World Bank activity in Central and Eastern Europe (CEE) has been explosive in the past year. The region's share in Bank lending increased from a mere 3 percent only two years ago to 18 percent now — a rise from $500 million to $2.9 billion — and the rate of lending likely will stay at that level over the next two to three years. This "loan explosion" has had an impact of equal magnitude on the organizational structure of the Bank itself.

Eugenio Lari, for eight years the director of the department responsible for bank operations in the economies of Central and Eastern Europe, recently was appointed, effective July 1, to the post of Senior Adviser to the Regional Vice President. Two new regional departments now replace the old one: Director Kemal Dervis and his team deal with Hungary, Poland, and Czechoslovakia, while Director Russell Cheetham and his group operate in Yugoslavia, Romania, Bulgaria and, as of the next fiscal year, Albania. Transition asked Mr. Lari about the Bank's behind-the-scene efforts to manage the sudden surge of East European lending and about the related policy issues the World Bank must confront.

Q. In a matter of weeks, the World Bank approved more than $2 billion to Central and Eastern Europe. Even assuming the normal rush is on to beat the fiscal deadline of June 30, the speed and magnitude of lending are remarkable. How does the World Bank cope with this new challenge?

A. We have introduced a number of innovative features in our lending procedures. For example, when Bulgaria and Czechoslovakia indicated that they wanted to join the Bank, we...
immediately undertook missions to assess their needs and did not wait for their membership to be processed, which would normally have been the case. Thus, comprehensive economic reports on the two countries — the basis of our loan operations — were ready by the time they became World Bank members. Furthermore, the Bank very quickly approved a number of policy-based structural and sector adjustment loans.

Q. How were you able to reallocate the necessary funds within the Bank?

A. It was a painful and stressful process. Our operations in the CEE countries were constantly underbudgeted, and we had to make time-consuming efforts to gain additional resources. Initially, a lot of skepticism thwarted our efforts to spend more money in the region, and it was only at the end of 1989 that we started to receive strong support to expand our activity. We tried to reallocate some resources within the EMENA region, although in the last two years we were compelled to overrun our budget — which was partly compensated for, in effect, by other parts of the Bank that spent below budget. The sudden surge of activity required our staff to work overtime as well, by as much as 50 percent.

Q. Did PRE, the policy research arm of the World Bank, meet the expectations of the operational arm? Were researchers able to support lending to the CEE countries with the necessary theoretical ammunition and analytical input?

A. PRE’s activity — their research and analysis — is crucial for our work. We learned a lot together in recent years. But there is still much more to learn to modify our methods of assistance to the CEE countries. I doubt, for example, that we are as flexible and imaginative in providing assistance at the enterprise level as we are on macroeconomic policy. In the latter area, for instance, Bank policy supports temporary government intervention to control certain prices and freeze wages when necessary. At the micro level, in terms of policy, we have not yet devised flexible approaches to take into account that the playing field in these countries is not level. To level the field requires intervention to promote the fast development of the private sector and of the market mechanism. I hope that in my new position I will be able to work with PRE in that direction.

Q. In retrospect do you think the Bank’s loans and technical assistance to the former CEE governments inadvertently helped bail out the old regimes?

A. On the contrary, through our loan operations and the underlying policy dialogues, the Bank bolstered the advocates of liberalization. Even representatives of the present democratic government in Hungary acknowledge the Bank’s role in their country in the mid-1980s — promoting tax reform, enterprise management, foreign investment, and banking. On the other hand, no assistance was provided to the former Polish government in trying to preserve the old political and economic structure — a course the Bank believed was neither possible nor desirable. The Bank recognized that only a fundamental change of both leaders and policies could guarantee the necessary political support for the governments in the region. This is a lesson with relevance today for Romania, Bulgaria, and Albania. For Poland, we had to consider its external debt situation as well. Until we could see “the light at the end of the tunnel” — that is, a feasible and conceivable way to restore Poland’s creditworthiness — we could not even begin our lending operations.

Q. The debt problem still remains. According to a new study by the New York-based Institute for East-West Security Studies, since the onset of political changes, Czechoslovakia, Poland, and Hungary have suffered a net capital outflow because their combined debt service outweighed grants and credits provided by the West. This year the trend could be reversed in Czechoslovakia and Poland, but Hungary could expect another $600 million net outflow. How can you assert that World Bank money does not end up in the coffers of the commercial banks, especially in Hungary, Poland, or Bulgaria, the countries most indebted to private institutions?

A. We have to face the fact that money is fungible. Particularly in countries where we have just started loan operations, our exposure increases suddenly, and undoubtedly there is a risk that other creditors may use the opportunity to withdraw their money. The answer is to help debtor nations work out feasible programs of external debt management and to cooperate with other creditors.

Q. Increased Bank lending to the emerging European democracies means chopping off the budget elsewhere, namely from the developing countries of Africa, Asia, and Latin America. No wonder they are not enthusiastic about this explosion of loans to Central and Eastern Europe. Or should they be?

A. I am sure the economic stabilization of the Central and East European countries, which combined have a population of 125 million, also serves the interest of the developing countries. Central and Eastern Europe could provide the Third World with a huge market and bring about beneficial economic relations overall. Conversely, if the situation in the CEE countries remains unstable, the region could become a major economic, financial, and social burden for the European Community, and that would impede relations between the developing world and Europe as a whole.

Q. You mentioned the need for rapid development of the private sector in the CEE countries. This is an area
where the Bank is criticized for not doing enough and, in fact, for still regarding the public sector as its only natural partner.

A. Such criticism is unfounded. We totally agree that a viable private sector is fundamental in these countries for their modernization. But how can they do it? In most cases, the private sector is almost non-existent. Property legislation is incomplete, domestic lending to raise capital is mostly unavailable, education or training of would-be entrepreneurs is missing, and basic services, such as telephone communication, are underdeveloped. The Bank can play a useful role by helping to create banking systems that can provide credit to new businesses, to develop telephone and electricity networks that function, and so forth. This is what the private sector requires. We also agree on opening up certain public sectors, such as telecommunications, and to promote their privatization. On the other hand, the governments of the region, even the more ambitious ones, are talking about privatizing about half their economy in three to five years — which means that about half the public sector will still remain. Therefore, it is very important that public enterprises be de-monopolized and exposed to competition as well as subjected to strict financial discipline, so as not to crowd out the fledgling private sector in terms of available economic resources. Thus, the public sector will continue to be an important recipient of our assistance, in terms of credit and institution-building advice.

The Bank is walking a thin line in supporting the economic policies of the borrower governments: it has to prevent the petrification of the public sector while heading off attempts to delay privatization of their economies. Therefore, we support policy programs that ensure a friendly environment for business start-ups and an unbroken process of privatization, and, at the same time, elimination of subsidies and exposure of public enterprises to financial discipline and the hard budget constraint.

Q. According to a draft of the “9+1 Union Treaty,” just reported in the Financial Times, the republics of the USSR, as “full-fledged members of the international community,” will be empowered “to take part in the work of international organizations.” Is the World Bank ready for associate membership for the Soviet Union or for any of republics? Could the Bank dispense technical assistance immediately?

A. Representatives of the Bank and from both the Soviet Union and the republics have had many informal meetings. Formalizing relations in one way or another is one thing, but how to provide technical assistance to a country that is not a full member of the World Bank? Of course there is always a solution: for example, members could establish a technical assistance fund, managed by the Bank.

And if the light turns green? I have little doubt that unless there is a prompt and major allocation of Bank resources and staff for the Soviet operations, the “stress and pain” — from bottlenecks and staff overtime — that accompanied the surge in the Bank’s CEE operations will be repeated. Nevertheless, I share President Conable’s view that the role of the World Bank as a multinational financial institution will not be fulfilled until the Soviet Union becomes a member. The Bank can play a major role there, but will it be enough to solve the huge problems of the Soviet economy? That is another question — which you fortunately did not ask.
Mongolia — Reform Efforts in a Cold Wind

Mongolia, in the midst of a deepening economic crisis, could find itself seriously hampered in the implementation of its ambitious agenda for reform. Key economic indicators for the first quarter of 1991 show severe deterioration in Mongolia's external and domestic position and indicate a possible decline in GDP of 15 percent for the year. Although last year's poor harvest and the problems associated with the partial start-up of the reform process are also responsible for this trend, the main factors are external and thus essentially beyond the Central Asian country's control.

Unpleasant surprises

The demise of the Comecon trade and payments system, the abrupt termination of Soviet financial assistance, and the disruption of petroleum supplies and other essential consumer and industrial imports from the Soviet Union have affected Mongolia's economy more quickly and severely than the government had expected in late 1990. As a result, domestic industries lack key inputs and are suffering electricity outages, for example, and the government is rationing basic staples. In addition, inadequate supplies of fertilizers and transport fuel may contribute to another poor harvest this year.

In April, the authorities requested emergency food aid, *inter alia*, from Germany, Japan, South Korea, the U.K., the U.S., and the EEC. The government is also seeking quick access to IMF resources — Mongolia having become a member of both Bretton Woods institutions in March, 1991.

For more than 60 years, the remote, sparsely-populated Mongolian People's Republic — “the second socialist country in the world” — has been a centrally-planned command economy implementing “five-year plans” for the development of a modern industrial state. Geographically isolated and, until this year, almost wholly dependent on the USSR for aid, trade, and international recognition, Mongolia's modern economic history and development are little known outside the erstwhile CMEA countries. Moreover, unlike the dramatic changes in Eastern and Central Europe and in the Soviet Union during the last two years, the quiet and hitherto peaceful process of political and economic reform in Mongolia has received scant attention in the Western media so far.

Privatization drive

Mongolia initiated its economic reform strategy, based originally on the Soviet policy of *perestroika* in 1985. State planning was restricted to investment policy, and the ministries and state committees were responsible for policy implementation. Similarly, the autonomy of state enterprises was increased, although production, distribution, and control of profits remained under government control. By early 1990, however, after student demonstrations, an interim government was formed to lead the country toward its first multiparty elections.

The new government also embarked on a comprehensive program of economic reform to expand the role of the private sector, diversify the economic base, increase trade with the convertible-currency economies, and strengthen the institutions responsible for indirect economic management. As a result, the government was able to:

- promulgate the Foreign Investment Law in March, 1990, to encourage foreign direct investment, including for the exploitation of mineral resources;
- eliminate restrictions on private ownership of livestock;
- increase farmgate prices, effective January, 1991;
- liberalize selected retail prices within a set range; and
- promote private enterprises and cooperatives.

After the elections in July 1990, the new government accelerated Mongolia's transformation toward a market economy and began to diversify the country's economic relationships with the international financial and development community. Overall policy remains to be defined, but the authorities resolve to implement the principal measures during the next three years (1991-94). Their main priorities are to improve rural living standards and reduce unemployment — as of mid-1990, 60,000 to 70,000 people, equal to about 7-8 percent of the work force, were unemployed, according to some reports.

Privatization measures under consideration include the return of state livestock herds to their former owners, the sale or lease of state enterprises, and the opening up of equity participation for the private sector. The scope for the last action may be limited in the short term, however, by Mongolia's low per-capita income and the dearth of private savings, estimated at about $40 per person.

The first auctions started at the end of June, to sell off state shops, restaurants, and service firms to private citizens. In the next phase, the government intends to sell 2,200 enterprises — representing 57 percent of all state-run assets — by auction or through stock issues. The plan is for every resident Mongolian citizen to receive a voucher. Foreigners will be able to buy a limited proportion of shares. Larger concerns will begin to issue their stock in August or September of this year, and a stock exchange is scheduled to open in the capital in September. The state plans to retain 200 major factories as well as such strategic sectors as railways,
public transport, telecommunications, energy, and aviation.

Laws to protect the transfer rights of private ownership are being drafted; this will be supplemented by a program to phase in price liberalization, probably this year. The government has already streamlined the central bureaucracy, reducing the number of ministries and state committees. Tax reform to expand the tax base and improve the tax system’s elasticity will begin this year as well. Financial sector reform will focus on establishing a central bank — the Mongol Bank — and several commercial banks as well as development of independent bank supervision and indirect monetary policy instruments.

**Ambitions and constraints**

It will not be easy for the government to implement such an ambitious and wide-ranging reform program while trying to maintain macroeconomic stability. Besides the economy’s vulnerability to external shocks, the country’s geography (both internally and vis-à-vis the outside world) and its lack of experience with market-oriented policies and institutions will likely constrain the transition significantly. In addition to its recent requests for short-term commodity assistance and quick-disbursing financial assistance, the government is seeking advisory and technical assistance. Specifically, it will need help to improve the quality of economic data, familiarize its senior government officials with the indirect tools of macroeconomic management, and, in general, strengthen the country’s administrative and managerial capabilities.

Mongolia is already receiving some external technical assistance from the United Nations Development Programme and the IMF and has expressed interest in similar cooperation with the Asian Development Bank and the World Bank Group. The Bank is considering a lending operation in FY92 to help finance imports of essential commodities such as petroleum, fertilizer, and spare parts for vital machinery. Although Mongolia’s proximity to the USSR and China will require continued, and closer, cooperation with those economies, Mongolian officials are particularly anxious to develop better relations with Japan and with the newly industrializing countries of East Asia — not only for aid and trade but also for the benefits of the NICs’ development experience.

Despite the gravity of its short-term difficulties, Mongolia’s longer-term prospects are encouraging. Mongolians, half of whom reside in rural areas, are naturally resilient to cold winds and a harsh climate. They can be expected to combine this physical stamina with the patience to absorb the initial hard economic adjustments. With a small population, a production structure concentrated in agriculture and agro-industries — in which the country has a comparative advantage — and vast, yet largely untapped, energy and mineral resources, Mongolia is well placed to reform its economy, resume growth, and achieve higher living standards.

David Pearce
ASSCO, World Bank

**From Genghis Khan to President Orrchibat**

After the collapse of the Mongol Empire (established by Genghis Khan in 1206), Mongolia was a frontier province of China from 1691 until early this century. It gained independence in March, 1921, and in 1924 the People’s Republic of Mongolia was founded. The period from then until the mid-1980s was marked by close relations with the USSR and, until the mid-1960s, only limited international recognition of the country’s independence.

In 1985 the Mongolian government initiated modest improvements in economic management as similar changes were beginning within the USSR. However, it was not until March, 1990, that a new, reformist government was established, headed by P. Orchirbat, the current president. In July, 1990, Mongolia held its first multiparty elections.

Surrounded by the USSR and China, Mongolia covers 1.6 million square kilometers — about half the size of India. In 1989 its population was 2.1 million, and half the population was under age 20. Three-quarters of the territory is steppe (including the Gobi semidesert and desert areas). The high average altitude (1,600 meters above sea level) and semi-arid climate bring long, cold winters, with average temperatures below freezing for six months of the year.

According to IMF estimates, Mongolia’s per capita GDP equaled $522 in 1989 (less than half the corresponding figure in Albania, the poorest country in Europe). Mongolia has abundant agricultural land, about 80 percent of it suitable for extensive animal husbandry. (The number of herd animals, mainly sheep, cattle, horses, camels, and goats, is estimated at 24 million.) The country is rich in mineral resources, including coal, iron, tin, copper, gold, silver, tungsten, zinc, fluor spar, and molybdenum, as well as semiprecious stones. The mining sector is dominated by the large joint Soviet-Mongolian Erdenet Combine, producing copper concentrate and molybdenum.

Petroleum exploration is just beginning. Mongolia Oil is inviting U.S. and U.K. firms to explore deposits.

The main exports are minerals, semiprecious stones, animal products, and meat. Industry is concentrated in the processing of livestock and animal products. Manufactured products such as clothing and wool items constitute only 20 percent of foreign sales. The country’s main convertible currency earners are minerals, leather goods, carpets, camel wool blankets, and cashmere knitwear.

Negotiations for most-favored-nation (MFN) status were recently concluded with Japan and the U.S. Former CMEA countries (i.e., the erstwhile Soviet-led trading block) have almost completely dominated foreign trade until now, with the USSR accounting for over 80 percent of Mongolia’s total export sales. About 98 percent of Mongolia’s aggregate debt (9.9 billion transferable rubles at the end of 1989) is held by the USSR.

Currency convertibility came a step nearer in mid-June with an 82.5 percent devaluation of the commercial rate of the tugrik, the national currency, from Tug 7.10 to Tug 40 to the dollar. (The unofficial rate had been about Tug 60 to the dollar.)

The tugrik (meaning disc) was introduced in 1924 after establishment of the Mongolian National Bank, a joint venture with the USSR.

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Milestones of Transition: USSR

The Soviet Union is heading for a balance of payments crisis before the end of the year — which increases the likelihood of commercial banks rescheduling their loans in the near future, warns Salomon Brothers' sovereign risk assessment group. In a recent report the group downgraded the Soviet risk to a low double-B sovereign credit, similar to the rating for Mexico or Venezuela. Lending by commercial banks dropped from 66 percent of the total external debt in 1989 to an estimated 53 percent of the total in 1990. Soviet economist Leonid Abalkin disclosed that the 1991 budget deficit is likely to reach 240 billion rubles, roughly four times last year's level. The projected deficit represents 21 to 24 percent of the Soviet equivalent of GNP.

Soviet President Mikhail Gorbachev will present his reform proposals to the G7 summit in July. However, according to Grigory Yavlinsky, the main author of a radical economic plan — the "Grand Bargain" — Gorbachev approves of 90 percent of the plan, which calls for Western aid to the USSR in two phases. Stage One, lasting about 25 years, calls for USSR associate status in the IMF and IBRD (the two main agencies for implementing and monitoring the plan) and would draw aid of $20 billion-$35 billion, largely from Western governments, but with a significant amount from commercial banks. Aid would be available only in parallel to steady economic and political reform, however. Stage One would begin liberalization of prices, small-scale privatization, and ruble convertibility, as well as a harsh squeeze on the budget deficit. The plan calls for elections by early next year and for an agreement that allows the republics that do not wish to be part of the union to go their own way. In this stage, much of the aid would go for importing food and supporting the unemployed. Stage Two would begin with convertibility of the ruble, supported by Western aid, and would cover large-scale privatization and the complete removal of price controls.

The Soviet News Agency Tass and various Western correspondents in Moscow disclosed details of the "9+1 Union Treaty":

- It envisages enhanced status for the constituent republics and proposes changing the name of the state to the Union of Soviet Sovereign Republics.
- Powers that come under joint control of the union and the republics would include: military policy, state security strategy, storage of nuclear materials, foreign policy, guidelines for social and economic development, and a common policy on fuel and energy resources.
- Powers reserved exclusively for the central entity would include: protecting the union's sovereignty and territorial integrity, command of the armed forces, determining Soviet foreign policy and foreign economic activity and coordinating republican activities in these areas, implementing the union budget, issuing money, and holding Soviet currency, gold, and diamond resources. The draft declares that republics have a right to a share in these resources and that further agreements would define their use.
- Powers that would devolve to the republics include: control over land and natural resources and the right to establish direct diplomatic, consular, trade and other relations with foreign states. The republics are described as sovereign states.

The draft also declares that the parliament will have two chambers, one elected directly by the population, the other consisting of deputies delegated by the republics. The union will have an executive president elected for no more than two five-year terms. The union and member states will support all forms of property. Finally, the draft includes a plan for a two-tier taxation system, including a direct federal tax (currently opposed by Russia and the Ukraine).

The seven leading industrial democracies (G7) agreed in principle at their meeting in June, preparatory to the July 12 London summit, that the Soviet Union should be offered associate membership in the IMF and the World Bank, according to the New York Times. The move would allow the Soviet Union to gain technical assistance for economic reform. U.S. Treasury Undersecretary David Mulford later said that Soviet associate status in the IMF would allow Article IV Consultation, which would begin 30 days after the IMF board approved the associate status. This might mean that a shadow IMF program could serve as the basis for creditor institutions and governments to provide technical help to the USSR. Mulford told the House Banking Subcommittee on International Development. The Soviet Union could become a full member of the IMF after discussions that could last at least two years, he added. IBRD officials told reporters that IMF and Bank association with the Soviet Union would benefit all of Central and Eastern Europe.

On May 29, the Soviet parliament gave preliminary approval to legislation allowing for the repatriation of foreign investors' profits in hard currency, 100-percent foreign ownership of Soviet enterprises, and concessions for foreign entrepreneurs to take over and exploit natural resources, such as mines and oil reserves. The parliament later approved a law privatizing state enterprises, a crucial element of plans to revive the economy. The law would establish a privatization ministry and a special body to decide on the enterprises to be privatized. It also envisages turning over to private enterprise up to half of all state properties by the end of 1992 and at least 60 percent by the end of 1995. The government will retain much of the defense and energy industries and the communications industry.
Nuts and Bolts of Economic Reform in Central and Eastern Europe

by Jan Vanous

The current vogue among East European reformers is to be tough with enterprise management. By implementing a stringent monetary policy and allowing many enterprises to go to the brink of bankruptcy — and some to fail — managers (and labor) are “taught a lesson.” However, what is overlooked is that such a tight monetary policy would not create the same effect in a non-market economy in the process of reform as it would in a stable capitalist market economy.

Portfolio cleanup

For example, in market economies, firms would not, and do not, operate without liquid capital, and they would not operate under a burden of debt virtually equal to 100 percent of the value of their inventories. In East European countries, governments have covered their budget deficits simply by stripping state-run companies of their equity and substituting debt — which obviates the need for the governments to resort openly to borrowing, whether internal or external. In the past, this action mattered little, since the debt was low cost and the central banks made all the lending decisions. However, now that East European reformers are implementing tight monetary policies and allowing interest rates to skyrocket, they quickly send highly-leveraged companies into technical bankruptcy, through no fault of the companies themselves. The technically correct way to tackle the problem would be to return the “stolen” equity by issuing government bonds and using the proceeds to replace existing loans.

It is true that in a market economy, a sufficient fall in real wages ultimately leads to lower consumer prices, increased demand for products, and increased employment. However, even with a drastic fall in real wages, significant domestic economic recovery is not happening yet in Poland, for example, because of the lack of infrastructure for private enterprise. Starting a new business in Poland remains complicated, beginning with the bureaucratic obstacles in the application process, the dearth of loans, and the difficulties of securing office or manufacturing space or obtaining manufacturing inputs, and so on.

The reform process and creation of market economies in Eastern Europe cannot move ahead without a Western-style commercial banking infrastructure. Yet East European reformers are typically not willing to have Western banks come in at an early stage and set up such an infrastructure. The East Europeans believe that:

- Domestic banks would be unable to compete. Measured by Western criteria, they are essentially bankrupt due to their limited capitalization (equity typically is around 1 percent of assets) and the burden of the large loans inherited from the Central Bank, which absolutely cannot and will not be repaid by debtor enterprises.
- Western banks would pick the most creditworthy clients and further degrade the quality of the loan portfolios of domestic banks.
- Western banks are also likely to hire away the most talented people at high salaries and thus further cripple the ability of domestic banks to compete.

By protecting domestic banks from competition, governments are ensuring that banking services in Eastern Europe remain inadequate and unable to support the creation of full-fledged market economies in the near term. To give domestic banks the chance to compete requires a massive clean-up of portofolos. This could be done by creating a special bank (perhaps something along the lines of the Consolidation Bank in Czechoslovakia) to which the bulk of troubled commercial bank loan portfolios would be transferred. To cover the liabilities of the special bank vis-à-vis the commercial banking sector and, ultimately, vis-à-vis the population (through the savings banks), the governments must issue bonds at competitive interest rates.

Privatization vs. restructuring

The “fiction” that has been spread by reform economists now in power in the East is that the key to the turnaround of East European enterprises is to change enterprise ownership. This is an extremely dangerous fiction. Just because an East European enterprise manages to garner a multitude of new private owners, little is likely to change — in fact, in the short- to medium run, the structure of output will remain unchanged, the same production technology will be used, quality changes will be unlikely, and management style will stay the same. There is little reason to believe that a large number of inexperienced
stockholders with no initial business experience would have a substantial positive impact on the running of a typical East European enterprise.

The true critical factors in turning around an East European enterprise in the near term are: (i) restructuring and (ii) an infusion of capital. Successful complex restructuring typically requires concentrated ownership. Recapitalization requires the entry into the market of investors with available capital — that is, foreigners. Yet in most East European countries the governments appear intent on encouraging broad share ownership and discouraging concentrated share ownership. Moreover, the entry of foreign capital in the initial stages of large-scale privatization is being discouraged, explicitly or implicitly, in some countries.

Some East European reformers are pushing privatization schemes based on the coupon method. This would apply in a situation where:
• there is no objective valuation of company assets nor is there the basic financial information that any investor in the West would take for granted;
• only a very limited group of individuals has any real sense of which companies are good or bad investments, and these individuals might not be particularly eager to share such information,
• securities buyers have no investment experience; and
• the entire process will require infrastructure, which is totally lacking, to carry out the enormous task if much of the population opts to participate in such privatization schemes.

A far simpler and more sensible method of privatization is to create various mutual funds in each country and transfer a portfolio of companies to these mutual funds. The funds could be organized on an industrial branch/product basis (such as an automotive fund, a glass and china fund, an apparel products fund) or, preferably, with diversified portfolios to stymie monopolistic or oligopolistic tendencies in the economy.

These mutual funds would be managed by both Western and Eastern management teams on a contractual and profit-sharing basis. The managers would be selected competitively according to various criteria, and the teams might bid for the management of specific company portfolios. Each fund would issue shares equal to the number of people eligible to receive free (or low-cost) shares, plus a certain number of shares would be reserved for other uses (pension funds, for example).

The main advantages of the mutual fund method for massive and quick privatization include:
• no need to establish the initial value of assets and relative share prices;
• no need for inexperienced investors to make investment decisions;
• no danger of concentrating large shareholdings with investors who might possess inside information about specific companies; and
• a simple and low-cost method of distributing shares to the population.

Each eligible individual would receive mutual fund shares that would represent an initial share endowment. Over time, as managers trade properties and a capital market develops, the value of mutual funds shares would be established, followed by "informed" trading of these shares.

Role of the “visible hand”

Given the tragic experience of East European economies under the “visible hand” of central planners, I hesitate to propose that there is still a role for the planners — although not as planners but as industrial strategists with strong business backgrounds. There are several reasons to support this concept:
• East European economies are in a state of severe crisis and lag decades behind Western Europe. If democracy is to survive, with political stability for the region ensured, progress on the economic front should be rapid — probably much faster than a free market approach would permit.
• Although interfering with market processes is risky in the West, because decisionmakers might not know from experience what the optimal outcome would be, this is not so in Eastern Europe. For example, if 85 percent of the food in Western Europe is sold through supermarkets, it makes sense to encourage the development of supermarkets in Eastern Europe, too.
• The “follow-the-market” philosophy is incremental in nature and at times lacks courage and foresight. A typical market approach to restructuring is to start small and grow by steps if the experience is positive. A bold strategy that encourages contraction of industries for which a country lacks comparative advantage, and encourages those with superior prospects, might well be a sound approach to industrial restructuring.

I could envision a government role in building several key multinational companies in each East European country in fields where each country already has a comparative advantage. This support would be for the development of traditional industries and based on the availability of attractively priced inputs and/or on resource endowments. Similarly, the hand of governments in cross-border mergers in Eastern Europe would make sense at times, for example to create a trans-East European airline instead of supporting the current uneconomical national airlines.

If I were looking for a "new Spain" in Eastern Europe, I would bet on Slovenia, Bohemia and Moravia, Croatia, Vojvodina, Hungary, and possibly some of the Baltic republics. I am somewhat less optimistic about Poland and least optimistic about the Balkan area other than its westernmost part. This judgment reflects historical considerations above all — it simply is much easier for a country to recover to its "normal" rank, after having been temporarily depressed by the disaster called communism, than to rise from rags to riches as have South Korea and Taiwan. The sooner East European reformers regain this historical perspective, the more likely the prospect of their respective countries "rejoining" Europe.

The author is president of the Washington-based consulting firm, PlanEcon. This article is based on a paper prepared for the World Bank's 1991 Annual Conference on Development Economics (papers published in 1992).
Comment on Jan Vanous’ article

I support in substance what seems to be Mr. Vanous’ overall diagnosis of the problems of the current economic strategies in the region: that they frequently ignore or underplay the microeconomic differences between capitalistic economies and the economies of Eastern Europe. As a result, the application of the new policies leads to unexpected and unpleasant results, such as large and prolonged drops in real production, protracted financial problems in the existing enterprises, and the conspicuous absence of a supply response.

Mr. Vanous is concerned about the financial tensions that restrictive monetary policies can cause for East European enterprises. Their governments have played a financial trick by extracting all their equity capital and providing the same funds through the banking system. This has left enterprises vulnerable to increases in interest rates — which, in fact, characterize the restrictive monetary policies. In Vanous’ view, until this “trick” is reversed, so to speak, enterprises in Eastern Europe will be forced to carry out adjustments that go beyond what is economically necessary.

I have serious doubts about this diagnosis, for several reasons. Stabilization programs in Eastern Europe have never resulted in “excessive” enterprise adjustment — in fact, what is endangering these programs is the reverse: enterprises in the region do not adjust at all. By refusing to adjust — trimming their administration, reducing their wage bills, ridding themselves of unprofitable activities and diversifying into profitable ones — the enterprises create an explosive situation in which either all of them go bankrupt or the government opens the Pandora’s box of monetary creation. When the government resorts to this activity, enterprises use the money to increase wages or social benefits for their workers and managers, thus leaving themselves again on the brink of bankruptcy.

Mr. Vanous traces the vulnerability of the East European enterprises to their defective financial structure, which I interpret as a lack of liquid assets, and their lack of equity capital — an item on the other side of the balance sheet. However, if there are inventories but no equity capital, why not sell the inventories to reduce the financial burden of holding on to them? Or why not sell other liquid assets they do not need? Even by attempting to sell all unnecessary assets to alleviate the liquidity squeeze, enterprises’ overall debt would remain excessive, given the actual value of the capital assets of most of them. This suggests serious capital losses (aggravated by inappropriate investment decisions) or excessive current costs of production (overmanning, inefficient use of production equipment, and so on). I suspect the problem is both.

Mr. Vanous also gives the impression that governments can control real wages — I assume through monetary policies. But I wonder: how can a government prevent a fall in the real wage when a country produces less than it consumes and when enterprises do not, or cannot, fire workers? There are two recourses: put the burden of increased unemployment on the young, or finance unjustified wages with monetary expansion. The result is either inflation or rationing and scarcity.

This discussion suggests that the basic microeconomic problem in Eastern Europe is that socialized enterprises do not react to market incentives in the same way as their counterparts in full-fledged market economies. I have argued that this behavior is just a symptom of the principal-agent problem. Without an owner — an advocate for capital inside the enterprise — the incentives are to increase the income of workers and managers, using up the enterprise’s liquid resources, rather than to increase the net worth of the enterprises.

As Mr. Vanous correctly notes, privatizing in an arbitrary way does not make enterprises efficient. After privatization, if the ownership of the enterprises becomes too dispersed, the principal-agent problem remains. However, Mr. Vanous’ privatization method advocates a mechanism that would leave the problem unattended. The Western experts who would manage his proposed mutual funds would be vulnerable to the same temptations as under the principal-agent problem, since the ownership of the mutual funds would be quite dispersed. Incentives through which the new owners could control the behavior of the trust fund managers would be weak. Furthermore, a few mutual funds managing all the enterprises in the economy would replicate the system of the old branch ministries.

I believe that the solution to the management problems in Eastern Europe lies with local managers, although they would be under the control of local capitalists who would be handling savings from the local economy. For this to occur, privatization is essential, but it has to be done in ways that ensure that entrepreneurial groups take control of each enterprise.

In my view there is no perfect method of privatization applicable to all cases in all countries. Also, I do not believe that the use of a particular instrument or institution — such as vouchers or mutual funds — determines the overall shape of the privatization process. Vouchers can be used in combination with mutual funds, for example, or with sale of firms and with many other instruments, institutions, and procedures appropriate for each case.

The same is true for the recapitalization and privatization of banks. The key problem here is to avoid the crowding out of the efficient banks by the inefficient. This requires the early creation of private banks to finance both new private enterprises and efficiently privatized ones. Two things are worth mentioning, however: these banks need not be the old ones reconstituted — and maybe it is better that they are not — and providing financing to the socialized enterprises must be constrained to avoid the crowding out effect.

I have the impression that Mr. Vanous underestimates both the gravity of the situation in the East European countries and the difficulties that will obstruct their sustainable growth. I hope I am wrong.

Manuel E. Hinds
EMTF, World Bank

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The World Bank/CECSE

June 1991
No end of German-, English- and French-speaking businessmen can be found lurking in the over-decorated hotel lobbies of Eastern Europe these days, willingly eating the strange and greasy food, happily enduring the lack of telephone connections and fax machines. Nearly every major Western consulting firm, investment bank, or accountancy now has its very own Eastern European research division, staffed by ‘regional specialists’, usually American-born executives with Polish or Hungarian surnames who were fortuitously discovered in the Chicago office. Many of these professional advisers have newsletters, special advertising campaigns, and good connections with the finance minister. A few have some business as well.

There has been much talk so far, as they say, and little action. Out of 3,000 joint ventures registered in Poland, only about one-third are actually operable, and only a tiny portion of the one-third is worth more than the $50,000 minimum required investment. In Czechoslovakia, the number is more like 600 and the money involved even less. With about 5,000 registered joint ventures, things are better in Hungary, although major deals have been slow in coming there too — a lot of men in suits are complaining about high taxes, complicated customs regulations, and low worker productivity.

If business is being discouraged, however, the foreigners aren’t the ones doing the discouraging — in Prague factories, they argue that before the war Czechoslovakia was one of the most industrialized nations in Europe. ‘We did it once without anyone’s help, we can do it again without anyone’s help, and never mind that our infrastructure is rotting or that our engineering is now 40 years out of date.’

The Polish government could not be more different, issuing streams of fax statements encouraging foreign investors and inviting packs of advisers to explain how to lure business to Warsaw. But new regulations and favorable investments are one thing; putting them into practice is quite another. With a stroke of a pen, a local official can wipe out a lucrative investment simply by refusing to sell a plot of land that nobody uses. But in Poland the term ‘foreign investors’ has become a synonym for Germans. Hardly a penny of serious German money has come Poland’s way, partly because it is so clearly unwelcome.

Hungary is relatively free of anti-foreigner sentiments. Yet even in booming Budapest, there are constant worries about the allegedly low prices being paid for Hungarian companies and scandal after scandal involving Western companies who actually make profits buying and selling Hungarian property. There was grumbling when an Austrian bank bought shares in the state-owned Tungsram light-bulb factory and resold them at a profit to General Electric. There were complaints when a state-owned hotel chain, most of which required extensive renovation, was sold for mere tens of millions instead of the hundreds of millions that the Hungarians felt they merited. For the record: the price of a post-communist company is impossible to calculate properly. If Hungarian or Polish or Czechoslovak companies weren’t relatively cheap, no one, given the complexity of their problems, would bother to invest in them at all.

Everywhere, fundamental misunderstandings about the nature of modern commerce are the main stumbling block. Taught for decades that wealth, Soviet-style, means coal mines and minerals, iron, steel, and heavy industry, the Eastern Europeans are now emerging into a world where wealth requires resource management rather than resources, and where some of the wealthiest countries have no natural assets at all. It isn’t how much you have buried underground that counts, but how you organise things on the surface. Accordingly, foreign investors are not trying to steal locally-mined diamonds and sell them elsewhere for profit, but to sell diamond mining and processing equipment to the natives.

But the Westerner who is willing to make concessions to the local conditions is very rare. A businessman of my acquaintance recently arrived in Warsaw for lunch, announcing that he had been in Zurich yesterday and would be in Dusseldorf tomorrow. He professed total ignorance of Polish company structure. Like many other denizens of Eastern Europe’s international hotels and fine restaurants, he may well be destined to emerge from his Polish adventures empty-handed, a victim of the assumption that business works more or less the same way everywhere.

These are countries where the rules are unpublished, or are unknown, or are about to change, tomorrow or the day after, when and if the parliament meets. These are countries where complex systems of book-keeping exist far from any concept of ‘profit.’ There is no standard for commercial behaviour because there wasn’t any commerce until very recently, so anyone expecting ‘business as usual’ will end up throwing money into a great, black, post-Communist hole.”

From a recent article “Who needs foreigners?” in the London weekly The Spectator. The author is Warsaw correspondent for the publication.
On the World Bank/IMF Agenda

MIGA's services in Poland

To attract foreign capital, the Policy and Advisory Services (PAS) of the Multilateral Investment Guarantee Agency (MIGA) recently designed an investment promotion conference for Poland's Foreign Investment Agency. (MIGA is part of the World Bank Group.) Under the motto "Managing the Search for Foreign Partners," PAS and the Polish Export Development Bank also initiated a program for senior business executives on how to attract foreign investment and increase Polish firms' international activity. In addition, the Foreign Investment Advisory Service, MIGA's joint facility with the IFC, and PAS have been working with the Polish Government to revise the foreign investment law.

Czechoslovakia: the first SAL

With a $450 million Structural Adjustment Loan (SAL), the World Bank is supporting the first phase of Czechoslovakia's program to become a market economy. The program includes phasing out price controls by the end of this year (with some exceptions), further liberalization of foreign trade, and privatization of businesses. The program also includes provisions for a social safety net for those adversely affected by the transition process. Japan's Eximbank will cofinance the loan up to $200 million. In a separate development, the IMF has provided $110 million from its CCFF facility as part of a $1.78 billion IMF credit package for Czechoslovakia to pay for fuel imports.

China: irrigation project

A new World Bank loan of $147.1 million and an IDA credit of $187.9 million will finance an irrigation development project in the provinces of Anhui, Jiangsu, and Shandong. Improving agricultural inputs and support services should boost the income of some 2.8 million families in the North China Plain by about 40 percent.

Algeria: Bank and IMF support

The World Bank is supporting Algeria's enterprise reform and banking modernization with a $350 million loan approved in June. The government wants to eliminate restrictions on private business and open the door to foreign investment, develop financial and capital markets, and strengthen the Central Bank. For its part, the IMF recently approved a $405 million stand-by credit for Algeria to support the country's economic reform program through the end of March 1992. The program includes speeded-up import liberalization, decontrol of prices (except for staple foods and energy) by the end of 1991, convertibility of the dinar by early 1992, and establishment of a social safety net. The IMF will make another $283 million available if the price of oil falls below $20 per barrel.

Project loan to Yugoslavia

The World Bank has approved a loan of $300 million to Yugoslavia to finance construction of a 700-MW thermal power plant and development of a lignite mine with a capacity of 7 million tons per year. The "Kolubara B" project — the only Bank loan to Yugoslavia in FY91 — is expected to provide about 4 billion kwh annually. This would overcome energy shortages in Serbia and maintain supplies in the other republics.

Romanian comeback

On June 25 the World Bank approved $180 million for Romania to finance technical assistance and critical imports. The technical assistance will strengthen the government's macroeconomic management capacities, help develop an accounting system, promote privatization, and support commercial banks. By financing the purchase of foreign equipment and spare parts, the loan will help reactivate more than 1,000 oil wells, increase electricity, lignite, and agricultural production, and improve transport services.

Hungary: the second SAL

The World Bank is supporting Hungary's changeover to a market economy with a second structural adjustment loan, for $250 million, approved in mid-June. The government intends to promote competition by further liberalizing trade, reforming the financial sector, restructuring insolvent banks, and reducing state involvement in the nation's economy. The government will also strengthen the country's "social safety net" with worker retraining programs and expanded employment services.

Poland: loan series

The World Bank recently approved four loans to Poland:

- $100 million to help the transformation of about 2,400 rural cooperatives into member-owned, market-oriented enterprises that provide crop-marketing, credit and other services to farmers and businesses.
- $200 million to make the financial sector more commercially oriented by lifting subsidies for bank lending rates and limiting government involvement in allocation of credit. The program will support the formation of capital markets and the eventual privatization of state-owned banks.
- $280 million to support privatization or restructuring of hundreds of state-owned industries, including privatization of about 50 percent of 6,000 state-owned enterprises and streamlining the ownership structure of firms remaining in state hands.
- $100 million to assist Poland in developing a social safety net and employment services through a variety of measures to improve income-support programs, strengthen key government institutions, ensure that cost-effective unemployment compensation programs are in place, build up worker retraining programs, and develop services to help the unemployed find new jobs. The loan will also finance a pilot program to help the unemployed set up small businesses. (By the end of 1991, the number of

(continued next page)
Conference Diary

Environmental Impact Assessment Techniques in Eastern Europe
September 16-20, London

Organized by Planning and Transport Research and Computation. A one-week course for senior professionals from government departments, environmental agencies, and consulting organizations. Will include: Workshop on Air Pollution, Noise Workshop, Social and Community Effects, Pollution of Air and Water.


World Bank 1991 Annual Meeting — Seminars
October 14, Bangkok, Thailand

PRE-conducted seminars on, inter alia, Worldwide Transition from Socialist to Market Economies: Lessons for the Future; The Private Sector and the State: Meeting the Challenge of Development.

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

Hosted by the Southern Conference on Slavic Studies. Highlights include a roundtable discussion on

Managing in a New Area
March 23-25, 1992, Hong Kong

Hosted by the City Polytechnic of Hong Kong. International/interdisciplinary conference on business in socialist and post-socialist economies. Submissions that cut across traditional academic disciplines and that include multiple, interdisciplinary perspectives are encouraged.

Information: Dr. David H. Kent, Principal Lecturer, Business and Management Dept., The City Polytechnic of Hong Kong, Kowloon, Hong Kong (fax: 852-788-7220).

Agenda (continued)

unemployed likely will reach about 2 million, or almost 11 percent of the labor force.)

Mozambique: buy-back scheme

A $10 million grant from a special facility funded partially by the World Bank will aid Mozambique to reduce its debt to commercial banks through a "buy-back" program. The government will buy back $308 million in debt from commercial banks at a 90 percent discount. Additional debt-reduction support of $12.9 million is likely from Sweden, Switzerland, the Netherlands, and France. As of 1989, Mozambique's total debt to commercial and official lenders totaled more than $4 billion; the average per capita income in Mozambique reached only about $80.

Bulgaria: technical assistance

To help the Bulgarian government implement its economic reform program, the World Bank will provide $17 million for technical assistance. (The European Community is expected to co-finance with $13.2 million and the U.K. Know-How Fund with $1.3 million.) The program will finance advisors, consultants, studies, training, and a limited amount of equipment for private sector development, bank restructuring and reform, modernization of the social security and welfare systems, reform of the energy sector, institutional development for trade reform, and design of a debt strategy.

Cambodian opening

Cambodia's Supreme National Council recently called for restoration of the country's links to the IMF and the World Bank and announced that the country intends to attend the upcoming World Bank Annual Meetings in Bangkok.

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Research Update
Transitions in the African Socialist Economies — A New Project

In parallel with Eastern Europe, socialist economies in sub-Saharan Africa are in the process of a transition toward market-oriented systems. Their aim is to reduce direct government control over their economic activities — their dilemma is that there are few precedents among their neighbors in Africa for doing so.

To deepen the information on which these governments may draw for their transition strategies, the World Bank’s Africa Region, in collaboration with the Country Economics Department, is launching a research project on the transition of African socialist economies. The project will provide a comparative analysis of key transition issues in several sub-Saharan economies — namely Ethiopia, Guinea, Madagascar, Mozambique, Tanzania, and possibly Angola, Benin, the Congo, and Somalia. The comparative analysis will also include several reforming, but non-socialist, sub-Saharan countries.

Finally, to provide a global perspective, the study will compare socialist reforms in Africa with those of socialist economies elsewhere, notably in Eastern Europe.

Research will focus on four broad transitional issues:

- redefining the role of the state in the economy. This will cover changes in property rights, the legal status of private economic institutions and transactions, and an examination of the mechanisms (such as administered prices) that affect the allocation of income and resources.

- managing the internal and external balance. An economy during transition. This will entail special emphasis on consolidating the fiscal and quasi-fiscal deficits within government budgets, establishing autonomy for the domestic financial system, and avoiding inflation while liberalizing the price system.

- reforming public enterprises. This will mean eliminating direct budgetary subsidies and indirect subsidies, improving management incentives, and allowing (even encouraging) greater competition from the private sector.

- reforming the agricultural sector, including deregulating crop markets, making changes in land tenure, and reforming other factor markets.

In addition, the research will examine transitional issues related to social safety nets and incentives for the private sector generally.

Consolidation of the substantive output of the research will take place during a workshop in Africa in late 1992. The research may be published subsequently.

The research is expected to strengthen institutional capacity in African socialist economies so the countries may undertake their own economic analysis of transition issues. They will then also be able to facilitate the flow of information on the transition process among African socialist economies and establish better links among researchers, not only in Africa but with socialist economies outside the region.

The study is managed by Jo Ann Paulson, with Charles Humphreys, of the Economics and Finance Division of the Africa Technical Department, in collaboration with the Socialist Economies Unit of the Country Economics Department. A grant from the government of Japan likely will finance part of the study. Interested institutions and individuals may contact Ms. Paulson or Mr. Humphreys at the World Bank, AFTF, Room 3-0180, 1818 H Street, NW, Washington DC 20433. Telephone: (202) 473-4360 (Ms. Paulson) or 473-4807 (Mr. Humphreys).

More Milestones

The Czech Republic’s Industry Minister Jiri Vrba reports that his government plans to sell more than 50 firms to foreign investors. The companies have a market value of $500-$500 million each and employ about 50,000 people. An official at the London office of Bankers Trust Company, which is acting as adviser to the government, said the Czech Republic has attracted $500 million in foreign investment so far this year and hopes for another $1.5-$3 billion in 1992.

Hungary’s parliament has voted to compensate property owners for land and property expropriated by the communist regime. Compensation will be in the form of vouchers that can be used to buy up to 50 hectares of land, purchase state property, or buy apartments. Former landowners will be able to buy agricultural land at auction, thus stimulating a previously non-existent land market.

At the G7 summit meeting, Poland will propose that aid to Central and Eastern Europe should go toward financing Soviet purchases of goods from the CEE countries, to reverse their export decline. Radio Moscow reported that the Soviet Union has agreed to settle accounts with its East European trading partners in rubles or in the currencies of those countries since trade in hard currencies between the CEE countries and the USSR has failed.

China’s budget deficit, ballooning because of excessive spending, hit $2.6 billion in 1990. Finance Minister Wang Bingqian told the National People’s Congress recently. (The deficit under IMF calculations is about $9.4 billion.) Chinese Premier Li Peng said the country will dismantle its double system of free and controlled prices and will buy agricultural produce from farmers at lower prices than it sells to consumers. Li forecast overall price rises of 6 to 7 percent this year.

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Books and Working Papers Briefs

Richard A. Debs, Harvey Shapiro, and Charles Taylor
FINANCING EASTERN EUROPE — A STUDY GROUP REPORT

The report focuses on two possible scenarios for developments in the Central and East European (CEE) economies. In the first, or “baseline,” scenario, economic reform continues its course, with long-term debt and equity financing from both private and official sources likely to total $77 billion over five years. Net resource transfers, after debt servicing, would reach only $400 million, aggregate GNP would shrink in 1991 and 1992, and growth would resume only in 1993. By 1995 annual growth would average just over 3 percent.

In the second, “accelerated reform” scenario, faster recovery and more rapid economic growth would occur as of 1993. Comprehensive reform would improve the investment environment, help to use resources more efficiently, and remove deadweight economic activity (jobs and enterprises with negative value added). Consequently, the absorptive capacity of these economies would increase and capital inflow expand. Portfolio and direct investments would reach $90 billion and net transfers jump to $9 billion. In this scenario, private direct investment in the CEE would markedly accelerate by the mid-1990s.

The authors recommend that the governments of the region accelerate the reform process, with the support of the industrial countries, by eliciting larger official financial flows and by improving foreigners’ access to Central and East European exports. Only then will significant private capital flow in, according to the authors.

Oleh Havrylyshyn and David Tarr
TRADE LIBERALIZATION AND THE TRANSITION TO A MARKET ECONOMY

Because of their distorted relative prices, poorly functioning factor markets, concentrated domestic production structure, and lack of domestic competition, the CEE economies should accelerate trade liberalization, argue the authors, especially since the political environment in the region is relatively supportive. The advantages are obvious: a rational price structure, a strong supply response from already privatized firms, and, due to better price signals, improved performance of state-owned enterprises. The elimination of trade barriers also would help speed up the privatization process.

Exposed to foreign competition, outdated plants in the CEE countries sooner or later would go out of business. To fend off expected social dislocation, a safety net would have to be created, advises the study. The risk of large-scale unemployment in post-socialist economies would be mitigated by the labor-absorption capacity of the service sector. The service sector in the CEE economies is much less developed than in comparable market economies with about the same GNP per capita (for example, Portugal and Greece). Recent experience in Hungary and Poland shows that the impact of trade liberalization on employment is less explosive than originally thought.

Richard Portes
THE PATH OF REFORM IN CENTRAL AND EASTERN EUROPE: AN INTRODUCTION

This paper appears as an introduction to the special issue of the EC publication European Economy (June 1991). It summarizes lessons about changes in regimes and sequencing of the transformation process in Central and Eastern Europe. The author argues that too much was expected too quickly. So far even the “J-curve” of economic transformation seems to be assuming too much. Economic transformation from autumn 1989 to spring 1991, and the immediate prospects — as confirmed by World Bank projections — follow more closely an “L-curve.”

To analyze what went wrong, the paper cites primarily the effects of exogenous demand and supply shocks, such as the collapse of CMEA trade. Adjustment costs are also high, partly due to pending restitution issues, the ill-suited legal framework for private investment, and delays in privatization of large firms. Misjudged sequencing and other policy errors also have left their mark. The new “Europessimism” is exaggerated, says the author, but the path of reform in Eastern Europe will be longer and more difficult than first anticipated.

Charles E. McLure, Jr.
A CONSUMPTION-BASED DIRECT TAX FOR COUNTRIES IN TRANSITION FROM SOCIALISM

Reforming economies generally lack the administrative infrastructure, accounting practices, and experience with tax administration to make a modern tax system function. As pri-
vatization occurs and revenues can no longer be taken from captive state enterprises, tax collection is likely to become more difficult and revenues are likely to fall.

By suggesting that reforming economies adopt value-added taxation and income taxation, for both individuals and companies, too little thought is given to the specific features of the CEE countries. The paper offers a plan for direct taxation reform geared to the problems of the CEE economies. A consumption-based direct tax, which the author calls the Simplified Alternative Tax, or SAT, encourages savings and investment in a way that is economically neutral. It avoids many problems of the income tax, especially those stemming from the issue of timing and the need to adjust to inflation.

The SAT system consists of two separate taxes: one imposed, perhaps at progressive rates, on individuals' wage and salary income; employers would withhold this tax for the revenue authorities. The second, the business tax would be levied on business' incomes, at a flat rate. Both interest and dividends would be exempt from the taxes; borrowing and lending would carry no tax implications. "The SAT is not a panacea, but it deserves serious consideration," asserts the author.

Adrian Wood
CHINA'S ECONOMIC SYSTEM—A BRIEF DESCRIPTION, WITH SOME SUGGESTIONS FOR FURTHER REFORMS

The paper, consisting of two short essays, analyzes the nature of China's economic system and concludes that nearly all microeconomic agents now pursue profit and have some freedom to adjust prices or quantities, although government intervention still restricts their freedom. Chinese economists debate whether price reform should precede enterprise reform or vice versa. The author reasons that price reform and decontrol of virtually all commodity prices should come first. Tight restriction of aggregate demand and administrative control of state enterprises, investment, wages, and employment — as long as other sorts of reform, particularly enterprise reform, are more advanced — could prevent inflation.

Townships and villages, individuals, and families are the proper owners of small enterprises. However, large enterprises should not be turned over to their employees, or privatized, at least not in the short term. Instead they should be converted into profit-oriented joint stock companies, with asset management bureaus and banks holding the shares. Chairman Deng said about the economic system: "It does not matter whether the fish is red or blue, so long as it swims forward." The author opines that the fish is going to have to start moving again.

Other Discussion Papers in the series:
Copies can be obtained from Ms. Leila Alberici, China Program, The Development Economics Research Program, London School of Economics, Houghton Street, London WC2A 2AE (U.K.)

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Elizabeth Milne et al
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