Ukraine is a change in the mindset of people—the perception that while the move from socialism to a market economy can indeed be accomplished, short-term approach in politics leads to proliferation of inefficient structures and policies rather than to their eradication. [See also lead article in this issue. The Editor].

Bibliography of Selected Articles

Central and Eastern Europe


Asia


CIS


Subscribe to Transition

If you are not currently on our subscription list, beginning in calendar year 1999 you may receive Transition on a complimentary basis by writing to:

Jennifer Prochnow
The World Bank
1818 H Street, N.W.
Room MC3-374
Washington, D.C. 20433, USA
telephone: 202-473-7466
fax: 202-522-1152
Email: jprochnow@worldbank.org

For a free subscription to the Russian language version of Transition, write to:

International Centre for Policy Studies
8/5, Voloska St.
Kyiv, Ukraine 254070
telephone: +380 44 4636337
fax: +380 44 462 4937, 38
Email: marketing@icps.kiev.ua
Website: http://www.icps.kiev.ua

If you would like to receive the Transition Newsletter electronically, please email Jennifer Prochnow:

jprochnow@worldbank.org

We appreciate the support of:

DHL

BOFIT

We look forward to establishing similar agreements with other sponsors—whether individuals or companies. Please contact the editor for more details.

For Distribution Use Only
World Bank Focuses on Conflicts, Refugees, Migration

To deal with the current proliferation of ethnic conflicts, the Post-Conflict Unit was created in 1997 within the World Bank’s Social Development Network. The Bank plays a role in post-conflict reconstruction based on its comparative advantages in aid coordination, macroeconomic stabilization, infrastructure finance, social assessments of displaced populations, and social sector restoration. The Bank, along with the European Commission, is organizing the international community’s response to the situation in Kosovo.

Keep in mind that the Bank is not a relief agency, although there is often a humanitarian impulse to avert every incident of violent conflict that causes population displacement. Many of the Bank’s procurement and disbursement processes have proven to be a stumbling block in post-conflict recovery. The Bank’s major role comes later in the post-conflict reconstruction phase and during return to normal operations. To that end, the post-conflict fund was created to be a quick-disbursing instrument through which analysis and piloting of reconstruction activities can be carried out when normal Bank borrowing is not possible. Two grants each $1 million from the fund have been awarded to assist Albania with the refugees who have fled there from Kosovo.

More elusive are preventative measures that the Bank can take in countries to manage conflict before it erupts into violence. A better understanding of the historical dimension of the ethnic conflicts that give rise to violence and forced migration is a positive first step. However, no single set of circumstances leads to ethnic or intrastate conflict and population displacement. There is an ongoing debate about the role the aid plays in promoting civil society and good governance.

As a development institution, the Bank cannot resolve conflicts, nor is it in the Bank’s mandate. The Bank’s role is not to interfere in the internal affairs of a member country nor question its political orientation and obviously has less leverage with non-members—keep in mind that Yugoslavia is a non-member. Promotion of growth, equity, and inclusion—all included in the Bank’s mandate—can also go a long way toward conflict management. In addition to infrastructure reconstruction, which is at the core of the Bank’s role, more attention needs to be paid to sustainability issues. The Social Development Strategy Paper for the Europe and Central Asia region that is being drafted lists migration and ethnic conflict as one of the main social development issues—and challenges.

have yet to be found. A number of “pseudo states” exist—regions within sovereign states that operate autonomously but are not recognized as independent by any other country. These include the Transdniester region of Moldova, Nagorno-Kharabak within Azerbaijan, the Chechen republic within Russia, the Ossetian and Abkhazian regions in Georgia, and the Kosovo region within Yugoslavia. In all of these areas the push for autonomy or territorial claims has resulted in ethnic violence and population displacement. The resolution of these conflicts may cause further displacement.

As a development institution, the World Bank has an obvious, albeit uncertain, role to play in the ethnic unmixing and forced migration taking place across Europe and Asia.

More States, More Migration

Migration has always played a role in state building or unbuilding. Thus, it should come as no surprise that there has been so much migration as the number of states in the Europe and Central Asia region has increased from eight at the beginning of the decade to the current 27. Only five states in the region remain within the same borders as at the beginning of transition. Most of the new, or newly independent states are the homelands of a titular ethnic group who have the goal of making state and nation consistent, often with greatly exaggerated or conflicting claims of homeland. This has led to a number of episodes of forced migration, as well as noncoerced ethnic unmixing. Little of the bloody ethnic unmixing of the former Soviet Union has been directed at Russians; however, the largest number of Russians have migrated back to Russia from areas where ethnic violence is the greatest.

In the new states of the former Soviet Union, much of the increase in ethnic homogeneity has been due to the return migration of more than 10 percent of the Russian diaspora population from the non-Russian states. The rate of return among the states varies considerably, ranging from 50 percent in the three Transcaucasus states and Tajikistan to barely 1 percent from Ukraine and Belarus. While the return migration of nearly 3 million Russians is considerable and has placed great strains on the depressed Russian economy to absorb them, most Russians outside Russia were reluctant to migrate. Russia realized the potential burden of absorbing 25 million Russians from non-Russian states, and discouraged migration while helping the expatriots feel part of the Russian nation by persuading the states to allow dual citizenship. Thus, with a few exceptions, most of the non-Russian successor states are embarking on state building with significant minorities of Russians and other nationalities.

The mosaic of nationalities in the Transcaucus region has been the area of some of the most violent and severe ethnic unmixing in the former Soviet Union. The conflict between Armenia and Azerbaijan over control of the Armenia-majority enclave of Nagorno-Kharabak has
caused an estimated 350,000 Armenians to leave Azerbaijan, of which 260,000 went to Armenia, and 167,000 Azeris to leave Armenia for Azerbaijan. An estimated 550,000 internally displaced people remain in Azerbaijan. The separatist movements in Georgia by the Abkhaz and Ossetian regions has caused an estimated 275,000 displaced people. At its peak the civil war in Tajikistan, which lasted from 1992 to 1997, caused the displacement of 900,000 people, 700,000 of them internally. By mid-1997 a peace agreement had been reached and a majority of those displaced have returned. Even two of the relatively peaceful and prosperous Baltic states—Latvia and Estonia—have been taken to task by the international community over their exclusion of large Russian-speaking populations through restrictive citizenship and language laws.

The four-year war in Bosnia and current dispute in Kosovo are rather well known. At the end of 1997 more than 800,000 Bosnians remained internally displaced. More than 600,000 Bosnian refugees remained outside the country and 40,000 refugees from Croatia were in Bosnia. An intentionally decentralized state consisting of the Muslim-Croat Federation of Bosnia and Herzegovina and the Serb Republic Srpska continue the difficult rebuilding process there. The recent end to hostilities in Kosovo has allowed a tentative start to the repatriation of Kosovars and to the reconstruction of infrastructure. Still, the Serbian government views Kosovo as part of the Serbian homeland.

The transition states of the Europe and Central Asia region contain about 7 percent of the world's population but have about 15 percent of the world's refugees and internally displaced people. Other estimates place the region's share of refugees and displaced people at closer to 30 percent. In most cases the conditions that caused these population displacements are unresolved and the affected people remain in a state of permanent migration.

Displacement and Consequences

During the 1990s some titular members of the newly independent states tried to correct what they perceived as historical wrongs by giving preference to their ethnic group, often by arbitrarily defining citizenship or introducing discriminatory laws. The majority of states, however, are trying to walk the fine line between creating a homeland for members of the titular nationality while also accommodating minority nationalities. Kazakhstan, with its large Russian population, is a good example of this balanced policy.

A number of factors dictate the level of migration and the degree to which it is forced. These have to do with the characteristics of the diaspora group, the homeland, and the host country.

• Size, history, rootedness, and geographic concentration characterize the diaspora group. Russian populations in non-Russian states tend to be large and concentrated, usually in the capital cities. Most were born in these non-Russian states.

• A homeland's attitude toward the diaspora community affects migration at both formal and informal levels, which translates into how much of a pull factor it becomes. Some states such as Kazakhstan and the Baltics automatically grant citizen-
ship to members of the titular ethnic group anywhere in the world. Others, such as Hungary, took a more neutral approach to its diaspora members. Hungary, while recognizing that Hungarians living in neighboring states are part of the Hungarian nation, is not ready to offer nonresident citizenship—this is done to preserve good relations with those bordering countries that were established in the ruins of the Austro-Hungarian empire, inheriting millions of Hungarians. Germany and Israel are two homelands that have greatly affected migration patterns in the region by inducing a mass migration of German and Jewish populations.

- As previously mentioned, the characteristics of the host nation toward ethnic minorities and the degree of social inclusion have been among the largest factors influencing either coerced or noncoerced ethnic unmixing.

This recent and ongoing population displacement has negatively affected social development in the region by increased uncertainty among those affected, fragmentation of social relationships, loss of livelihood and savings, increased poverty, and necessary adjustments to new surroundings and new social institutions. Many migrants have been forced to make difficult adjustments. Urban Russians from the non-Russian states, for example, have been directed to live in rural areas that they are unaccustomed to. Many of the displaced remain in limbo, wanting to return to their homelands or integrate into the resident societies, but are barred from doing so. At the same time, a country unable to handle its large minorities, and which forces them into uncertain status, will sooner or later be destabilized itself.

Tim Heleniak is in the World Bank's Development Data Group (DECDG). He researches and writes on internal and international migration in the Europe and Central Asia region. This article is based on the author's own work and selected papers presented at the conference "Diasporas and Ethnic Migrants in 20th Century Europe" held May 20-23, 1999, Humboldt University, Berlin, Germany.

---

**Foreign Loans Diverted in Monster Money Laundering? The Mafia, Oligarchs, and Russia's Torment**

Federal and state authorities, examining possible money laundering through the Bank of New York, suspect that Russian organized crime may have been involved in skimming International Monetary Fund (IMF) loans and other foreign economic aid to Russia, the Wall Street Journal reported on August 25. Altogether, as much as $10 billion was allegedly laundered through the bank, the 16th largest asset-holding bank in the United States. A top IMF team started consultations in Moscow to pour over Russia's finance books.

The probe into the route of IMF loans to Russia is part of a wide-ranging U.S. federal investigation into Russian money transfers that passed through the Bank of New York (and its London offices) in the past year or so.

**Capital Flight Schemes**

Russia's national police agency, the MVD, conservatively estimates that $9 billion illegally flees the country each year. A study by the Institute of Economics of the Russian Academy of Sciences and the Centre for the Study of International Economic Relations at the University of Western Ontario, published this May, suggested that up to $70 billion disappeared in 1992 and 1993 alone. Other specialists argue that total capital flight in 1994–98 amounted to more than $140 billion and currently is running at more than $15 billion a year. Overall, some $350 billion in capital has fled the country since the fall of the Soviet Union, with nearly a third of it landing in the United States, intelligence sources told the U.S. News and World Report. And investigators believe that the flow of funds has accelerated since the crash of the ruble in August 1998. As Russian companies face bankruptcy, their motivation to preserve assets tends to vanish.

During an August 21 raid on the Bank of New York, U.S. federal investigators seized the files of Natasha Gurfinkel Kagalovsky, a senior vice president who supervised the bank's East European division. She and the bank's vice president in London, Lucy Edwards, were suspended. Ms. Kagalovsky is the wife of Konstantin Kagalovsky, Russia's representative to the IMF in the early 1990s under Prime Minister Yegor Gaidar's government. After Gaidar was replaced, Kagalovsky moved to Russia's Bank Menatep, headed by Russian oil and banking baron Mikhail Khodorkovsky. Menatep snapped up a number of enterprises during Russia's controversial "loan to share" privatization, including a controlling stake in the country's second-largest oil company, Yukos. Menatep failed last year amid Russia's financial crisis (see box on page 16). Kagalovsky is now deputy chairman of Yukos.

Investigators say Menatep and Kagalovsky increasingly are becoming a focus of the investigation. Federal and international law enforcement officials say they are looking into whether Kagalovsky helped construct a byzantine network of offshore corporations that politically connected or mob-linked Russians may have used to siphon hundreds of millions of dollars out of the
country. Investigators say that sum may include part of foreign aid and funds pumped into Russia by the IMF to shore up the reeling Russian economy.

Yukos denies that it has been involved in transfer pricing schemes, but oil industry analysts calculate that its subsidiaries effectively lost hundreds of millions in revenue last year by selling its oil to the holding company at bargain rates. Yukos, like all petroleum companies battered by last year’s low world oil prices, itself reported a $79 million loss for 1998. A deal earlier this year scattered the ownership of Yukos’s two oil production companies among six separate offshore firms, from the British Virgin Islands to the windswept Pacific atoll of Niue in the South Pacific.

Elaborate shell games have become a dominant feature of Russia’s post-Soviet economy. Menatep’s own purchase of Yukos back in 1996 began with a flourish of thinly disguised deception by Kagalovsky. He said “an unknown company called Monblan” had won 85 percent of Russia’s second-biggest oil company. Menatep later admitted that Monblan was a subsidiary.

Secrets of New York Bank Accounts

Also under the scrutiny of U.S. federal and local investigators is Russian businessman Peter Berlin and his wife, Lucy Edwards. Berlin, British corporate records show, is listed as a director of Benex Worldwide Ltd., the company that kept several of the suspicious accounts at the New York Bank. Benex maintained close ties to Semion Mogilevich the alleged head of Solnetsevo, Russia’s largest organized crime group. Mogilevich has built a $100 million empire from arms dealing, extortion, prostitution, and other rackets. Before submerging in recent years, he lived in Budapest, Hungary, but is thought to have moved to Moscow in recent weeks. Mogilevich allegedly is the principal target of a strike force assembled in early 1998 by the U.S. government. The force is comprised of the FBI, the Treasury Department, the State Department, the Central Intelligence Agency, and the Hungarian Interior Ministry.

A senior U.S. government official said there were “substantial links” between Benex and YBM Magnex International Inc., a Newtown, Pennsylvania, maker of industrial magnets. Mogilevich was a founding shareholder of the company. Founded in 1994 by a Russian emigre scientist, YBM Magnex, a magnet and bicycle manufacturer, rose from an obscure penny stock to a multinational worth nearly $1 billion in less than four years. Its numbers astonished competitors and delighted stockholders. Net sales quadrupled from 1994 to March 1998, net income jumped ninefold, earnings rose by a factor of five, and the future looked just as promising. Benex became a distributor of YBM Magnex’s magnets. By March 1998 YBM was boasting of plans to become “the world’s leading producer of high-energy permanent magnets.”

But six months later, in June of last year, YBM Magnex pleaded guilty to conspiracy to commit securities fraud and has since filed for bankruptcy-law protection. In December 1998 the company’s new board, composed of outside investors, admitted to U.S. authorities that there was evidence of YBM’s criminal wrongdoings, possibly involving links to organized crime. YBM had faked customer lists showing money laundering activity in accounts and business dealings in Eastern Europe and the Caribbean. (Money laundering means moving ill-gotten gains through a series of bank accounts to make them look like legitimate business proceeds).

Earlier this year, the FBI and other federal agents raided YBM’s world headquarters in Newtown. The confiscated documents suggest that Russian mobsters may have used the company’s Eastern European operations to launder millions in dirty money through a web of related enterprises.

Transfer Pricing—Techniques to Syphon Money Abroad

Under the transfer pricing scheme, or “tolling,” Russian companies have been selling products at below-market prices to their offshore intermediaries. The intermediary then sells the products at the international price and the foreign currency proceeds never enter Russia. This practice has drained billions in profits from Russia’s core metals and oil companies into offshore accounts.

Some groups also carry out domestic “transfer pricing”—selling their goods at below cost to a Russian intermediary company that is controlled by a few executives, thus depriving shareholders of the original company of their profits. These goods can then be exported at a fair market price.

While transfer pricing understates the true value of exported goods to minimize the amount of foreign currency that is legally required to be re-exchanged into rubles, an alternative approach is to overstate expenses.

These so-called bogus service agreements involve an offshore company—often set up by an intermediary that takes a commission for its efforts—that offers fake consulting services to its Russian “client.” This practice allows money to be exported, while the bills “paid” by the Russian company reduce the domestic profits on which it is required to pay tax to the authorities.
The Budapest-based production facility of Magnex was established eight years ago as the property of the Mogilevich-controlled Arigo Ltd. Shortly thereafter its capital increased and it started to produce high-tech magnets. (As the Budapest-based World Economy Weekly reported, the shabby, run-down building that employed 200 people, one third of them Russian, did not reveal much about the high-tech production, and hardly reflected the $80 million investments in the mid-1990s). “The products were sent back to the offshore company at Caiman Island and then reshipped to the CIS countries.”... At least that is what the owners claimed.

A year ago the Hungarian company, now renamed Crumax Inc., decided to start a new investment with $20 million in order to increase production and build a new research and training basis. The Canadian investors vetoed the plan.

With the Money, Mogilevich Disappeared Too

Mogilevich disappeared from Budapest following a Hungarian-American coordinated raid. Officials confiscated documents and computers in his Budapest offices that well-informed sources link to the FBI’s New York investigation. The Hungarian authorities declined to discuss the results of these raids. The Hungarian tax police have extended an ongoing inquiry into companies controlled by Mogilevich.

Investigators in New York estimate $6 billion zipped through the Benex accounts in the short time since authorities began monitoring the transactions last fall. They told the New York Times that the Berlins may be involved in one of the largest money-laundering operations ever conducted in the United States. Some $4.2 billion passed through a single account in more than 10,000 transactions between October and March, the New York Times reported. The cash in question appears to have passed through European and U.S. banks before landing in an offshore account in the Channel Islands that was controlled by a Russian commercial bank.

Some of the accounts Berlin established at the Bank of New York weren’t regular deposit accounts but “micro/CASH-REGISTER” accounts. These accounts are typically used by businesses for cash management purposes and are designed to make international fund transfers simpler. Account holders access their accounts and can conduct numerous transactions, including wire transfers and payment orders in foreign currencies, via a personal computer.

Were IMF Funds Hijacked?

The IMF said on August 23 that it was looking into reports of diverted funds but that it had made payments only to the Central Bank of Russia. IMF spokesperson Graham Newman pointed out that under the current standby credit IMF money is paid into the Russian government’s account at the New York Federal Reserve Bank and that these funds can only be used for repayments to the IMF. Earlier credits were paid into either the central bank of Russia’s account at the New York Federal Reserve, or its account at (Germany’s) Bundesbank, and were used by the authorities to build up reserves, help finance the budget, or pay international obligations.

The possible siphoning of funds from IMF credits to Russia comes at a time when an audit released this summer by Pricewaterhouse Coopers shows that Russia’s central bank funneled $1.2 billion in IMF money in 1996 to a firm it controlled called Financial Management Co., or Fimaco, in the Channel Island of New Jersey. The central bank hid that transaction from the IMF and later explained it was trying to keep the money beyond the reach of creditors. The IMF has lent about $20 billion to Russia since 1992. In July the IMF approved a new loan of $4.5 billion for Russia.

All this makes the ongoing IMF-Russia discussions even more complicated. Moscow’s IMF envoy, Mikhail Zadornov, told NTV television that negotiations, scheduled to last here until September 1, will concentrate on the 2000 budget parameters and Russia’s compliance with a tight fiscal policy agreed on with the IMF over the summer. The IMF wants Russia to aim for a primary budget surplus of 4 percent of GDP next year—a figure that excludes Russia’s foreign debt payments. Moscow ministers want the IMF to lower its sights, stressing that chronically poor revenue collection should improve only enough next year to meet a three-percent surplus.

Meanwhile, some members of Congress are launching their own probes into the matter. James Leach, a Republican from Iowa and chairman of the House Banking Committee, is planning a hearing, tentatively set for mid-September, on the role Western banks may have played in helping Russian money laundering, including an investigation of whether IMF funds have been siphoned. “Russian banks appear to be more platforms for insiders seeking to spirit money out of the country than intermediaries for domestic economic growth,” Leach said in a press statement. At issue is whether foreign theft has been facilitated by self-serving banking practices in the Western world, including the United States.

This article was based on reports of reporters Michael Allen, Paul Beckett, Michael Binyon, James Bone, David S. Cloud, Alan S. Cullison, Andrew Higgins, and David Lister of the Wall Street Journal, Lacy McCrary of the Philadelphia Inquirer, Gyorgyi Kocsis of the World Economy Weekly, Budapest, and David E. Kaplan of the U.S. News and World Report.
Curse or Blessing?—Financial-Industrial Groups in Russia by Tatiana Popova

Starting in the early 1990s, Russian industrial companies and banks set up financial-industrial groups through equity ownership, sometimes through cross-ownership arrangements. Their goal was to combine financial and industrial capital and managerial know-how, gaining advantage on the market and through the authorities. Both government-induced and market-driven financial-industrial groups became important factors shaping the development of the Russian economy. Their role in the Russian economy has been mixed: it remains to be seen whether they can help overcome the investment and structural crisis or worsen the crisis through inefficient investment policies, monopolistic behavior, and abuse of power and influence.

The drive for financial-industrial integration has been rooted in Soviet history in a number of ways:
- Russia's large industrial enterprises originate from the Soviet era, and bureaucrats tend to preserve bureaucratic structures.
- Managers of industrial enterprises have been unable to adjust to market conditions in their approaches to distribution and sales on domestic and external markets.
- Russia's financial capital and institutions have operated in imperfect and fragmented markets. To combine financial and industrial capital for investments and to restructure enterprises became a necessity.

In 1990–92 Russian merchant capitalism—a mix of commodity exchange, trading, smuggling, and corruption—created the first large-scale conglomerates. Their assets increased as financial markets evolved, and the phoenix of financial capitalism was reborn on the ruins of the socialist industry. Opinion was split on whether the financial resources of these conglomerates were channeled into long-term productive investments based on real needs or aimed more at gaining concessions from the authorities.

By mid-1997 about 130,000 state-owned enterprises—over half—had been privatized. Although formal privatization in Russia proceeded quickly, it did not create responsible proprietors willing to retool technologies, modernize production, manufacture competitive products, and manage their enterprises more efficiently. Decisions to privatize were essentially guided by social and political goals.

Voucher privatization, the preferred approach, produced a spectacular rate of privatization—at least on paper. Large industrial enterprises were transformed into open joint-stock companies. Due to the large number of new owners, including voucher holders and labor collectives, ownership and control were scattered and unmanageable. This prevented the emergence of clearly identifiable owners. While workers acquired most small firms in trade and services, the state retained controlling blocks of shares in many formally "privatized" industrial firms. Efforts to privatize by selling enterprises through offerings have yielded meager results.

The Russian government thereafter decided to promote the financial-industrial integration of enterprises and financial organizations, hoping that it would help solve structural problems while avoiding further monopolization of the economy.

Russia's legislation currently covers two corporate forms of financial-industrial integration: official financial-industrial groups and holding companies. A holding company is defined as an enterprise, in any organizational and legal form, that possesses controlling blocks of shares of other enterprises. A financial-industrial group is defined as a group of enterprises and other organizations that pool their capital, or a group of companies that consolidate all or part of their assets, carrying out joint investments aiming at technological and economic integration.

Regulators tried to prevent the formation of monopolies through envisaging the creation of at least three financial-industrial groups with similar profiles in the same regional market. The 1995 law limits the participation of any bank or enterprise to a single financial-industrial group.

A financial-industrial group can be formed around an industrial enterprise, research organization, bank, or trade firm. However, to qualify as a financial-industrial group, participation of a manufacturer of goods or provider of services and a credit organization is necessary. Financial-industrial groups that include legal entities in other CIS countries are registered as transnational group. If the financial-industrial group is based on an intergovernmental agreement, the group is given the status of an international group.

Participants in a financial-industrial group pursued different interests: enterprises frequently sought the umbrella of a financial-industrial group to milk the government or banks in order to stay alive or to acquire funds for covering their operational costs, such as wages. Banks wanted to diversify their property, including having a direct role in owning and managing industrial enterprises.

The government had its own stake in the success of financial-industrial groups: it hoped efficient groups could take over the roles of investors, managers, and liquidators of bankrupt enterprises. It offered support to officially recognized financial-industrial groups. Groups of industrial and financial companies willing to register as financial-industrial groups in principle received state support and were classified
as “official” financial-industrial groups—
once the authorities registered them.

The state support can take several forms:
- A financial-industrial group may receive blocks of state shares. The state can offset the debt of a member enterprise and grant state guarantees for loans, basically for investments. The state also can provide investment credits and other financial support for the group projects.
- An international financial-industrial group can receive favorable treatment on customs tariffs.
- A financial-industrial group can be recognized as a consolidated group of taxpayers with consolidated accounting.
- A financial-industrial group can receive the right to define the period of amortization of equipment and accumulate the funds for its activity.
- The central bank can provide banks that participate and invest in financial-industrial groups lower reserve requirements and change other rules in order to increase investments.
- The government can financially support financial-industrial groups that participate in federal programs.

In 1998 the 75 officially registered financial-industrial groups produced about 10 percent of the Russian GDP and employed 5 million people—almost 30 percent of the industrial workforce. Official financial-industrial groups—a group of about 1,150 non-financial enterprises and 160 financial organizations—are concentrated in a few regions. In 1997 almost 40 percent of them were located in Moscow and most of the rest in Siberia and the Urals region.

The government initially expected a larger volume of integration in industry, but it couldn’t afford to offer more generous incentives. Many manufacturers were afraid of the dominance of the banks. Banks on their part found the rule of restricting their participation to one financial-industrial group frustrating. This has slowed the formation of officially registered financial-industrial groups and led to the fast spread of ad hoc, “unofficial,” financial-industrial groups. Hundreds of unofficial financial-industrial groups have been set up by industrial, trading, investment, and insurance companies, which also established their own “pocket banks” to provide financing for the groups, work out investment projects, and take part in the management.

The huge financial-industrial alliances—comprising financial, investment, insurance, trading and leasing firms, pension funds, as well as large banks under the control of oligarchs—have grown out of the unofficial groupings. Even after the shock of August 1998, these oligarchs—heads of several unofficial financial-industrial groups—still control Russia’s oil, gas, and metal industries, employ millions of people, bring in the bulk of the country’s hard currency earnings, and excessively influence Russia’s politics. Financial-industrial groups gained special privileges, including tax concessions and exemptions from customs duties.

The future of Russia’s large conglomerates depends on the willingness and power of the state to enforce effective antimonopoly policies in regulating official and unofficial financial-industrial groups, especially clipping the wings of the oligarchs.

The author is Economist at the International Fund for Social and Economic Reform, Moscow.
The Twelve Oligarchs—What Are They Doing?

Since most banks owned by the oligarchs had invested an average of 35 percent of their assets in the GKO (short-term treasury bills), the GKO moratorium—introduced after the collapse of the ruble in August 1998—effectively made their banks insolvent. As Marshall I. Goldman, professor of Wellesley College and Director of the Davis Center for Russian Studies at Harvard University, recently pointed out, "in a high-stakes shell game the oligarchs, though considerably poorer, are defying the current economic malaise and remain ahead of the rest." (The following list is based on his article in the International Economy).

So, who are the twelve oligarchs and what are they doing now?


- **Petr Aven and Mikhail Fridman** (co-chairmen, Alfa group). The Alfa group suffered less from the August devaluation and default than most of its rivals. In October, however, it admitted to being unable to repay a $77 million syndicated loan arranged by Bank of America. Alfa holds on to Tjumen Oil, the group’s major corporate investment, besides real estate, securities trading, and cement and chemical industries.

- **Vladimir Bogdanov** (president, Surgutneftgas). His position did not change. Surgutneftgas, the second largest oil company, produced 35.2 million tons of oil last year.

- **Anatoly Chubais** (president, United Energy System). His position is unchanged.

- **Vladimir Gusinsky** (founder, Mostbank, Mediamost). His media interests (including the second largest television network NTV, and the daily newspaper Today/Segodnia) put him in a strong position as the parliamentary, presidential, and regional election campaigns get under way. There is talk of him taking a major stake in the telecommunications holding Svyazinvest.

- **Mikhail Khodorkovsky** (founder, Rosprom/Menatep). His more valuable assets have been transferred from Menatep Bank to the new Menatep, St. Petersburg. The group owns majority stake at the Yukos oil company; controlling shares in plastics, metallurgy, textiles, chemicals, and food processing companies.

- **Vital Malkin** (president, Russian Credit Bank). He has promised foreign creditors to restructure the $650 million debt owed by his bank, but also has shifted assets to the newly established IMPEX bank.

- **Vladimir Potanin** (president, Interros Trading Co./Oneximbank). The former first deputy prime minister and putative architect of the 1995-96 loans-for-shares scheme, faces severe problems. License of Oneximbank has been withdrawn in July, but assets had been shifted to Rosbank, leaving behind debts—$525 million owed to foreign depositors and investors and $1.5 billion to domestic. Interros assets shifted to Interros Prom. The oil company Sidanko faces bankruptcy proceedings together with a number of its subsidiaries, including Rosneft. Potanin has lost control over the telecommunications holding Svyazinvest, having used it as collateral for a credit he was unable to repay. The group still owns 38 percent of Norilsk Nickel, 26 percent of jet-engine maker Perm Motors, 26 percent of car manufacturer Zil, and has holdings in oil, metallurgy, and real estate businesses.

- **Aleksandr Smolensky** (chairman, SBS-Agro Bank). SBS Agro was closed and temporarily placed under the administrative control of the Russian Central Bank, later saved by a government stabilization fund. Smolensky’s new “front” banks include Soyuz Bank and First Mutual Society. Smolensky still heads the SBS-Agro group, the parent holding company.

- **Rem Vyakhirev** (president, Gazprom). The August crisis strengthened Gazprom and its chief, as the government has become more reliant on the company for revenue. Gazprom’s main problems remain unchanged: collecting domestic payments and negotiating its tax bills with the government. In 1998 it registered a $2 billion loss. The February appointment of former Gazprom boss and ex-prime minister Viktor Chernomyrdin as the government’s representative in Gazprom was seen by many as a prelude to Vyakhirev’s removal.

- **Vladimir Vinogradov** (president, Inkombank). Russia’s third largest bank was temporarily closed, its license withdrawn.
Russia’s Oligarchs Stole the State Machinery
by Stefan Hedlund

In 1989 Francis Fukuyama gained worldwide fame with his book The End of History and the Last Man. The fundamental point of the book was that the ongoing collapse of the communist order also meant a final triumph for the Western way of life. Basic liberal values concerning democracy, market economy, and the rule of law had emerged victorious.

Given the realities of the time, with the peaceful “revolutions” in Central Europe and the growing signs of a pending implosion of the Soviet Union, Fukuyama’s point was compelling. It would also come to underlie much of the Western democracies’ attitudes toward the growing number of former socialist states in Eastern Europe. In an environment marked by the “Washington consensus,” it had become difficult indeed to question whether a slavish imitation of the Western way really was the right way for everyone.

Is There Just One Right Way?

Ten years later we have accumulated sufficient experience to return to that question. In the part of Europe that then was cast in a “Soviet” mold and that on the surface looked the same from Potsdam to Vladivostok, widely divergent degrees of progress have been recorded. During transition to democracies, Central Europe raced ahead of the former Soviet republics, and on the territory of the former Soviet Union the three Baltic states have outperformed their Russian neighbor.

In the field of policy advice there has been a strong drive to explain such divergences in performance by pointing to varying degrees of adherence to the prescriptions issued under the Washington consensus. Now, however, the time is ripe to set such explanations aside and to question instead if there is any valid ground at all for the notion of universally applicable policy advice.

While the relative success stories in Central Europe have had little if anything to do with Western advice and Western financial support, in Russia the Western aid effort has been overwhelming. And Russia, as we all know, is now de facto bankrupt and a pariah on the financial markets. The artificial life support that is being offered by the IMF can do little more than postpone this realization. How then could all this effort fail so miserably?

No one has come closer to an answer than Jeffrey Sachs when he proclaimed that in the case of Russia he felt like a surgeon who had sliced open a patient only to discover that everything that was supposed to be there was not. So what exactly was missing? Some simple tools out of institutional theory may help us clarify that important question.

The Institutional Change Triad

Putting it briefly, institutional change is determined by the interplay among formal rules, which may be changed overnight, informal norms, which change only gradually if at all, and enforcement mechanisms, which provide legitimacy for the formal rules and may thus help transform the informal norms.

The main thrust of “shock therapy” was to change the formal rules, and to do it as quickly as possible. Tactically, if not openly, it was assumed that any cultural differences between nations that are embedded in social norm systems could safely be assumed out of existence.

The long string of discouraging events that have played out in Russia following the start of “reforms” in January 1992 have brought home the truth that cultural specificity can be ignored only at a price. The factors underlying the plunder and destruction of the Russian economy that have taken place in the name of “radical reforms” may be sought in two different dimensions—both linked to the institutional triad laid out above.

Beginning with the informal norm systems, it must be emphasized that a functioning market economy presupposes a set of supporting social norms that serve to block the formation of collectively irrational individual strategies of the prisoner’s dilemma kind. (See box next page.)

The “Wrong” Path Dependency in Russia

In the Russian case, however, social norm systems were very far from market conforming. This was due not simply to the antimarket practices of the Soviet system but also to historical patterns of behavior that are strongly marked by path dependency. A long list of examples could be advanced but perhaps the most important is a deeply rooted rule aversion—drawing actors into elaborate schemes of rule evasion.

Path dependence in such behavior may be established in two mutually supportive ways. On the one hand, we have organizational responses to a widespread practice of rule evasion that are marked by increasing returns and may, thus, not be
easily dislodged. On the other hand, we have the formation of mental models that serve to rationalize behavior that might otherwise have been clearly seen as socially irrational. These mental models constitute a perhaps even greater obstacle to the imposition of universal and transparent rules of the game.

To recommend and undertake sweeping deregulation in an environment that was marked by a whole set of such nonmarket attitudes and modes of behavior was tantamount to courting disaster, for the simple reason that there would be no one left to care for the collective rationality. Those who—somewhat belatedly—have been scolding the widespread Russian practice of rent seeking serve only to underline what really should have been obvious from the start.

The other dimension in which we may find Russian specificity concerns the role of the state. Again it bears emphasizing that a functioning market economy cannot exist in a vacuum. To mention one example, there can be no property without government, and without property rights there can be no market economy. It also bears recalling that it was not deregulation but the ability and willingness of the state to guarantee contracts and to act as a third party enforcer that gave birth to the market economy in the Northern Italian city states in the 12th and 13th centuries.

In the Russian case we may find another powerful path dependence in the view of the state as an alien and often hostile force—in a society that never really has evolved any sense of mutual relations between the rulers and the ruled. For example, the strong notions of mutual rights and obligations that marked medieval Western Europe, and which gave rise to the "Western way" of democracy, market economy, and the rule of law, have no correspondence in Russian tradition. The Soviet system in this respect did little more than reinforce old patterns of viewing the law as a mere instrument in the hands of the rulers.

Returning to what was said above about sweeping deregulation in a nonmarket environment, it must be added that the neoliberal crusade against the state has greatly compounded the damage. Given that the purpose of deregulation was to allow a wide scope for private revenue maximization in an environment where there were few if any norms against stealing from public coffers, the forced abdication of the state from its role as enforcer of common rules was a sure way of completely the disaster.

The grand program of privatization, once hailed as "the fastest in human history," provides but one illustration of this important point. By now there has been plenty said about the predatory behavior of the Russian oligarchs, but none has put it bet-

---

The Prisoner's Dilemma: Cooperate or Defect?

Two people have been arrested separately, and are held in separate cells. They are not allowed to communicate. Each is told the following:
* We have arrested you and another person for committing this crime together.
* If you confess, and the other person confesses, we will reward your assistance to us and your sparing us the expense of a trial by sentencing you both fairly lightly: to 2 years of prison.
* If you don't confess, and the other person also doesn't confess, we will not be able to convict you, but we will be able to hold you here and make you as uncomfortable as we can for 30 days.
* If you confess and the other person does not, we will show our appreciation to you by letting you go free. We will then take your testimony, in which you will implicate the other person as your accomplice, and put that person in prison for 40 years.
* If you don't confess, and the other person does, that person's testimony will be used to put you in prison for 40 years; your accomplice will go free in exchange for the testimony.
* Each of you is being given the same deal. Think about it.

What should each player do?

A risk-averse person will always confess. Confessing is better if the other person confesses (that way, you get 2 years instead of 40), and confessing is also better if the other person does not confess (that way, you get to go free instead of having to serve 30 days). Thus the equilibrium—the behavior we expect to see—is that each player confesses. The optimum, however, is clearly for each player not to confess, since each player then gets only 30 days.

With 40 years at stake, confession has nothing to do with whether one is guilty. It has only to do with what is at risk. The prisoner's dilemma would be a completely depressing game if not for the possibility that cooperation can evolve in the long run, even though in the short run it seems always better to strike and run—to defect.

Robert Axelrod in The Evolution of Cooperation (1984) conducted a series of experiments in which the game was played repeatedly. Participants were invited to submit strategies for playing this game over and over. He found that cooperation could arise if the game were played over and over again and if the players involved have a large enough chance of meeting again.

Based on material from Alannah Orrison, Social Sciences, Saddleback College, Mission Viejo, California.
UNDP Report Exposes Transition’s Dark Side—
The Rise in Poverty, Crime, Disease and Mortality

Countries of the former Soviet Union and Eastern Europe are paying the price for their transitions to a market economy. So claims the United Nations Development Programme (UNDP) in a newly released report, Human Development Report for Central and Eastern Europe and the CIS, 1999. The UNDP finds that “a human crisis of monumental proportions is emerging in the former Soviet Union.” The report had several major findings.

During the transition process, gains in freedom have been accompanied by losses of basic economic and social rights. Millions of people in the region are now unemployed or underemployed. Workers have been driven into the low-paying and insecure employment of the informal sector. Average cash incomes have plummeted. The comprehensive system of social protection has crumbled. Many basic social services now require fee payments or have been partially privatized. Public education and health facilities have deteriorated or have been replaced by private facilities available only for those rich enough to pay. Transition in the region has had other human development costs.

Loss of Life: The Missing 10 Million

Loss of life has been the largest single cost of transition, represented by the decline in life expectancy in several countries of the region—most notably in the Russian Federation and most strikingly among young and middle-aged men. The transition countries of Central Europe have fared much better than those of Eastern Europe. Most regrettable, this reversal of the trend in life expectancy means that several million people who did not survive the 1990s would have done so if life expectancy levels from before the 1990s had been maintained. As a consequence, an estimated 9.7 million men are “missing” from the region.

Morbidity levels have also risen. High morbidity is characterized by higher incidences of common illnesses and by the spread of such diseases as tuberculosis—diseases that had been reduced to marginal health threats in the past. Particularly serious has been the spread of sexually transmitted diseases and the rising threat of the HIV/AIDS epidemic.

Rising Poverty

The World Development Indicators 1999, published by the World Bank, provides the most recent illustration of the rapid rise in poverty: “Even before the crisis, poverty was undermining transition in Eastern Europe and the CIS. In 1989 about 14 million people in the former Communist bloc lived on less than $4 a day. By the mid-1990s that number had risen to about 147 million (from 4 percent of the population in 1988 to 32 percent in 1994).” In Armenia a household survey conducted by the Ministry of Statistics in 1996 found that about 55 percent of households were poor, based on a minimum consumption basket. In the Kyrgyz Republic, according to the National Statistics Committee, 71 percent of the population had an income below the poverty line in 1996—which was based on a scale of poverty in which 60 percent of total income is spent on the minimum food needed for survival. In George-
some form of malnutrition. Income-poor families in the transition countries have greatly reduced their consumption of milk, meat, and vegetables and are now relying on cheaper, lower-quality foods. Iron deficiency is common in the region. The number of Russian women suffering from anemia at the end of their pregnancies nearly tripled between 1989 to 1994. An area study in Uzbekistan showed that about 65 percent of women ages 15–50 were anemic in 1994. A 1996 survey in Moldova revealed that 20–50 percent of children had rickets because of inadequate intake of vitamin D. Infant mortality rates have been held down in most countries, but the number of low birthweight babies is on the rise, signaling future problems in child mortality and malnutrition.

Some people have experienced much greater impoverishment than others. In Russia in 1997 the average old-age pension was 34 percent of the average wage—and this probably overstated the real figure because delays in pension payments were even greater than wage arrears. Statistics show a sharp increase of inequality in Armenia, the Czech Republic, Hungary, Macedonia, Moldova, Russia, and Slovakia. In many countries—including Armenia, Georgia, Russia, and Ukraine—the share of average income spent on food rose dramatically. Despite the rising share of food, daily calorie intake fell as average incomes and expenditures declined.

### Shrinking Spending and Rising Costs in Education

Azerbaijan, Bulgaria, and Georgia are among the countries where educational spending has shrunk most. In Bulgaria education spending has been cut by more than 50 percent in real terms. Value amounts of scholarships and the number of students receiving them have declined. In Moldova, for instance, stipends for students have fallen to about a quarter of the average wage and are now provided only to students achieving good academic grades. Students and their families have been expected to bear the growing burden of schooling costs. Enrollment and attendance rates have fallen. Expenditures on nursery and other preschool facilities have been slashed. In the countries of the former Soviet Union, more than 30,000 pre-schools have closed between 1991 and 1995. This has increased the burden of household work on women and diminished their opportunities for employment.

In most countries the direct and indirect costs of school attendance have risen for children and their families because facilities, transport assistance, stipends and subsidies for books, and school meals have all been cut. Increasingly, the quality of schooling has declined due to overcrowding, dilapidated facilities, lack of heating in winter, underpaid teachers and support staff, and lack of health checks among children.

### Rising Unemployment and Informal Sector Activities

Mass unemployment has been a major source of social hardship in the 1990s for transition countries, with Macedonia and Moldova having extremely high levels (more than 30 percent), others with more than 20 percent.
percent (such as Armenia), and most not having more than 10 percent of their labor force officially out of paid work. Added to the openly unemployed are the millions of discouraged workers in the region who have dropped out of the labor force and the millions of others who are classified as on "administrative leave" or who continue to work but have not been paid for many months—as in Belarus, the Kyrgyz Republic, Russia, and Ukraine.

With the increase in unemployment and underemployment, informal economic activities—including the black market or other illegal activities—have expanded. In Russia informal activities accounted for about half the GDP in 1997, while in Hungary they were about 30 percent of the total national income. A high proportion of the economically active population is thus not covered by entitlement to insurance-based social protection and is being subjected to insecure working conditions with low pay and negligible or nonexistent benefits. This has become an important problem

### Ranking of transition countries according to their Human Development Index

<table>
<thead>
<tr>
<th></th>
<th>Life expectancy at birth (years)</th>
<th>Adult literacy rate (%)</th>
<th>Real GDP per capita (PPP$)</th>
<th>Life expectancy (years)</th>
<th>Education index</th>
<th>Human development index (HDI)</th>
<th>Real GDP per capita (PPP$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>79</td>
<td>99</td>
<td>99</td>
<td>22480</td>
<td>0.9</td>
<td>0.9</td>
<td>0.9</td>
</tr>
<tr>
<td>Norway</td>
<td>78.1</td>
<td>99</td>
<td>95</td>
<td>24450</td>
<td>0.89</td>
<td>0.98</td>
<td>0.92</td>
</tr>
<tr>
<td>United States</td>
<td>76.7</td>
<td>99</td>
<td>94</td>
<td>29010</td>
<td>0.86</td>
<td>0.97</td>
<td>0.95</td>
</tr>
<tr>
<td>Slovenia</td>
<td>35</td>
<td>74.4</td>
<td>99</td>
<td>11600</td>
<td>0.82</td>
<td>0.91</td>
<td>0.8</td>
</tr>
<tr>
<td>Czech R.</td>
<td>39</td>
<td>73.9</td>
<td>99</td>
<td>10510</td>
<td>0.81</td>
<td>0.91</td>
<td>0.78</td>
</tr>
<tr>
<td>Slovakia</td>
<td>42</td>
<td>73</td>
<td>99</td>
<td>7910</td>
<td>0.8</td>
<td>0.91</td>
<td>0.73</td>
</tr>
<tr>
<td>Poland</td>
<td>58</td>
<td>72.5</td>
<td>99</td>
<td>6520</td>
<td>0.79</td>
<td>0.92</td>
<td>0.7</td>
</tr>
<tr>
<td>Hungary</td>
<td>48</td>
<td>70.9</td>
<td>99</td>
<td>7200</td>
<td>0.76</td>
<td>0.91</td>
<td>0.71</td>
</tr>
<tr>
<td>Estonia</td>
<td>-7</td>
<td>68.7</td>
<td>99</td>
<td>5040</td>
<td>0.73</td>
<td>0.93</td>
<td>0.66</td>
</tr>
<tr>
<td>Croatia</td>
<td>-7</td>
<td>72.6</td>
<td>97.7</td>
<td>4895</td>
<td>0.79</td>
<td>0.88</td>
<td>0.65</td>
</tr>
<tr>
<td>Cuba</td>
<td>n.a.</td>
<td>75.7</td>
<td>95.9</td>
<td>3100</td>
<td>0.84</td>
<td>0.88</td>
<td>0.57</td>
</tr>
<tr>
<td>Belarus</td>
<td>-62</td>
<td>68</td>
<td>99</td>
<td>4850</td>
<td>0.72</td>
<td>0.93</td>
<td>0.65</td>
</tr>
<tr>
<td>Lithuania</td>
<td>-76</td>
<td>69.9</td>
<td>99</td>
<td>4220</td>
<td>0.75</td>
<td>0.91</td>
<td>0.62</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>69</td>
<td>71.1</td>
<td>98.2</td>
<td>4010</td>
<td>0.77</td>
<td>0.89</td>
<td>0.62</td>
</tr>
<tr>
<td>Romania</td>
<td>79</td>
<td>69.9</td>
<td>97.8</td>
<td>4310</td>
<td>0.75</td>
<td>0.88</td>
<td>0.63</td>
</tr>
<tr>
<td>Russian Fed.</td>
<td>-67</td>
<td>66.6</td>
<td>99</td>
<td>4370</td>
<td>0.69</td>
<td>0.92</td>
<td>0.63</td>
</tr>
<tr>
<td>Macedonia, TFYR</td>
<td>-80</td>
<td>73</td>
<td>94</td>
<td>3210</td>
<td>0.8</td>
<td>0.86</td>
<td>0.58</td>
</tr>
<tr>
<td>Latvia</td>
<td>-92</td>
<td>68.4</td>
<td>99</td>
<td>3940</td>
<td>0.72</td>
<td>0.9</td>
<td>0.61</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>-93</td>
<td>67.6</td>
<td>99</td>
<td>3560</td>
<td>0.71</td>
<td>0.91</td>
<td>0.7</td>
</tr>
<tr>
<td>Georgia</td>
<td>-105</td>
<td>72.7</td>
<td>99</td>
<td>1960</td>
<td>0.8</td>
<td>0.9</td>
<td>0.57</td>
</tr>
<tr>
<td>Armenia</td>
<td>-103</td>
<td>70.5</td>
<td>98.8</td>
<td>2360</td>
<td>0.76</td>
<td>0.9</td>
<td>0.53</td>
</tr>
<tr>
<td>Ukraine</td>
<td>-95</td>
<td>68.8</td>
<td>99</td>
<td>2190</td>
<td>0.73</td>
<td>0.92</td>
<td>0.52</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>-100</td>
<td>67.5</td>
<td>99</td>
<td>2529</td>
<td>0.71</td>
<td>0.91</td>
<td>0.54</td>
</tr>
<tr>
<td>Turkmenistan</td>
<td>-85</td>
<td>65.4</td>
<td>98</td>
<td>2109</td>
<td>0.67</td>
<td>0.95</td>
<td>0.51</td>
</tr>
<tr>
<td>Kyrgyzstan</td>
<td>-107</td>
<td>67.6</td>
<td>97</td>
<td>2250</td>
<td>0.71</td>
<td>0.88</td>
<td>0.52</td>
</tr>
<tr>
<td>China</td>
<td>-108</td>
<td>68.8</td>
<td>82.9</td>
<td>3130</td>
<td>0.75</td>
<td>0.78</td>
<td>0.57</td>
</tr>
<tr>
<td>Albania</td>
<td>102</td>
<td>72.8</td>
<td>85</td>
<td>2120</td>
<td>0.8</td>
<td>0.79</td>
<td>0.51</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>106</td>
<td>69.9</td>
<td>96.3</td>
<td>1550</td>
<td>0.75</td>
<td>0.88</td>
<td>0.46</td>
</tr>
<tr>
<td>Moldova</td>
<td>110</td>
<td>67.5</td>
<td>98.3</td>
<td>1500</td>
<td>0.71</td>
<td>0.89</td>
<td>0.45</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>115</td>
<td>67.2</td>
<td>98.9</td>
<td>1126</td>
<td>0.8</td>
<td>0.89</td>
<td>0.4</td>
</tr>
<tr>
<td>Vietnam</td>
<td>121</td>
<td>67.4</td>
<td>91.9</td>
<td>1630</td>
<td>0.71</td>
<td>0.82</td>
<td>0.47</td>
</tr>
<tr>
<td>Mongolia</td>
<td>n.a.</td>
<td>56.8</td>
<td>84</td>
<td>1310</td>
<td>0.68</td>
<td>0.74</td>
<td>0.43</td>
</tr>
<tr>
<td>Lao People's Dem. R.</td>
<td>n.a.</td>
<td>53.2</td>
<td>58.6</td>
<td>1300</td>
<td>0.47</td>
<td>0.57</td>
<td>0.43</td>
</tr>
<tr>
<td>Eastern Europe and the CIS</td>
<td>68.6</td>
<td>98.7</td>
<td>76</td>
<td>4243</td>
<td>0.73</td>
<td>0.91</td>
<td>0.63</td>
</tr>
<tr>
<td>Industrialized countries</td>
<td>77.7</td>
<td>98.7</td>
<td>92</td>
<td>23741</td>
<td>0.88</td>
<td>0.96</td>
<td>0.91</td>
</tr>
<tr>
<td>World</td>
<td>66.7</td>
<td>78</td>
<td>63</td>
<td>6332</td>
<td>0.69</td>
<td>0.73</td>
<td>0.69</td>
</tr>
</tbody>
</table>

for a growing number of women, who have been pushed out of the formal labor sector.

How Can New Development Strategies and Policies Help?

Because of the protracted and complex nature of transition, the responsibilities of the state should increase rather than decrease. The state should be active and intervene in critical areas where market forces cannot ensure an efficient allocation of resources or where access to basic assets and opportunities for livelihood is inequitable. Market forces alone can never be relied on to create a fair or equitable society.

The key to economic recovery is to stimulate higher levels of investment—including investment in human capabilities. Revitalizing economic growth should be a priority over expanding systems of social welfare. This does not imply, however, that essential expenditures on human development should be postponed. Such expenditures are a stimulus to growth and affect the trajectory, speed, and destination of the transition.

Shifting from universal coverage of benefits and services to selectivity and targeting based on means testing has created substantial problems. Such schemes rarely are effective in reaching the intended beneficiaries and invariably involve high administrative costs. In addition, governments have been wrongly advised to privatize many of their social services and social protection programs. The state must intervene because the substantial positive externalities from such expenditures, or additional benefits, are enjoyed by society as a whole.


Statistical Systems Need Overhaul in Transition Economies
by Misha Belkindas, Mustafa Dinc, and Olga Ivanova

Since the countries of Central and Eastern Europe and the former Soviet Union began the transition to market-based economies, their statistical systems have struggled to operate in the new environment. The quality of socioeconomic indicators has deteriorated significantly over this time, due primarily to the following reasons:

• With loosened controls, enterprises have been less inclined to provide complete data to statistical authorities. In pursuit of tax evasion, there are strong incentives for underreporting.
• Many newly established private enterprises, especially if family-owned, have escaped the statistical network because business registers are both incomplete and outdated.
• With the loosening of state control the informal economy—already well developed in the pre-reform period—expanded. Informal activities were not measured by statistical reporting and the macro aggregates were not properly adjusted to capture them.

In 1998 the Technical Assistance in Statistics team of the World Bank Development Economics Data Group conducted a survey to assess the quality of statistics in a number of transition countries. The findings suggest that in many countries the basic data are well below satisfactory level (assumed to be equal to 3; see figure), with a strong correlation between average data and the destination of the transition.
World Bank Loan Strengthens Russia’s Statistical System

A $30 million World Bank loan to Russia supporting the “Development of the State Statistical System” project was approved in May 1999 and covers all aspects of the statistical system. The Russian government will contribute an additional $8.55 million to the project. Goskomstat, the state statistical office, together with other data collecting agencies, faced many challenges that emerged with the systemic changes in the Russian Federation. In macroeconomic statistics, the Goskomstat started to shift to new macroeconomic indicators in compliance with the 1993 System of National Accounts (SNA), and began collecting and disseminating data on prices. It introduced the Consumer Price Index (CPI) and other price indexes as well as new indicators reflecting the social development. These efforts, helped by international organizations and bilateral donors, have led to substantial improvements in macroeconomic and social statistics in Russia.

Despite these achievements, further efforts are needed to achieve timeliness, quality, relevance, and comprehensiveness of the statistics. Further, certain economic activities carried out by those in the shadow economy either are not captured or covered partially by official statistical reports. This places additional challenges on statisticians to make adjustments to primary information. The World Bank-supported project will help to restructure the statistical system and strengthen the data collection agencies. It will introduce up-to-date information technology based on modern equipment and software to the system.

Goskomstat will implement the main part of the project at the federal and regional levels. Several subprojects will be implemented in other agencies—for example, the Ministries of Finance and Economy, the State Customs Committee, and several regional administrations. Consultation, collaboration, information sharing, and support among stakeholders (the World Bank, Goskomstat, other data producing government agencies, and data users) are considered to be key factors for success.

Collecting, Processing, and Disseminating Data

Data Collection. In the transition economies, most statistical observations are based on questionnaires filled out by respondents and returned to regional statistical offices. The amount of information reported varies and may include from 10 to 100 indicators. Because respondents include both enterprises and authorities, the content of the forms—along with the number of respondents—defines the “width” and the “depth” of the raw data made available for further processing.

The number of respondents depends on the survey technique. Statistical data collection can be conducted either on a full-coverage basis (census) or a part-coverage basis (a sample survey).

The full-coverage census—a predominant method under central planning—does not work in a market economy because it imposes an impossible workload on statistical offices due to the explosive growth in the number of entities to be surveyed.

For a sample survey to be representative, those developing the survey need to know the total number of enterprises and their relevant features. As the private sector grows and enterprise activity extends over regions and diversifies in nature, the reliability of statistical registers becomes increasingly important. Comprehensive and regularly recurring censuses of major economic areas are still needed to provide detailed statistics at the national, regional, and local levels. These censuses also provide a benchmark for the design and conduct of modern sample surveys based on probability sampling methods. Sample surveys, while technically more demanding in design and conduct, are less expensive and can produce more timely statistics than censuses.

Data Processing. Still highly decentralized in most transition countries, data processing in the form of data capture, editing, and tabulation is done in local offices. Thus primary data never get to the central headquarters; only summary information is passed upwards. This decentralized system was designed to help administer the command economy and track fulfillment of the plan. Its legacy is still alive: statistical data processing is carried out on microcomputers, using individual software programs. Thus central statistical offices are unable to use the more handy and efficient standard data processing and data analyzing packages available.

The data processing system needs to be changed. Data processing is more effective if done centrally—allowing for economies of scale in personnel and equipment. Sophis-
ticated data capture—high speed keying, coding, scanning, and electronic collection techniques—machine editing and imputation, complex tabulation, data storage, and backup are also easier to handle from a single location. Centralized processing improves uniformity and access to data, but it requires statisticians with better training and more powerful computers.

Data Dissemination. Statistical offices and other government agencies in transition economies have just started to provide data to users in electronic formats. Most of these products are simply electronic versions of printed reports. Electronic products should contain more detailed information than printed products, given the lower cost of providing data in such electronic formats as CD-ROM. Even entire data sets can be provided to users, allowing them to aggregate the data according to their needs.

The Internet is rapidly becoming the worldwide medium for information dissemination. Statistical offices should use the Internet to deliver products to users. But this assumes the availability of the necessary electronic hardware. The Internet offers new possibilities to central statistical offices to recover some of the costs of their operations. They can make available certain statistical information on a subscription or fee basis. Government agencies, however, should have access to all this information free of charge.

Checklist of Unfinished Business

Transition economies have made considerable improvements in their statistical systems, but there remains much to accomplish:
- Designing and conducting sample surveys that meet international standards, gradually replacing regular economic and business censuses with sample surveys, using an optimum mix of censuses and sample surveys for economic and business statistics, and providing the necessary training for staff.
- Conducting a broad-based review of what kinds of statistics are economically justified at the state, regional, and district levels; deciding how frequently these are needed and what accuracy criteria should be applied to key statistics; and working out a timetable to apply internationally accepted, standard practices.
- Establishing a solid statistical infrastructure and well-designed legal framework that includes business and household registers, questionnaires, censuses, and survey procedures.
- Reorganizing and modernizing the design, strategy, and implementation of the data dissemination system, thus improving economic management and decisionmaking in the government as well as in the private sector.
- Creating standardized electronic data sharing facilities, with user-friendly software, supported by effective communications, to serve government users in a timely manner.

How to Find Funds?

In many transition countries, restructuring the statistical system requires substantial resources—technical and financial. The World Bank's support takes several forms, depending on the scale and scope of the project. It can come in the form of a grant, part of a larger World Bank loan, a separate loan, or a partnership arrangement cofinanced with bilateral donors and other international agencies.

Governments in transition countries should work out detailed plans and cost estimates for developing their statistical systems. These plans would enable them to assess their financial needs, decide whether to apply for a World Bank loan, and allow possible donors to coordinate support. To accomplish this more effectively and efficiently, Development Economics—the research arm of the World Bank headed by Vice President and Chief Economist Joseph Stiglitz—has recently established a special trust fund that will extend the ability of transition economies to get technical assistance and financing for development of their statistical systems.

Misha Belkindas is Team Leader, Mustafa Dinc, Consultant, and Olga Ivanovais, Economist at the TAS team at DECDG, the World Bank.

Parental Advice

"I can make you member of a board of directors, but you have to finish elementary school on your own."

From the Hungarian magazine Hôcipô
A substantial amount of output in many developing and post-communist transition economies goes unreported. This "unofficial economy"—made up of underground and often illegal activities—impedes the country's economic growth in a number of ways. First, firms operating underground in this shadow economy cannot make use of market-supporting institutions—such as the courts—and so may invest too little. Second, doing business in secret generates distortions because of the effort needed to hide activities and avoid detection and punishment. Resources that are hidden may not find their highest-value uses. Third, underreporting costs the government tax revenue that might be put to worthwhile use.

Some Reasons for Hiding

What causes firms to operate in these unofficial economies? Economic literature offers four explanations, each with distinct policy implications:

- Entrepreneurs may go underground when statutory tax rates are high and other official regulations are onerous. Cutting taxes and red tape are, according to this view, the main ways to keep firms in the official economy.
- The predatory behavior of government officials—who seek bribes from anyone with officially registered economic activity—will drive some businesses into unofficial activities. In this view eliminating bureaucratic corruption will prevent some of the flight into the shadow economy.
- Firms might hide some of their output to escape extortion by criminal gangs. In this view the remedy to unofficial activity is better policing and enforcement of the criminal code.
- The unofficial economy may result from the inadequacy of the institutional environment. If it is hard to enforce contracts because the courts do not work, a firm gains little from registering its business. In this view the state needs to invest in a commercial court system to deter unofficial activity.

Most of the empirical research on the unofficial economy uses macro data, such as the amount of cash in circulation or electricity consumption. These estimates consistently show that countries with inefficient regulatory environments and widespread corruption have an unofficial economy leading more than in excess of 40 percent of the official GNP.

Does Experience Match Theory?

Post-communist countries offer an opportunity to examine the determinants of unofficial activity because, starting from similar levels of unofficial activity, their regulatory environments have diverged. Recent studies estimate that in 1995 the unofficial economy in Poland was less than 15 percent of GDP but in Russia and Ukraine it was around 50 percent.

So why do firms hide? Using firm-level data from a survey of similar private manufacturing firms in Poland, Romania, Russia, the Slovak Republic, and Ukraine, we tried to find the reasons. The data show that the five countries fall into two groups: Russia and Ukraine on the one hand, Poland, Romania, and Slovakia on the other. By all measures the countries of the former Soviet Union are more hostile toward business than the East European countries. A striking 90 percent of Russian and Ukrainian managers say it is normal for bribes to be paid to government officials. Around 90 percent of the managers also said that firms in their industry pay for "protection" of their activities. The firms suffer extortion not only from bureaucrats but also from criminal gangs.

Corruption is less pervasive, though not uncommon, in Eastern Europe. In the Slovak Republic 40 percent of managers say bribes are paid, and in Poland and Romania that number is 20 percent. The mafia is less of a problem in Eastern Europe as well. Only 15 percent of Slovakian managers, and still fewer Polish (8 percent) and Romanian (1 percent) managers, said protection payments are normally made. The firms' tax payments are lower in these three countries than in Russia and Ukraine. One cost to a firm operating outside the formal economy might be less reliance on the protection of the courts, making it hard to maintain contracts with its trading partners. When asked whether they could use courts to enforce contracts with trading partners, just over a half in Russia and Ukraine said they could, whereas two-thirds or more in Poland, Romania, and the Slovak Republic said they could.

All the firms in our survey are registered and operate in the formal economy, but many of them hide at least some output. Underreported sales are highest in...
Ukraine (averaging 41 percent of total sales) and Russia (29 percent), and much lower in Poland, Romania, and the Slovak Republic (between 5 and 7 percent). Managers in Russia and Ukraine, then, face worse bureaucratic corruption, more mafia extortion, higher taxes, and a less effective court system. They also hide more of their output. Comparing averages across the countries, therefore, gives support to all four explanations for hiding.

Firm-level data from Poland, Romania, and the Slovak Republic find no significant association between tax rates and the extent of unofficial activity in those countries. If there is a tax rate effect, it probably lies more with the way the tax system is operated.

We find only weak evidence that the ability of the legal system to enforce contracts affects entrepreneurs’ decisions on whether to hide their activities. Ability to access bank loans and to involve outside owners also do not appear to be significant issues. This is probably because the firms in our sample maintain at least some official activity and have access to government provided public services.

We find no evidence that payments to private criminal groups affect the decision to hide activities. This may be because we surveyed manufacturing firms that are relatively immune from mafia-run protection rackets. Most likely, however, it indicates that organized crime is not as large a problem in Eastern Europe as it is in Russia and Ukraine.

There is a significant association between corruption—in the form of bribes paid to government officials—and the hiding of output. This is far worse in Russia and Ukraine than in Eastern Europe. But even within Eastern Europe, firms that say bureaucrats are corrupt are more likely to hide their activities. However, we cannot distinguish whether firms hide more to avoid corruption or whether firms that hide more have to make illegal payments. We leave this for further research.

This article is based on a paper by Simon Johnson, The Sloan School, MIT and WDI Research Fellow, Daniel Kaufmann, World Bank, John McMillan, Stanford and WDI Research Fellow and Christopher Woodruff, UCSD.

Foreign Investment and Emerging Markets: 
Highlights of a Conference Organized by the William Davidson Institute 
by Bernard Yeung

On June 18—19, 1999, 25 distinguished experts on FDI attended a conference in Ann Arbor, Michigan, on the impact of FDI on emerging markets. Following introductory comments, the five sessions focused on capital markets, labor markets, institutional and economic performance, social transformation, and public policies.

The sessions were linked by the theme that the institutional environment matters—where the institutional environment is defined to include the level of entrepreneurial and monitoring capability and the legal and sociological structure. The impact of foreign entry on emerging economies depends on the initial institutional environment and how it evolves. In turn, foreign entry changes the institutional environment, as does the behavior of the indigenous firms. Understanding these relationships and their underlying dynamics will lead to fundamental insights for researchers, managers, and public policy decisionmakers.

Richard Caves of Harvard University set up the conference’s theme in his introductory presentation. He surveyed crucial findings on the spillover effect of FDI, arguing that the capability to develop complex business organizations might be important for economic development and for the interaction between FDI and indigenous firms. Spillovers thus depend on exactly what constrains the indigenous development of complex enterprises. He proposed four constraints: the local environment’s traditional forms of interpersonal relationships and its shortage of skills, knowledge, and managerial capabilities.

Following Richard Caves, Monty Graham of the Institute of International Economics noted that most of the recent empirical literature on FDI and economic growth fails to reveal a robust relationship, partly due to weaknesses in data and measurement. FDI data are not very reliable. Also, FDI is not merely bricks and mortars, it includes the extent to which the investing firm involves itself in the local economy. To measure FDI properly, one has to master how it manifests itself in terms of “ownership, control, and contribution to capital formation.” Measurement is further complicated by the fact that the influence of FDI on economic growth is both multifaceted and highly variable.

Capital Markets

Randall Morck of the University of Alberta presented a summary of his work with various coauthors including Bernard Yeung, University of Michigan and Davidson Institute, David Stangeland, University of Manitoba, Wayne Yu, Queen’s University, Ontario and Artym Durnev, University of Michigan. He presented evidence that economic growth is slower in countries in which the control of wealth is concentrated.
in a few hands. Many emerging economies have such "controlling hands"—entrenched managers who often do not have a significant share of ownership. To preserve their status, these managers discourage the development of a healthy capital market, resist reforms and liberalization, and typically do not introduce innovations in their own firms. Morck showed some evidence that firms with these controlling hands have access to less expensive capital but also have subpar performance. Moreover, economies where control of wealth is concentrated tend to be less open and spend less on innovation.

After controlling for openness, regulations, and spending on innovation, economic growth remains negatively associated with concentration in the control of wealth. Morck’s results suggest that concentration in asset control negatively affects the rest of an economy. He further showed evidence that foreign entrants tend to break up the stranglehold of controlling hands by reducing their control of corporate assets.

Simeon Djankov of the World Bank and Caroline Freund of the Federal Reserve Board followed with a discussion on foreign acquisition activities in Korea. They showed that foreign acquisition targets are more likely to be affiliated with business groups.

Labor Markets

Juan Alcacer of the University of Michigan presented evidence that FDI is attracted not only by low wages but also by inexpensive human capital. In order to attract FDI, a country needs to attain a minimum level of human capital development and then offer that capital at a competitive wage. Cross-country data fit better with his model than arguments focusing on wages. Implicit in this argument is that in order to attract FDI, an emerging economy’s workforce needs to attain a fair level of “business sophistication,” a point that echoes Richard Caves’ opening presentation. Alcacer then raised the issue that there was little FDI in many Eastern European economies, despite their high levels of human capital. His statistics suggested that the explanation is that these economies lack infrastructure and entrepreneurial capabilities and that they carry a high political risk.

The work by Ann Bartel and Ann Harrison of the Columbia Business School further developed the conference’s emerging theme. The authors disentangled the sources of public sector inefficiency using 1981–95 panel data on manufacturing firms in Indonesia, focusing on protection from competition and access to soft loans. According to their results, the existing controlling hands of corporate assets clearly are not running their firms competitively and yet try to preserve the status quo. As a consequence, the local economy does not readily develop indigenous agile firms that can benefit from interaction with foreign business.

Institutional and Economic Performance

Bruce Kogut of the University of Pennsylvania and Andy Spicer of the University of California–Riverside focused on the importance of institutions. They showed that in the absence of an institutional mechanism of state regulation and trust, privatization policies in the Czech Republic and Russia are not successful. Indeed, without strong institutions markets become arenas for political contests and economic manipulation.

Taru Khanna of the Harvard Business School presented his work with Krishna Palepu, also of Harvard Business School. Using Chilean data they demonstrated that firms enjoyed net benefit from their affiliation with Chilean business groups in the 1988–96 period if group diversification exceeded a threshold level. They also found evidence of nondiversification-related group benefits. Their results suggest that firm-groups may be useful substitutes for poor market institutions.

Social Transformation

Srilata Zaheer of the University of Minnesota drew the audience’s attention to how interactions with foreign business led to social changes. Interactions with foreign business include direct investment, licensing, joint ventures, and more. Social change as a result of these interactions was felt in labor rights and environmental standards, just to name a few. Public discussions in developed economies often tend to be ethnocentric, condescending, and dominated by special interest groups, many with hidden self-interests. Special interest groups often use multinationals as a means for pushing their social agenda on poorer economies. Most often lacking in the discussions is an understanding that people in the poorer economies are capable of making conscious and voluntary choices on their own, though in some cases they may not be very well informed. Zaheer pointed out that although systematic research has begun to appear, the literature in this area is still thin.

Public Policy

Marina Whitman of the University of Michigan Business School discussed the change in U.S. policy discussions regarding FDI. In the past, FDI was seen as a vehicle for the economic development of poor nations and as a partial substitute for foreign aid. Also, a clear positive relationship was thought to exist between economic development and political stability—pointing the way toward democracy. In the 1990s the focus shifted to economics. Policy discussions now focus on the relationship between FDI and employment, wages, income distribution, trade and payments balances, home capital investment, and spending on innovations.

More recently new and important issues have been added to the discussion: Do multinationals lead to “racing for the bottom” as regards environmental rights and
labor rights? Do domestic policies like export controls (for security reasons) and does the Foreign Corrupt Practices Act affect a multinational's ability to compete globally? Finally, Whitman drew the audience’s attention to a question Danny Rodrick first raised: has globalization gone too far? In a number of industrialized countries there is tension between the greater economic uncertainty and the perceived need for social insurance created by increased openness. Tension also stems from the growing limitations on the ability to tax mobile factors of production—particularly capital.

Jan Svejnar, Executive Director of the William Davidson Institute, described the uneven distribution of FDI in Eastern European countries. All these countries have gotten over an initial fear of being taken over by foreigners, and the race has begun for FDI. The attempt to have a level playing field has been replaced by an attempt to maximize FDI flows.

**FDI Motivations**

Linda Lim, of the University of Michigan Business School, pointed out that Asian economies were more receptive to FDI. Cases in point would be Singapore and Malaysia, which have by far the highest per capita, or per dollar of GDP, FDI in the world. She offered several important explanations. The first is the geography and pro-trade history of these countries. The second is that these countries have diversified local cultures that are receptive to the economic participation of foreigners. Finally, foreign entrants are competing with local capitalists who are mostly a very small and politically vulnerable ethnic minority. These countries use familiar public policies like tax holidays to attract FDI. Often attached to these attractions are pre-designated regional location and requirements in local content, technology transfer, and employment. Many of these countries are opponents of the WTO policy intended to remove some of these practices.

David Li, of the University of Science and Technology, Hong Kong, and the Davidson Institute, described the peculiar pattern of FDI in China, most of which has taken place in the form of joint ventures between foreign entrants and indigenous firms since 1992. A large majority of the investment was round trip in nature; in other words, indigenous firms invested in Hong Kong and then reinvested in China as foreign investment. He argued that local governments, competing for foreign investment, created internal taxes and regulations that favored FDI. As a consequence, a local enterprise forming a joint venture with a foreign enterprise could use the joint venture to compete more successfully with other local firms.

Simon Evenett of the World Bank highlighted the concerns of the supranational organizations—the growing pressures for local autonomy within many developing nations, leading to political instability and whether there is too much globalization. The fear is whether too much globalization leads to economic instability. Additional concerns about globalization include urban population growth, environmental issues, and the needed improvement in banking and other capital markets.

Don Lessard of MIT concluded the conference by pointing out that we need to know more about institutional environment and how it affects a country's economic interaction with other economies.

**Recent working papers of the William Davidson Institute:**

How Will We Know Transition is Over?
by Annette N. Brown

This introductory chapter of the author’s study “When Is Transition Over?” brings together the thoughts of leading scholars on the process of transition, with a focus on the institutional, economic, and political standards that indicate the end of the transition period.

The countries that are changing from communist to post-communist societies are undergoing a process that has been and continues to be difficult, tumultuous, and often painful for their citizens. In a few short years, people in these countries have lived through more social, political, and economic change than those in more developed, Western economies will see in a lifetime. Both for those living through this process and for those who study and analyze it, there is a recurring question: When is this transition over?

During the 1997/98 academic year, six distinguished economics scholars—Marie Lavigne, Alan Gelb, Anders Åslund, Nicholas Lardy, Jan Svejnar, and János Kornai—visited Western Michigan University and offered their answers to this question. Their answers are in some ways very different and in others very similar, but always interesting and insightful. In this introduction, I will present the speakers, their lectures, and their answers.

The Speakers

Marie Lavigne began her lecture by outlining the many legacies of communism and explaining how they negatively affect the transition process. She argued that one significant legacy is what she calls, crediting János Kornai, “paternalism.” This legacy means that changes in basic attitudes are needed before people behave as proper economic “agents.” She then described the basic elements of the transition package, discussed generally how these elements have been implemented, and compared the outcomes. In short, she found that in the transition countries liberalization has been fast (in most cases), stabilization fragile, and structural transformation slow. Unlike the other authors, she also assessed the outcomes using the Human Development Index, which so far shows improvements in only a few countries. Lavigne listed several barriers to achieving standard market economies and then discussed more specifically the obstacles that the candidate countries face in achieving EU membership. In terms of barriers, she again stressed the problem of attitudes and emphasized the need to build strong civil societies. For EU membership, the obstacles arise from poorly defined membership conditions that are in some cases stricter than those for current members.

Alan Gelb started by elaborating a point that general economic analysis often forgets or ignores, but is brought to the forefront by transition: “Like automobiles, market economies come in many different models.” To be successful, Gelb argued, reform policies need to be broad-based (because they are highly interdependent) and sustained (because the cumulative exposure to reforms is more important than the immediate reaction in determining outcomes). Different forces drive reforms, which naturally lead to differences in the pace and phasing in of change across countries. There are also many, if not too many, explanations for transition outcomes. Gelb asked the question, “Could an alternative policy have worked in Central and Eastern Europe and the former Soviet Union?” In his conclusion, he raised an even more important question: “What kinds of economies and societies will the transition countries turn out to be?” He identified, in particular, the increasingly unequal distribution of property and income as a major challenge for the future. Where Gelb offered explanations for the differences in outcomes among countries, Anders Åslund focused on one issue: rent-seeking. Åslund drew a clear line between rent-seeking (which he defines as the extraction of monetary benefits from the government) and inflation and between inflation and GDP performance. He then identified the various types of rent-seeking and identified who has benefited the most from each. In explaining why rent-seeking was so much more a problem in the former Soviet Union than in East-Central Europe, Åslund explored the political-philosophical legacies of the communist system, including the strength of the old communist elite (nomenklatura); the weaknesses of the post-communist state, democracy, and civil society; the quality and independence of the media; and the people’s understanding of media; and the people’s understanding of

Nicholas Lardy’s lecture was distinct in that it focused on one country—China—that has followed the very different reform path of gradualism. Lardy compared China’s reforms, starting in the 1970s, to those of Eastern Europe and the former Soviet Union and argued that in spite of China’s superior economic performance, its reforms are unsustainable. Three issues raise particular concern: enterprise performance and debt, nonperforming bank loans, and declining tax revenues. In the second part of his lecture, Lardy examined the necessary reform of China’s banking sector in more detail. It would be extremely difficult for China to default on
household liabilities, as Russia did, because the volume of household savings is tremendous. It would also be infeasible for China to gradually recapitalize banks through reinvestment of profits, as Hungary did, because the necessary recapitalization is too great. Instead, Lardy recommended that China recapitalize by injecting government bonds into these banks.

Jan Svejnar, in the first half of his lecture, described the “Central European model” of transition and compared and contrasted it with two other models, the “Asian model” and the “Russian and NIS model.” Svejnar identified several key areas where the transition outcomes have been systematic across the Central European countries, chief among them being that all of these countries now have functioning market economies. More interesting, perhaps, are the distinctive results that he identified among these countries, which so often are considered a group. Privatization has proceeded unevenly, labor force adjustment has differed significantly, and various exchange rate policies have resulted in diverse foreign trade performances. The second half of his lecture focused on the challenges ahead for Central Europe. Although other speakers visited this theme, Svejnar provided the most detail, giving what Lavigne might call a “full prescription for finishing transition in Central Europe.” The foremost challenge, Svejnar argued, is to generate and sustain high rates of growth. The building blocks for this growth include such strategies as high rates of efficiently placed investment, human capital development, and establishing effective corporate governance.

János Kornai set out to discuss transformation rather than transition, where transformation can be called the processes following transition that improve the functioning of a capitalist system. An important part of transformation—not just in formerly communist countries but also in some Western countries—is the reform of the welfare state. Kornai stated explicitly the ethical principles underlying his analysis: respect for individual sovereignty, moral obligation to solidarity, and commitment to democracy and the transparency of public decision-making processes. The initial conditions in any transforming economy determine which of these principles might be problematic. Kornai argued that there is a clear need for health care reform in Hungary. Hungarians are currently demanding improvements in the quality of their health care system without understanding who pays for this service. He offered several concrete suggestions as to how the provision of health care can be changed in line with his underlying ethical principles.

These lectures shared several threads. All speakers accounted for the initial conditions, or legacies, in their analysis. In particular, they all mention the need to change people’s attitudes toward and understanding of capitalism and market economies. Related to these changes at the individual level, most also mentioned the necessity to develop strong civil societies, in which institutions support both capitalism and democracy. The speakers generally considered transition to occur in two stages: the first primarily involves liberalization and stabilization, the second encompasses a myriad of structural reforms. They roughly agreed that the first stage is complete in many of the countries, but that progress and success in the second stage have been quite mixed. Finally, most emphasized the concept of transparency as an important goal in a variety of contexts. The lectures also differed in many ways, and perhaps the most interesting divergence lies in the answers that are presented.

The Answers: When Is Transition Over?

Lavigne responded directly: “I think the question is unanswerable.” Indirectly, however, she offered another reply: transition is over for the CEE countries when they become members of the EU. This answer is important to consider because it is obvious to many people in Europe, but Lavigne deems it unworkable because the EU conditions are vague and unequally applied. Although she did not offer her own criteria for the end of transition, Lavigne concluded that transition is not over yet.

Gelb answered the question straightforwardly: “Transition is over when the problems and the policy issues confronted by today’s ‘transition countries’ resemble those faced by other countries at similar levels of development.” He further stated that no matter how this definition is operationalized, the “transition countries are not there yet.”

Åslund measured the end of transition according to the reduction of rent-seeking, which reflects a variety of institutional reforms. According to his standard, Åslund concluded that transition is over in all but a few countries.

Lardy argued that transition in China would not be complete until three sectors were aggressively reformed: state-owned enterprises, the financial sector, and government service provision.

Svejnar presented two conditions for transition to be over: when central planning is abolished, and when an efficiently functioning market system has taken its place. According to these conditions, he concluded that transition is not over in any of the considered economies.

Kornai answered this question with the most precision. Transition is over when three—and only three—criteria are met: when the communist party no longer has monopoly power, when the dominant part of the means of production is privately owned, and when the market is the dominant coordinator of economic activities. Using these criteria, he concluded that transition is over in Hungary and probably in several other countries as well. We can group these answers into three categories: systemic, outcomes, and institutional.
Systemic. Komai’s answer is systemic in that he looks at changes in the features of the economic systems to judge when transition is over. He makes clear that the new system, the endpoint of transition, is a market economy as defined by his specific criteria. Gelb’s answer also contain a strong systemic component but is more obscure than Komai’s. Gelb defended this obscurity by arguing that models of market economies vary greatly. Each transition economy will have its own terminus of transition, which may or may not resemble a Western market economy. Therefore, the indicator seems to be when the economy resembles a market system rather than a communist one. In spite of a similarity in their criteria, Komai and Gelb reached very different conclusions. Komai believed that transition is over, at least in some countries, while Gelb said none of the countries has reached this stage.

Outcomes. In the second category, the answers are based on outcomes. Lavigne considered, and then discarded, the criterion that countries have gained EU membership. While such a result is certainly dependent on systemic changes, the suggested criterion itself examines just the outcomes. Svejnar also proposed a results based answer: the end of transition is the state of an advanced market economy. Again, a systemic component is involved, especially in the first condition of eliminating central planning, but the ultimate condition is based on outcomes. Svejnar defined efficient functioning to include achieving rapid and sustainable rates of growth and becoming compatible with advanced market economies. In short, these answers suggest that transition will be over not just when economies operate differently, but also when they operate successfully. As a result, although Svejnar and Komai clearly agree that the countries of Central Europe are market economies, Svejnar said they have at least 10 years to go, while Komai said transition is over.

Institutional. Åslund’s and Lardy’s answers, which I have categorized as “institutional,” fall somewhere in the middle. Although the rent-seeking that Åslund examined arises from the systemic changes, clearly the new market system is considered to be part of his endpoint. For example, the liberalizations of domestic prices and trade represent two measures toward eliminating rent-seeking that are also part of the systemic change. However, Åslund’s endpoint encompasses more. Policies to abolish rent-seeking include the liberalization of foreign trade, the unification of the exchange rate, and the elimination of interest subsidies. He also indicated that a strong central bank is important. With these latter conditions, Åslund included elements of institutional, or structural, change in his criteria for the end of transition.

Like Åslund, Lardy identified specific institutional reforms, beyond the systemic changes, that are required for the completion of transition in China. State-owned enterprises need to be restructured so that they are forced to be profitable and desist from accumulating large bank debts. The financial sector, the emphasis of the lecture, needs to be recapitalized and reformed so that banks operate as effective financial intermediaries. The government needs to change its operation as well. It needs to collect more tax revenues and increase its role as a provider of social services so that the enterprises can focus on their primary production. These criteria are clearly institutional, especially since Lardy avoided calling for the privatization of state-owned enterprises, which would be a more systemic change.

Gelb also highlighted institutional determinants. For example, he suggested that, even with private ownership (a systemic feature), the Czech voucher funds (an institutional element) will make the Czech economy distinctive, and thus in transition for some time to come. He concluded that, in practice, the core systemic changes and the combination of institutional changes go hand-in-hand in moving an economy toward its transition endpoint. Compared with Åslund’s and Lardy’s approaches, how-ever, Gelb’s is again more obscure. Where for Åslund rent-seeking identifies a fairly specific set of necessary institutions, Gelb allows that the combinations will vary according to different levels of development.

In sum, the answers the speakers provided were very different, and the old maxim that economists never agree seems to hold true. The question is academic, however, and more important than the proclamation about whether or not transition is over is the analysis of the problems these countries still face and the recommendations for what can and should be done to address them. Along these lines, the speakers tended to agree.

Postscript

Clearly the productive structure of any market economy is constantly evolving, and these changes on the margin are vital for the continued success of the system. I do not mean to say that transition is over when the organization of production stops changing, but rather it is over when the productive structure has been transformed from its inherited organization to one that continues to change only slowly with the evolution of the economy. For example, when the processes of entry, exit, expansion, and contraction act to completely reshape industries, the economy is still in transition. When these processes settle such that they only change overall industry structure during a long period of time, then transition is over. Like Gelb’s endpoints, mine are obscure—because we do not know what the long-run equilibrium will resemble. We do not even know whether for any given country there is one, or more than one, possible equilibrium. Thus, this answer, like many answers to academic questions, leads to more questions.

How to Make Transition Work for Women—
Gender Equality: A Wake Up Call
by Sarah Nedolast

Transition from a socialist to a market economy in Central and Eastern Europe has sparked wide debate about shock therapy, gradualism, and sequencing. But what effects have these changes brought on by transition had on those who live in these changing societies? In particular, what effects have these changes had on women?

While there is always a price to pay and sacrifices to be made during economic development, the groups that pay most dearly are often overlooked. In Central and Eastern Europe, women bear the brunt of change—as shown by labor market, political, and poverty indicators. Women's position in these societies has declined rapidly during transition—a transition that largely is being managed by men.

Under the communist system gender equality was a nonissue—the state proclaimed that equality had already been achieved. Officially, women and men were guaranteed equal pay for equal work, equal access to education, equal property and parental rights, and equal representation in the political realm. In addition, women were granted liberal maternity leave and inequality between spouses was abolished by the state. But much of the equality proclaimed by the socialist system was equality under an oppressive regime.

After 10 years of transition, women in this region are facing many difficulties. Statistically, economic reforms have most adversely affected women as a social group. Women's participation in the labor force has declined sharply, they have lost their voice in government, and they make up an increasingly large percentage of the poor.

- **Labor force participation.** Women's participation in the labor force has decreased in Central and Eastern Europe, making women a disproportionately large percentage of the unemployed. Although women make up just a little more than 50 percent of the population in the region, a of post-communist societies are still unwilling to acknowledge women's rights as an issue, and women often are not aware of their rights—or how to defend them. As a result of free elections in transition economies, women on average hold few parliamentary seats. Although under the communist electoral system women were assigned one-third of these seats, these fixed elections were misleading because real decisions were made in the Central Committees and Politburos of the Communist Parties—where women were highly underrepresented.

- **Poverty.** As the number of single parent families rise, state benefits decrease, and employment opportunities fall, women are becoming the most populous group of people living in poverty in Central and Eastern Europe.

These outcomes may be explained by a variety of events. Many large, state-owned enterprises—which once employed many women—have closed during transition. Because women are considered higher risk and more expensive labor, finding employment for men is the priority. Women might, for instance, take maternity leave and stay at home during the first years after a child is born, a period during which it is against the law to fire them in several countries.

Women are also often under pressure to return to traditional roles: staying home and taking care of the family. Under these circumstances a woman's chances of being considered a serious contender for a job—or for that matter political office—are rather slim. Further, men are more likely to benefit from retraining or education opportunities.

These trends and the prospects for eliminating gender discrimination were the topics of the recent seminar “Making the Transition Work for Women in Europe and Central Asia,” hosted by the World Bank in Washington, D.C. The seminar brought together gender experts, scholars from Central and Eastern European, NGO leaders, and practitioners to offer suggestions to ensure that transition would work for women in the region. Their suggestions included the following:

- **Women entrepreneurs should receive more support and easier access to credit.**
- **Women should be encouraged to participate more actively in politics, especially by increasing their presence in national legislation.**
- **Women should be encouraged to take part in retraining and take advantage of educational opportunities.**
Women-oriented civil organizations should be granted adequate support.

Democratization and economic progress provide women with the tools to overcome the “invisible barriers” impeding their advancement. Opportunities exist to capitalize on their entrepreneurial skills and assume positions of management. Women can pursue meaningful participation in the political system. At the least they can participate and voice their concerns in civic organizations, which are becoming an important force in society.

Transition strategies should take into account the policy effects on women, and women must participate in the formulation and implementation of reforms. The best way to ensure an equal and open society is to provide for equal participation in the society’s development.

Sarah Nedolast is Junior Associate for PREM Vice Presidency, the World Bank.

World Bank/IMF Agenda

World Bank Lends Record $29 Billion in Fiscal 1999

The World Bank’s loan commitment totaled $29 billion in the fiscal year that ended June 30, with Argentina, Indonesia, China, and the Republic of Korea receiving the largest portions. The total surpassed the previous record of $28.6 billion set in 1998. The World Bank said that at the same time that its lending amounts increased, the quality of its loans also improved with fewer projects at risk of not reaching their goals. “While we see for a second fiscal year that the financial crisis has resulted in record lending, I am cheered to see an increase in the quality of loans we have provided,” World Bank President James Wolfensohn explained.

During the 1999 fiscal year the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA) combined gross disbursements (transfer of money) totaled $24 billion, compared to nearly $25.5 billion in fiscal 1998. IDA accounts for about 25 percent of the loans made by the Bank. The remaining 75 percent of World Bank loans are market-rate loans through the IBRD.

ECA: More Loans Less IBRD Disbursement in Fiscal 1999

New lending commitments from the World Bank to countries of the Europe and Central Asia (ECA) region totaled $5.29 billion for 74 projects in 21 countries in fiscal 1999. This figure includes market-rate loans made by the IBRD and concessional loans from the IDA. The total compares with $5.22 billion in fiscal 1998, and $5.05 billion in fiscal 1997. At the same time, IBRD disbursements in fiscal 1999 dropped to about half of fiscal 1998—from $4.41 billion to $2.43 billion. The crisis in Russia and Ukraine and the Kosovo-related developments played a large role in the negative trend. IDA disbursements increased a bit: amounting to $501 million, compared to $439 million in fiscal 1998. Since 1990 the Bank has committed $38 billion to the borrowing countries in the ECA region.

World Bank Resumes Loan Disbursements to Russia

In early August the World Bank resumed the third Structural Adjustment Loan (SAL-3) program for Russia, along with a revised repayment schedule. This was the Bank’s first cash injection for Russia since August 1998. A year ago, just before crisis struck, $1.5 billion in lending was agreed on and a tranche of $300 million was released. Under the revised agreement, the remaining $1.2 billion in the program will be paid out in four tranches ($100 million, $100 million, $400 million, and $600 million) by the end of next year. The first $100 million tranche has been released—the rest depends on Russia’s success in implementing agreed structural reforms such as reforming monopolies in the energy sector, promoting development of the private enterprises, improving budget management, and further reform of the bank sector.

The World Bank also will restart two other lending programs: one for reform of Russia’s coal industry (the Coal 2 was approved in 1997) and one for strengthening the social safety nets (Social Protection Adjustment Loan, SPAL). So far $950 million of a $1.6 billion total of these programs was released. The remainder of the coal program has been revised into four 50 million-dollar tranches (the first was remitted on July 30) and two 100 million-dollar tranches. The program is scheduled to end next June. The remaining $250 million in the social safety net program will be released this fall.

The Fund’s Russia Analysis

According to the latest Fund report on Russia, a turnaround has occurred in 1999. Industrial output in the second quarter was up 5 percent over the same period a year ago, the ruble has stabilized (in recent days it has shaken again), and inflation was held to 2 percent in June in response to budget cuts and tighter monetary policy. But the report also noted that “policy implementation under past programs had been disappointing and that important elements of the new program had been proposed before but had not been carried out.” According to the report, the government’s ability to strengthen tax collection will be critical to the new initiative. “Russia’s fiscal problems reflected, to an important degree, the fact that many large enterprises were using their political influence to avoid seizure of assets in
cases of tax delinquency," executive directors concluded in the report. The board found that Russia had made little progress toward reforming its principal economic institutions in the past year, particularly in bank restructuring. It urged authorities to continue liquidating insolvent banks or to refer them to the bank restructuring agency.

**Russia's Envoy to the IMF and World Bank Resigns**

Mikhail Zadornov, Russia's special envoy to the international financial institutions, resigned from his post on September 2, saying he will run for parliament in the elections slated for December. Zadornov said he will seek a parliamentary seat as a candidate of the liberal Yabloko party.

Zadornov said he believes the IMF will disburse the next $640 million loan installment to Russia as scheduled. Russia and the IMF agreed on a $4.5 billion package of loans to be used to pay back Moscow's previous borrowings from the IMF. The first tranche of more than $600 million has been disbursed and conditions for further payments are being negotiated at present. The ongoing envoy said the money laundering scandal that has prompted U.S. politicians to demand further checks on the use of any IMF money before more lending is not likely to prevent the disbursement of the new tranche. Zadornov denied that Russia had misused IMF funds or that his planned resignation has anything to do with the ongoing probe about IMF money being illegally channelled abroad.

**World Bank Helps Romania Restructure Mining Industry**

On August 31 the World Bank approved a $44.5 million loan to Romania for a Mine Closure and Social Mitigation project. This loan will help the government to permanently close 29 unproductive coal mines, with the smallest possible social and environmental cost, and to streamline the management of the mining sector. The Bank loan will also support the operation and creation of small enterprises, retraining, and relocation for miners who are losing their jobs. The Bank loan will be at the Bank's standard interest rate for LIBOR-based single-currency loans, repayable in 20 years, including a 5-year grace period. Romania joined the Bank in 1972, and since 1990 its total commitments have reached about $3.5 billion for 26 projects.

**IMF Credit to Romania—But Not to Foreign Creditors**

In August the IMF approved a $547 million credit for Romania. The Fund has suggested Romania raise $350 million on international capital markets to pay back private creditors. Romania has so far managed to borrow only $108 million on the private capital market, reports the Financial Times. "This accord is a passport allowing Romania to return to the international capital markets," remarked Romanian Prime Minister Radu Vasile. IMF Deputy Managing Director Stanley Fischer encouraged Romania "to continue to work vigorously toward obtaining additional private foreign financing in support of its reform program." The country has thus become a test case for the new IMF bail in (as opposed to bail out) policy of forcing private creditors to provide liquidity to financially troubled countries, rather than relying on the IMF to do so, the Financial Times notes. Ukraine is another test case.

**World Bank Has New Communication Head**

Mats Karlsson, the World Bank's new Vice President for External Affairs and UN Affairs, took up his post in early September. Karlsson moved to Washington from Stockholm, where he was State Secretary of International Development and Cooperation at the Swedish Ministry of Foreign Affairs. He will be responsible for managing the Bank's global communications programs and for reaching out to the Bank's key constituencies—government officials, parliamentarians, NGOs, business, and academics. He replaces Mark Malloch Brown, who recently left the Bank after being appointed to the position of Administrator of the United Nations Development Programme (UNDP). Actively involved in defining and executing Sweden's international development policy for the past 16 years, Mats Karlsson also took charge of Sweden's cooperation programs with Central and Eastern Europe. To our relish, in recent years he also co-authored several articles in Transition.

**Credit to Vietnam Uses Innovative Approach**

On August 3 Vietnam and the World Bank signed two credit agreements: one for Vietnam to use $80.5 million (Sanitation Project) to improve public health and promote development in three urban areas (Danang, Hai Phong, and Quang Ninh) and another of $101.8 million to increase agricultural productivity in the Mekong Delta. "The Mekong project will benefit 610,000 people, create 80,000 new jobs, add 500,000 tons to rice production, and bring clean water to 280,000 people," World Bank Director Andrew Steer pointed out. The Mekong Delta accounts for nearly 30 percent of national GDP, 40 percent of the country's overall agricultural production, and more than 80 percent of the country's rice export. The sanitation project uses an innovative approach: a revolving fund, to be administered by the City Women's Union, will be established in each city to assist low income families.

**World Bank Introduces New Loan Products**

On September 1 the World Bank launched its new loan and hedging products, offering developing countries more flexibility in managing their financial risks in the following ways:

- A fixed-spread LIBOR-based loan will provide increased flexibility for borrowers to tailor loan maturities and to manage currency and interest rate risks over the life of the loan. Borrowers will be able to change the currency and fix, cap, or collar
the interest rate of their loan at any time prior to the loan's final maturity.

- Hedging products, linked to borrowers’ existing Bank loans, will assist borrowers in managing their currency, interest rate, and commodity price risks through currency and interest rate swaps with the Bank. Borrowers transacting risk-limiting hedges with the Bank would need to do so under a master derivatives agreement to be signed with the Bank. Countries including Argentina, China, Colombia, Hungary, Latvia, Lithuania, and Mexico have asked for the service, said Doris Herrera-Pol, the World Bank’s manager for marketing and client outreach in financial products. Since 1996 Bank borrowers have selected single currency loan terms for more than 95 percent of their Bank loan commitments. Borrowers also converted $67 billion equivalent (58 percent) of their currency pool loans to single currency terms under the conversion offer that concluded July 1, 1998. The World Bank’s New Products Website is located at http://www.worldbank.org/fps.

Successful Donor Conference for Kosovo

Officials from 100 donor countries and international organizations pledged sufficient financial support to meet about $560 million of urgent human needs and immediate reconstruction expenses in Kosovo until the end of this year. The European Commission and the World Bank, which jointly chaired the first donors’ conference for the war-torn province on July 28, said pledges made yesterday added up to $2.08 billion, including funding already disbursed during 1999. The next donors’ conference in October will consider Kosovo’s overall reconstruction needs. The donors said they would give $200 million for immediate humanitarian aid and $45 million to meet the costs of the UN in setting up a civil administration and paying the wages of public servants like customs officers and teachers. The EU said it would pick up the $300 million needed until the end of the year to help rebuild damaged housing.

Milestones of Transition

EU expansion will be staggered. Günter Verheugen, the nominee for the post of European Commissioner for EU enlargement, said he envisions an expansion of the EU in at least four stages, with the EU ready to accept new members by 2002. He noted that each aspirant will be judged on individual merits, “which will inevitably mean various dates for joining the EU.” Analysts say that Hungary’s position in the accession race has remained stable, but both Poland and the Czech Republic have fallen behind. The Czech Republic is behind because of delayed structural reforms, slow growth expectations, and slow privatization of the banking sector, while Poland has grappled with agricultural and environmental issues.

Central and Eastern Europe

Baltics

Rising public sector deficits. A decrease in economic activity in the first half of the year contributed to higher public sector deficits in all three Baltic nations.

- In Estonia the state’s fiscal shortfall reached 1.2 billion kronos (about $80 million) for the first six months of this year, the equivalent of 1.6 percent of Estonia’s GDP in 1998. The recently approved supplementary budget reduces government spending this year by 1 billion kronos.

- In Latvia the state deficit in the first half of this year was reported at 45.6 million lats ($77 million), or 1.2 percent of 1998 GDP. The overall public sector deficit for the first half was 67.3 million lats. The government decided to cut state expenditures by 30 million lats this year. The finance ministry now forecasts a fiscal deficit this year of approximately 3.5 percent of GDP.

- In Lithuania the state deficit in the first half of this year was 394 million lats ($87 million), or 0.9 percent of 1998 GDP. Lithuania planned a balanced budget for this year, but finance minister Jonas Lioginas now says that cuts of at least 800 million lits are called for in order to rebalance the budget. The current budget foresees expenditures of 7.2 billion lits.

Growth slows. The growth figures for the early part of this year have been clearly weaker than anticipated, although growth is still expected to accelerate in the second half of the year. Estonia’s finance ministry lowered its earlier GDP growth forecast of 2.2 percent for this year to 0.4 percent. The ministry also forecasts 4.1 percent GDP growth for next year. In June the Latvian government gave its GDP forecast for this year as 2 percent. Now the Latvian central bank expects GDP growth of between 1–2 percent. Lithuania’s finance ministry has adjusted its GDP forecast to 1.5 percent, and the economy ministry now says 1.3–1.6 percent is likely. Previous GDP growth forecasts for this year were around 4 percent.

Unemployment is still high. Studies based on International Labour Organization (ILO) calculation methods show that unemployment averaged 9.6 percent of the labor force in Estonia in the second quarter of 1999. Also using ILO methods, figures for Latvia from November 1998 indicated an unemployment rate of 13.8 percent. Similarly, Lithuanian unemployment in May was 13.1 percent.

Czech Republic

Government is preparing to sell its stake in Komercni Banka, the country’s largest bank. Although Komercni Banka, with total assets of 402 billion crowns ($12 billion), dominates corporate lending in the Czech Republic, its loan portfolio is plagued by nonperforming assets. The bank lost 4.475 billion crowns in the first half of this year. If not for the government’s recent transfer of 23 billion crowns of nonperforming loans from Komercni to Konsolidaci Banka—a state-owned bank set up to deal with bad debt—Komercni’s capital adequacy ratio would...
have fallen to about 4 percent, far short of central bank requirements. The government intends to subscribe to at least half of the 9.5 billion crowns capital increase, doubling Komercni's share capital and boosting the state's stake in the bank to more than 50 percent. This would make the bank more attractive to potential investors as they would gain full control of Komercni. A group of local minority shareholders in the bank have challenged these plans. Many analysts in Prague believe that Komercni's loan portfolio will need further restructuring next year. By some estimates, the bank's problem loans will fall between 45 billion to 50 billion crowns, of which some 70 percent are irrecoverable.

Poland

Poland's current account deficit widens. Poland, Eastern Europe's smoothest-sailing economy, is hitting rough seas, according to the Wall Street Journal. Poland's current account balance showed a deficit of $1 billion for July, indicating that slow economic growth in Germany and Italy and economic collapse in Russia have dealt a heavy blow to Polish exports. If this trend continues, the current account deficit could amount to between 6-7 percent of GDP for 1999, which would be the nation's highest ever. Economic growth is slowing, FDI is lagging, and the central government's budget deficit threatens to overshoot its 1999 target. Overhaul of the coal mining sector and its health care and pension systems are proving costly. Those expenses have pushed the central government's 1999 budget deficit to 97 percent of its planned target for the year—2.15 percent of GDP—at the end of July. Domestic growth has also slowed. While Poland's finance ministry predicts that GDP will show 3 percent growth in the second quarter, that still lags behind the 5.3 percent increase the country enjoyed during the earlier period. FDI was down 48 percent in July, compared with July of 1998. If that trend continues, FDI in Poland will cover only half of its current-account deficit, as compared with 75 percent in 1998.

CIS

Higher industrial production in most CIS countries. The Commonwealth of Independent States (CIS) Interstate Statistics Committee reports that eight CIS states increased industrial output in the first half of 1999. Compared to the first half of 1998, industrial output rose in Tajikistan by 7.9 percent, in Belarus by 7.0 percent, in Uzbekistan by 5.6 percent, in Russia 3.1 by percent, in Armenia by 2.8 percent, in Azerbaijan by 2.0 percent, in Georgia by 0.6 percent, and in Ukraine by 0.2 percent. Industrial output was down in Moldova by 15.2 percent, in the Kyrgyz Republic by 10.0 percent, and in Kazakhstan by 4.1 percent.

Russia

New investment law. In mid-July a new foreign investment law came into force in Russia, intended to protect investors' rights and guarantee that tax obligations will not suddenly change. It defines foreign investment as a project with at least 1 billion rubles ($41 million) of foreign investment or when a foreign investor has at least 100 million rubles in the charter capital of a company. The law does not apply to foreign investors with stakes in Russian banks or portfolio investors. The law also defines the rights of foreign investors, freezes tax rates for investment projects for seven years, and prohibits changes to tax or customs laws that hurt investors' profits by regions or the federal government.

The decline in Russia's population shows no sign of ending. With a further fall of up to 8 million people expected by the year 2016, the Washington Times reports that Russia's population, now at around 146 million people, has been in steady decline for the past decade—a trend that will likely continue. Experts blame factors such as a drop in medical standards, poor nutrition, and fewer women giving birth.

AIDS cases exploding. Vadim Pokrovskii, head of the Russian Research Center for the Prevention of AIDS, said in July that a lack of prevention and public education in Russia has led to a surge in the number of people infected with the HIV virus. Pokrovskii said there has been a 12-fold increase in the number of HIV-infected people in the Moscow area during the first six months of this year, compared with the same period in 1998. He also said that Russia lacks the money to keep the disease from spreading and that the disease most commonly passes into the heterosexual population via drug-using prostitutes. The Health Ministry reported that almost 16,000 HIV-positive cases were registered in the country as of last month.

Asia's Reforming Economies

China

China's parliament approves two growth-boosting economic measures. Income tax exemption for bank deposit interest had been repelled in China. The new tax on savings interest is aimed at boosting domestic consumption and ending a 22-month slide in retail prices that is bruising China's producers. The tax measure is intended to discourage savings and propel some of the 5,900 billion yuan (about $72 billion) of private savings into the economy. The tax will also amass revenue for increased unemployment subsidies. A special 60 billion yuan bond issue will finance a wide-ranging spending program in infrastructure, technology, and environmental protection projects aimed at reversing the sharp drop in domestic investment. Fixed-asset investment rose just 3.8 percent on the year in July, down from 22.7 percent growth in the first quarter of the year. Dampened by dwindling inflows of foreign investment, weak exports, and falling prices, China's economy grew just 7.1 percent in the second quarter of this year, down from 8.3 percent in the first quarter. In the past three months Beijing has cut interest rates for the fourth time since March 1998.