Transforming the Ownership System in Eastern Germany

As part of a shared legacy with Eastern Europe, what was formerly East Germany now faces the formidable task of transforming its ownership system. On the eve of unification, East Germany's public sector, including cooperative farms, accounted for about 95 percent of total employment and output. Specifically, the public sector comprised 126 national kombinats (vertically-integrated groups of enterprises with similar product lines and under common management) covering 3,300 enterprises. Each kombinat employed an average of 24,000 workers. The public sector also included 95 regional, multi-unit kombinats, each employing about 2,000 workers, and some 4,000 agricultural production cooperatives, virtually state owned.

The state trustee agency Treuhandanstalt (Treuhand) was set up in June 1990 to handle the management of this vast empire. Treuhand is de facto the largest and most diversified holding company in the world, with a portfolio of some 8,000 enterprises, many of them multi-entreprise units, and reportedly holds 40 percent of the total area of eastern Germany. At its inception, Treuhand also assumed all public debt.

Although formally subordinate to the Ministry of Finance, for all practical purposes Treuhand acts autonomously, with its own management and supervisory boards. Most of these boards' members and chairmen are top managers of West German enterprises and banks.

Treuhand's mandate is to assume ownership of state enterprises and to carry out their privatization, reorganization, or liquidation. The number of such operations has been estimated at 30,000-40,000. Treuhand is empowered to make all the necessary financial transactions, including selective assumption of debt and envi-
Treuhand initially faced severe difficulties assembling a qualified staff. Eventually in October 1990, West German banks and corporations, after some political arm twisting, agreed to assign several hundred middle managers and experts from their own staffs temporarily to Treuhand. But staffing problems continue in the 15 regional offices. Although the head office in Berlin handles the 1,000 biggest units, all other enterprises are overseen by the regional branches.

By the end of October 1990, all state enterprises were formally converted into joint stock and limited liability companies; about 200 privatizations had been negotiated; and about 60 privatization arrangements - some involving very large enterprises - had become effective, with proceeds of DM1.5 billion realized. Financial statements are expected shortly. Negotiations over another 500 enterprises are under way. In addition, some 2,000 local public utility units and all housing units have been transferred to local communities to be managed or disposed of according to Treuhand guidelines.

This unprecedented task was begun by a new organization under enormous political and administrative pressures. Some widely-publicized cases of corruption and incompetence and a stormy settling-down period have marked the brief history of Treuhand. It is not surprising under these circumstances that the operational policies and practices are still forming.

Treuhand’s statutes and government pronouncements list the familiar catalogue of privatization objectives:

- introduction of competition;
- promotion of private entrepreneurship;
- collection of revenues from sales of assets;
- control over the fiscal drain from illiquidity;
- improvement of productive and allocative efficiency; and
- stimulation of inflow of technological and managerial know-how and capital.

Treuhand’s emerging philosophy implicitly rejects any “giveaway” privatization patterns. Specifically, Treuhand will remain the only agency, with some devolution to local branches dealing with smaller units. No other holding companies or mutual funds will be created. The agency will move with due speed, constrained only by the principle of financial prudence. Prudence excludes any free front-end distribution of ownership to citizens in the form of vouchers or shares. The citizens merely have a claim in the unlikely event that a surplus remains after Treuhand has completed its tasks. Furthermore, assets can be given away only if they are deemed worthless. In extreme cases even “negative” prices are conceivable. To the extent possible, ownership and control will be passed on to individuals and organizations that have sufficient resources and competency.

... Emphasis is clearly ... to avoid squandering East Germany’s precarious patrimony through haste or spectacular giveaways

For financial and managerial reasons, only West German or foreign firms normally will qualify as buyers for the large units. These will be broken up as much as possible, and debts will be written off as necessary to ensure solvency. No further restructuring will be carried out by Treuhand just to achieve quick privatization. Viable large firms that do not attract buyers who can offer a reasonable price will be reorganized under Treuhand as “mixed enterprises” and run by Treuhand-appointed managers and boards (as was once the case in West Germany with firms such as Volkswagen, Lufthansa, and Salzgitter). Such firms will have to be sold later through the stock market once a realistic market value is established; the speed of such privatization will be matched to the capacity of the stock market to absorb the increment of capitalization without a slump. At the same time, small service enterprises and retail shops are to be sold off or leased out quickly, if possible, to qualified local operators.

Treuhand’s mandate is to move at a speed commensurate with economic conditions and financial prudence and without the constraint of deadlines.

Proceeds from the sale of enterprises will be used to cover costs of other units’ liquidation. In addition, Treuhand’s revenues can be spent on selective debt write-downs or write-offs, assumption of external risks, such as claims from former owners, and accumulated environmental costs.

As implied before, Treuhand does not follow any particular procedural doctrine beyond choosing an approach on a case-by-case basis. Several forms of contractual arrangements, either applied or considered, further illustrate this pragmatic approach:

- Privatization can be accomplished through “incomplete contracts” if the process becomes stalled in the absence of realistic accounts — as no reliable asset evaluation of a firm is possible — or if the “risk premium” to prospective buyers would have to be very large because of the unpredictable requirements of rehabilitation. These incomplete contracts allow asset valuation by auditors to be postponed until after the status of the firm is normalized. On the basis of such a valuation, the appraised price of the firm is shared between the buyer and Treuhand.

- If heavy debt prevents the acquisition of an otherwise viable firm by qualified buyers, Treuhand can assume servicing and amortization of part or all of the debt.

- In addition to agriculture, where large-scale leasing seems to be the only type of conversion feasible in the short- to medium-run, leasing is also applicable in the manufacturing and
service sectors. Given the lack of sufficient funds on the part of local investors and operators, leasing is a useful approach for promoting local entrepreneurship.

• To ensure fair opportunity and to maximize public revenues, conversion is to be carried out on a competitive basis. For small units, this would be through auction. For large units, offers can be solicited by invitation. Unsolicited offers will be made public, with an announcement of intent before the legal procedures are completed.

Few conversions have been concluded so far, but the size of several currently under way is substantial. After much public debate and threats of legal intervention by the monopoly control agency, the power generation and distribution facilities were sold to nine West German power companies. Local distribution grids were transferred free of charge to the local communities. A controlling minority share of East Germany's gas distribution company was sold to the leading West German distribution company. Most of the remainder will be sold to former East German states and to other European gas distribution companies. These latter have a stake in the outcome because of the hook-up between the Soviet Union and the Western European pipeline, which goes through Germany. One of the largest East German cement companies was sold to a French firm, and equally large contracts have been signed in the automotive field.

Transformation of the agricultural sector, consisting of large specialized production cooperatives, is expected to be particularly difficult. The enforced collectivization in the 1950s was followed by massive emigration of the farm population to West Germany. Former ownership records were destroyed after the collectivization. For political and social reasons, selling land to West German or foreign investors on a large scale is not considered a feasible option. On the other hand, few members of the present cooperatives are interested in becoming independent farmers, and even fewer have the financial resources to purchase land. In any case, it is unlikely that the legal uncertainty can be disentangled except through a drawn-out process. Therefore, Treuhand must devise a legal framework for large-scale leasing of land to individual farmers or to small voluntary cooperatives and for settling questions of ownership.

Treuhand's approach and activities suggest a few partially overlapping, tentative generalizations about its divergence from the prevailing thinking elsewhere in Eastern Europe:

• The approach is a pragmatic mix of conventional measures implemented on a massive scale rather than being radically new.

• The expected flow of transfer payments within Germany from the western to the eastern part of the country is anticipated to be well in excess of $3,000 annually per capita for the next decade (in addition to large inter-regional capital flows). However, the emphasis is clearly on economizing the process to avoid squandering East Germany's precarious patrimony through haste or spectacular giveaways.

The political economy of Treuhand's approach does not seem to be encumbered by considerations of whether it is buying legitimacy through the free distribution of wealth, nor is it markedly affected by considerations of distributional equity or locus of control.

• Concern for economic and financial prudence and the preference for pragmatic over radical approaches may lead to trade-offs between speed and efficiency. One possibility is to devise an open-ended schedule for the completion of the program. Another possibility arises from the presence of a potentially sizeable commercialized public sector, or mixed sector, which will only gradually be privatized through conventional stock market operations.

Martin Schrenk
World Bank, CECSE

ADJUSTMENT LENDING — LESSONS FOR EASTERN EUROPE

Adjustment lending — characterized by quick-disbursing loans made conditional on policy reforms — were introduced by the World Bank in 1979 to assist member countries cope with the oil shock. By 1989 these loans accounted for 27 percent of the Bank's total lending commitments. Structural adjustment loans (SALs), which support economy-wide reforms and institution-building, and sectoral adjustment loans (SSEALs), which focus on specific economic sectors, are the two principal instruments of adjustment lending. Lessons have been learned from the experience with these loans that will help in formulating new programs in Eastern Europe.

Although conditions vary in Eastern Europe, there are some common elements, including excess demand at existing prices, massive external debt, balance of payments deficits, and an industrial sector dominated by large state-owned enterprises. Labor, land, and financial markets are absent, as are those institutions needed to support a market economy (for instance, accounting procedures, property rights, bankruptcy laws, and commercial regulations). On the positive side, these countries have a good human capital base, are close to Western Europe, and many of them enjoy a privileged political relationship with Western Europe.

In countries suffering from high inflation, widespread shortages, or current account deficits, stabilization should be initiated at the beginning of the adjustment program. Stabilization has two components in such countries: elimination of the money overhang and elimination of the public sector deficit. The former can be corrected by a price increase or by monetary reform. Immediately after World War II, most European countries chose the second option, but experience since the 1950s has been mainly with price increases.

This initial price increase could result in protracted high inflation. For example, Chile's three-digit inflation lasted from 1973, the year of its price liberalization, until 1977, despite achieving a public sector surplus in 1975. In countries where public enterprises are the main borrowers and capital markets are absent, monetary policy does not play a large role, and public expenditures must be cut through fiscal policy.

To avoid prolonged inflation, the public sector deficit should be cut in the first phase of the reform process by (a) imposing a hard budget constraint on public enterprises, (b) reducing public sector subsidies, and (c) setting up an efficient tax system. These reforms need to be followed by an income policy in countries where the labor market is inflexible, to break the course of inflation. This was done in Israel in 1985, Mexico in 1987, and Poland in 1990. However, using only the nominal exchange rate to bring inflation under control could jeopardize complete reform programs.

Socialist economies in transition, as well as the strictly regulated economies of Africa, must correct large distortions in relative prices as well as distortions resulting from over-regulated, not to say virtually missing, labor and financial markets. (This was the case in Turkey in 1980, Chile in 1973, and Mexico in 1982). These problems are aggravated by the large public enterprise sector's generally low response to price incentives and the lack of institutions to manage macroeconomic policies and establish minimum rules for the normal functioning of a market economy (such as property rights protection, bankruptcy laws, and accounting procedures).

Because socialist countries have much to gain from integration into the world economy, trade reforms have a very high priority. The initial stages of trade reform, such as replacing managed trade by open trade, substituting quotas for tariffs, and reducing high tariffs, should be put in place early in the reform process. But major trade liberalization should be undertaken only after clear and credible progress has been achieved in reducing inflation. In countries with uncompetitive domestic economies, trade liberalization may help the stabilization effort, as was the case for Mexico in 1989 and Poland in 1990. However, major fiscal adjustment is necessary to initiate spending reductions and avert a balance of payments crisis.

Trade reforms aim to shift investment and labor from non-tradable and highly protected import-competing activities toward export-oriented production. Unpredictable relative prices (usually the case in high-inflation countries), a lack of labor mobility, poor financial markets, and legal impediments to new enterprises are the major inhibitors of successful trade reform. In many Eastern European countries, privatization and the emergence of entrepreneurs could be important components of economic restructuring.

A study of countries that successfully implemented trade reforms showed that these countries had lower fiscal deficits and less inflation. In some cases successful trade liberalization was carried out while stabilization was still under way, as in Chile in 1974-79 and Turkey in 1980-84. In more typical cases, either severe macroeconomic instability contributed to economic failure — as occurred in Argentina, Brazil, and Sri Lanka in the 1980s and in Turkey and Uruguay, among others, in the 1970s — or stability facilitated successful liberalization, as in Greece, Korea, Spain, and all the other countries of Western Europe.

Impediments to the proper function-
Transitioning of markets limit the benefits of trade liberalization. The lack of labor mobility, including restrictions on inter-firm labor reallocation and mandatory high severance payments, prevents new firms from going into business. Restrictions on entering, expanding, and exiting could severely reduce the benefits of trade liberalization. Lack of incentives, as well as regulations that increase the costs of restructuring, played an important part in the costly and failed liberalization attempts in Poland, Hungary, and Yugoslavia in the 1970s. On the other hand, deregulation of the labor market contributed to the success of the trade reforms in Chile.

Experience suggests actions along the following lines:

- High (open or repressed) inflation and other symptoms of severe macroeconomic imbalances, such as unsustainable current account deficits or high positive real interest rates, should be tackled at the beginning of an adjustment program.
- Restrictions on labor and enterprise mobility should be removed in parallel with trade liberalization so that early reforms generate economic growth rather than unemployment.
- Development of a full-fledged financial system can wait until stabilization has begun to work, but credit markets to finance working capital should be set up early.
- Institution-building, including the capacity to formulate and execute macroeconomic policies and establish a regulatory framework, is an important complement to successful reform.

The road to reform is difficult, but the alternative — perpetual stagnation and deteriorating living standards — is even worse. The reforms in Eastern Europe are not based on recent economic precedents. It is likely that output levels will fall in the early years, but these adjustment costs should be considered investments in a viable economic system. Once the reforms start to work, the response from investment and output will rise.

Vittorio Corbo, World Bank, CECMG

The article is based on the author’s paper presented at a conference in Poland in October, 1990.

Quotation of the Month:
“The demand of the day decides all”

The ruble became an even more slippery creature last month, varying widely in value depending on region, type of deal, and timing with respect to new laws. On the three markets monitored, the ruble’s performance differed radically: the Soviet black market saw what is probably a temporary stabilization, the Vienna market changed little from October, and the European market saw the ruble hit a record low. Its plummet on the European markets was propelled by the Soviet West Army group’s selling off their rubles.

“Vienna was another story, with the ruble surprisingly stable. Bank operators in Vienna manage to earn R19.7 on each dollar, while their colleagues in Munich make a profit of R43.4 on each dollar. The ruble’s selling price remains lower in Vienna because that city is a major tourist center where people are more likely to buy rubles for spending later in the Soviet Union. As a result, Vienna’s banks buy more than twice as many rubles as they sell, compared with Munich’s banks, which buy nearly seven times more.

“In the latter half of November, the Soviet black market was still ‘rather nervous,’ to quote one black marker. ... with Soviet citizens unsure about the future. ... Under the circumstances, there is no long-term strategy for the development of the currency market in the country, which means that the ‘demand of the day’ decides all.

“But the trend toward interdependence between commodities and the direct exchange rate of the ruble continued during December. The commodity exchange rate — the market that converts dollars to rubles through the purchase of goods abroad for sale in the Soviet Union — is now about R15 to the dollar. But the direct exchange rate has seen wide fluctua-

Ruble exchange rates of the US dollar and the German mark

<table>
<thead>
<tr>
<th></th>
<th>US$</th>
<th>DM</th>
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<tr>
<td><strong>USSR Gosbank</strong></td>
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<td></td>
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<tr>
<td>Official</td>
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<tr>
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<tr>
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<td><strong>Vienna black market (mid-November 1990)</strong></td>
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<tr>
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<td>7.2</td>
</tr>
<tr>
<td>Selling</td>
<td>30.3</td>
<td>10.6</td>
</tr>
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<td><strong>Moscow black market (mid-October 1990)</strong></td>
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<td></td>
</tr>
<tr>
<td>Buying</td>
<td>15.0-16.0</td>
<td>9.0-10.0</td>
</tr>
<tr>
<td>Selling</td>
<td>18.0-21.0</td>
<td>11.0-12.5</td>
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Average free market prices of some staple foods in selected Soviet cities
in rubles per kilogram in November 1990

<table>
<thead>
<tr>
<th></th>
<th>Beef</th>
<th>Pork</th>
<th>Eggs (10)</th>
<th>Potatoes</th>
<th>Tomatoes</th>
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<tr>
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<td>20.5</td>
<td>23.4</td>
<td>11.0</td>
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<td>3.0</td>
<td>1.00</td>
<td>5.0</td>
</tr>
<tr>
<td>Odessa</td>
<td>11.0</td>
<td>12.0</td>
<td>3.0</td>
<td>1.30</td>
<td>2.5</td>
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<tr>
<td>Alma Ata</td>
<td>10.3</td>
<td>7.5</td>
<td>n.a.</td>
<td>1.03</td>
<td>2.5</td>
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<tr>
<td>Tbilisi</td>
<td>12.0</td>
<td>10.0</td>
<td>5.0</td>
<td>1.5</td>
<td>3.0</td>
</tr>
<tr>
<td>Vladivostok</td>
<td>10.0</td>
<td>15.0</td>
<td>n.a.</td>
<td>3.0</td>
<td>7.0</td>
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<tr>
<td>Minsk</td>
<td>n.a.</td>
<td>14.0</td>
<td>4.25</td>
<td>0.75</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

Average monthly nominal wage in the Soviet Union—according to the latest Statistical Annal of the UN Economic Commission of Europe and recent press reports—is about R260.

In the first half of November, hard currency increasingly shifted from the wholesale to the retail sector. The trend is probably due to higher ruble prices for foreign currency in the retail sector and the slackened demand for hard currency on the part of the currency operators who are increasingly active on the Soviet commodity market.

"The injection of sizable sums of cash helped offset Soviet citizens' growing demand for foreign exchange. They were anxious not only to hedge their savings against inflation but also to meet everyday needs. For example, the market price for meat is R30 or $1 per kilogram (about R14 or 45 cents per pound). With the black market exchange rate at about R21 per dollar, the use of hard currency nets significant savings.

"Regional differences, too, will play their part. ... With the good-for-nothing ruble savings soon to be devalued, the public will be more than willing to exchange their rubles for hard currency imported into the republic."

From the article Ruble Roulette—What the Ruble Is Really Worth, published in the Soviet business weekly Commerant.

From the Soviet weekly, Commerant.
Milestones of Transition

The nine-nation CMEA, the former trade group of the Soviet Union and Czechoslovakia, Poland, Hungary, Romania, Bulgaria, the former GDR, Cuba, Vietnam and Mongolia, has been replaced, as of January 1, by the Organization for International Economic Cooperation (OIEC). The OIEC will act as consultative and advisory body for member countries. It will encourage members to trade with non-member countries and to integrate with the world economy.

Vietnam published a new law on private business January 2. Private citizens will have the right to set up businesses, and private companies will have rights equal to public sector enterprises. According to statistics, Vietnam's economic growth rate (national income) dropped to 2.4 percent in 1990, and consumer goods output declined in two successive years. A new plan intends to double per capita income in ten years to $400, cut the inflation rate to a single digit, and increase exports, totaling $1 billion in 1988, fivefold.

Czechoslovakia has established a single exchange rate for the crown against the U.S. dollar (28 crowns = $1) to facilitate internal convertibility of the currency. The new rate represents a devaluation of 14.25 percent for the former commercial rate and a revaluation of 7 percent for the tourist rate. The Czechoslovak State Bank also announced that the discount rate would rise to 10 percent from 8.5 percent. Finance Minister Vaclav Klaus told parliament that a 30 percent inflation rate, a 5 percent drop in economic activity, and a rise in unemployment to 5-7 percent would be inevitable as economic reforms begin to bite in 1991. He forecast that foreign debt would rise from $7 billion to as much as $10 billion and said he was calculating a budget surplus of 13.5 billion crowns in 1990, the first since 1986, because of the current oil price rise. The country will earn an additional 25 billion dinars in exports and 15.5 billion dinars in tax revenues. The 1991 budget sets spending 27 percent higher, at 180.5 billion dinars, and revenue at 192.5 billion dinars. The budget assumes an average oil price of $23 in 1991. GDP is forecast to rise 4.7 percent expanding from 2.7 percent in 1990.

On December 30, the Central Committee of China's Communist Party called for continuation of economic reform according to the forthcoming five-year development plan. The party also stressed the importance of national self-reliance and listed areas where structural reform was necessary, including enterprises, prices, finance, the tax system, banking, labor, and wages. The party's communique said reforms should center on establishing a new economic system, but there was debate on whether the government should begin to free prices in a systematic way, commented the People's Daily.

In late December, Hungary's parliament passed a budget for 1991 of 931 billion forints. The current deficit will become small enough to make the country eligible for a three-year standby agreement with the IMF, said Frigyes Harshegyi, deputy president of the central bank. (As a result of the latest 15 percent devaluation of the Hungarian currency in January, 70 forints = US$1). A state budget deficit no bigger than 78 billion forints and a current account deficit of $1.2 billion were acceptable to the Fund, said the vice president, adding that Hungary will continue to cut subsidies, liberalize prices and imports, accelerate privatization, and promote foreign investment. After approval of the arrangement by the Executive Board of the IMF, Hungary expects to receive $1.1 billion from the IMF in

(continued on page 11)
The Malagasy government, like many other Sub-Saharan African countries that saw the industrial sector as critical to economic growth in the 1980s, encouraged industrial development by providing protection, granting subsidies, and intervening directly in the production process. Not surprisingly, these policies resulted in an inefficient and high-cost industrial sector oriented toward import substitution. In the mid-80s, the government initiated substantial reforms that have prompted a significant supply response. Although the principal distortions have been removed, much work remains to be done to achieve sustainable economic growth.

The age of extensive intervention

The Malagasy government's limited interference in economic affairs changed substantially following a coup in 1972. The new government's policy meant extensive intervention at all levels of the economy. For example, domestic firms began receiving extensive protection against imports. Until 1976 this protection had taken the form of high tariffs and import taxes. Thereafter, to provide further protection and help stem the outflow of foreign exchange, the government imposed increasingly tight import licensing requirements, quantitative restrictions, and import prohibitions.

At the same time, the system of foreign exchange allocation provided funds for importers of raw materials and inputs, without regard to the efficiency of the enterprises. The new government also imposed controls on prices and profits as a means of allocating goods and minimizing the effect of short-term shortfalls in supply.

Both entry and exit from industrial activities became subject to administrative controls. Approval was required for all temporary or permanent closures and bankruptcies. Anxious to avoid the political consequences of large-scale layoffs, the government tried to keep ailing units afloat by channeling credit to them through the nationalized banking system or through rehabilitation and temporary layoffs. For larger firms, closure became virtually impossible.

Foreign enterprises were nationalized, and many new public enterprises were established. Public investment grew rapidly after 1978 when the government embarked on a massive investment program financed by foreign borrowing and domestic money creation. By 1987 some 50 enterprises were entirely state-owned; the government held a majority interest in another 20, mostly large-scale operations. State-owned enterprises controlled an estimated 65 percent of sectoral output and a similar proportion of employment. Most of these enterprises are classic "white elephants," and in some cases the value added by public enterprises has been negative.

This policy environment discouraged investment in the private sector, sent distorted signals that oriented investment toward the domestic market and the use of imported inputs, and permitted continued inefficiency. The footwear industry was typical of what developed in this period. In 1987, the industry was dominated by a single firm that controlled more than 80 percent of the market and produced more than 2,000 different products. Raw materials, two-thirds of which were imported, accounted for half the cost of production; labor accounted for only 4 percent. In response to the increasing difficulty of obtaining foreign exchange, the firm stockpiled as much as nine months' supply of imported inputs when possible. By 1988, despite initial adjustment measures, the same footwear cost 15 times more to produce in Madagascar than in Taiwan.

Despite the emphasis on the industrial sector, in 1986 it accounted for only 10 percent of GDP — smaller, in fact, than in many other low-income countries in Sub-Saharan Africa. In 1960, manufacturing had accounted for about 4 percent of Madagascar's GDP; by 1970, it had tripled to about 13 percent, and further growth occurred during the 1970s. In contrast, the economic downturn of the early 1980s had a severe impact on industry. Manufacturing value-added fell by about 35 percent, far more than in any other sector, so that industry's contribution to GDP dropped to about 10 percent in 1986.

Crisis and adjustment

The result of the poor macroeconomic management and inefficient use of resources has been stagnation and decline. Apart from short-lived and unsustainable growth in 1979-80, real growth in GDP failed to keep up with population growth every year from 1971 to 1987. GDP expanded at an annual average of only 0.9 percent during 1972-80 and then declined 3.6 percent a year from 1980-83. To finance the higher rate of public investment, the government resorted to foreign borrowing and inflationary financing. This policy resulted in rapidly growing fiscal and current account deficits, which both peaked in 1980 at 18 percent of GDP. The debt service ratio reached 72 percent in 1982.

Many nationalized enterprises as well as most new public enterprises faced serious financial difficulties and survived only through infusions of credit from the state banks. The public enterprise sector absorbed an increasing share of the budgetary and credit resources: in 1987, it accounted for more than 50 percent of total bank credit, crowding the remaining private sector firms out of the credit market. And more than half of these loans were non-performing, leaving the
The collapse of the current account balance in 1981 led Madagascar to seek the first of a series of stand-by agreements with the IMF in 1982. The stabilization measures it adopted included tax measures, increases in the rates charged by public enterprises, reductions in subsidies, and a deceleration in the growth of the money supply. At the same time the government devalued the exchange rate and managed it more flexibly. Fiscal restraint and prudent monetary policies resulted in substantial reductions in the public sector and external current account deficits.

While these measures helped restore macroeconomic balance, they did little to address the underlying problems. In 1984 the government began a program of structural adjustment. The initial measures were tentative and limited, however—particularly as the government was apprehensive about possible social and political consequences—and reform did not begin in earnest until 1987.

The new reforms focused on the partial liberalization of domestic trade and prices and the rationalization of the public investment program. Administrative price-setting was eliminated for most goods. Although restrictions on profit margins were retained, they were less strictly enforced. Planned public investment dropped from $80 million in 1980 to $14-$18 million a year. Actual investment was considerably below even these figures and was restricted to completing existing projects. The least viable projects were put on hold temporarily. Limited measures to encourage exports were also instituted, and tariffs began to replace import prohibitions.

In 1987 the government instituted more far-reaching measures. After a large devaluation it undertook a substantial reform of the trade regime. An open general license system of foreign exchange allocation replaced the previous administrative mechanism. Tariffs were lowered and non-tariff barriers were eliminated and replaced by a temporary import surcharge, which has since also been eliminated. Credit to state enterprises was frozen or reduced, but funds were expanded for private sector enterprises. A moratorium on the creation of new public enterprises was instituted.

Results and obstacles

After the slow start adjustment is now well under way in some segments of industry, and the short-term effects on economic performance and exports are encouraging. Capacity utilization has increased in almost all subsectors, from an average of about 45 percent to about 60 percent. A number of new firms have been established, particularly in labor-intensive export-oriented activities. Garment manufacturing and knitwear industries have been the most dynamic, taking full advantage of the low-cost, good quality local labor. The dominant footwear manufacturer cited previously now has only about 35 percent of the market. The company has responded to its decreasing market share by reducing its product range from 2,000 lines to fewer than 200, a move that has resulted in greater specialization and economies of scale.

Despite these advances, in the aggregate the adjustment has produced little net growth in employment or production because the large public sector firms—many of which are not viable even on a sunk-cost basis, have fallen deeper into the red. The government has reluctantly begun the liquidation or privatization of these enterprises.

The subsectors that have begun to adjust still face numerous obstacles. Growth in the textile industry, for example, is hampered by continued government control over the marketing of cotton, which is controlled by a government monopoly. Even though Malagasy cotton is generally of superior medium- and long-fiber quality, poor processing often results in inferior quality. The garment industry is further penalized by excessive taxation of imported textiles and the heavy administrative requirements of the temporary admission mechanism.

The unavailability of credit at affordable rates has emerged as a major constraint on the industrial sector. In 1988 non-performing assets amounted to about 50 percent of the banks' portfolios. Subsequent portfolio cleanup did not address the efficiency of the banking system. Unsound banking practices, insufficient analysis of loan performance, and limited competition encourage the banks to require a large spread between the borrowing and lending rates to cover their costs. The resulting high interest rates, coupled with the delays in loan processing, make credit an unattractive financing option.

The condition of the industrial sector has improved considerably since the crisis years and has resulted in the emergence of new firms that more closely correspond to Madagascar's comparative advantage and that are operating more efficiently. The legacy of previous policies continues to hamper further adjustment measures, however, and has resulted in a fragmented supply response. Madagascar now faces two challenges: removing the remaining impediments that previous policies have strewn in the path of efficient economic activity, and turning its attention to the many structural problems that need to be addressed to achieve sustainable growth.

Stefano Pagiola, World Bank AF3IE

Optimism

From the Yugoslav magazine Jazz
Comparative analysis of enterprise behavior in Eastern and Central Europe, a research project under development in the World Bank's Socialist Economies Reform Unit, was the topic of a one-day workshop in December 1990, hosted by the unit's principal economist, I.J. Singh. The central theme of the research project is the efficiency and speed of adjustment in industrial enterprises in Czechoslovakia, Hungary, and Poland. Participants agreed that understanding the changing behavior, response, and performance of enterprises is crucial to policy formulation and project design. The research thus will focus on both country-specific and comparative analyses. Each country study will have three major components:

• monitoring and evaluation of enterprise performance in collaboration with key government agencies in the three countries;
• in-depth case studies of about a dozen enterprises in each country to gain understanding of the problems arising during the transition and for insight into the dynamics of adjustment to institutional, technological, and market changes, especially in ownership status;
• comparative analysis of changes in total factor productivity across industrial subsectors and their relationship to the different sequences and pace of institutional reforms.

The workshop was organized around three main themes: (i) major research hypotheses related to enterprise behavior, to be addressed both in individual country studies and in a comparative framework, (ii) methodologies (production functions, explicit behavioral modeling, case studies, simulation methods), and (iii) data requirements, ways to get around them, and additional data required.

Participants agreed that a better understanding of the response and behavior of firms is a central issue for research, since the adaptability and supply response of firms is critical for renewing growth in Eastern and Central Europe. They pointed out, however, that according to present research, between 65-80 percent of productivity growth cannot be explained by factor inputs, however carefully measured. The unexplained growth has to be traced to elements of "creativity," especially in the workplace, and to managerial response to external shocks, as well as to such institutional factors as market competition, state regulatory agencies, trade unions, and ownership. The proposed project would be useful in shedding some light on these issues.

Various participants highlighted the need to understand the different initial conditions of enterprises in each country. For example, macroeconomic forecasts of what would happen after the "big bang" in Poland were inadequate for confronting unanticipated "surprises" and paradoxes. Careful analysis of the microeconomic firm-level response would contribute to a better understanding of these issues.

For the research methods, a proposal to start with the received theory about firms and proceed first to measure technical and allocative efficiency, using some form of frontier production functions, was well received. However, the importance of institutional and market factors suggests the need to explain variations in efficiency as a function of these institutional variables, to find an explanation for the changing performance of enterprises in response to structural changes. This calls for an integrated approach that would use the monitoring and case study components to generate relevant hypotheses for econometric analysis.

Several models are used for analyzing socialist enterprise behavior, including one that treats firms as large "hoarding" enterprises. These would provide a good starting point for the research. However, the research should go beyond traditional measures of efficiency and should formulate better models for describing the way enterprises might behave during the transition. The research should proceed from stylized facts to examine alternative theories of firm behavior and test them against available data.

Other participants argued for a more eclectic approach that would include these methods but also would examine the dynamics of adjustment by modeling the rate at which adjustment would occur. The dynamics should not be achieved ad hoc; issues such as scale economies, market contestability, and the strategy of incumbents in an oligopolist setting should receive explicit attention.
Analysts working on similar issues using Chinese data raised two themes: the difficulty of using “socialist” data sets, where the variables need careful interpretation. Much of the Chinese research involved examining the available data to transform them into meaningful categories before analysis. Recognizing the special problems encountered in measuring capital stocks and flows accurately, those familiar with the research outlined a procedure that is used to adjust the Chinese data before proceeding to the estimation of efficiency parameters. The hypotheses of “convergence in factor returns,” which seemed to be confirmed by the Chinese data. The analysts made the novel proposal that perhaps the degree of convergence in factor returns could be used as a measure of the success of the reform process.

There was also clear consensus among the participants that the available data were inadequate for addressing the issues proposed in the research. Instead, it would be necessary to carry out additional surveys to collect key missing or institutional data. These “re-surveys,” newly-designed, would have to be an integral part of a research project. Agreements have been reached with statistical agencies to undertake such re-surveys.

It is expected that the research proposal will be ready for submission to the World Bank’s Research Committee by March 1991.

The December workshop was attended by Farid Dhanji (CECSE) and other participants from the Bank and professors Joe Brada, Stanislaw Gumula, Saul Estrin, Mark Schiffer, Tom Rowski, Jan Sueijnar, Gary Jefferson.

The project is directed by IJ Singh, principal economist (World Bank, CECSE). The complementary project on the impact of reforms on industrial efficiency in Chinese enterprises is also being carried out in the Socialist Economies Unit. Individuals or institutions with research projects under way on topics that relate to the above are invited to contact Donna Schaller, CECSE Unit, Room N-6011, the World Bank, 1818 H St NW, Washington, D.C. 20433, Tel: (202) 473-7066

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**Milestones (continued from page 7)**

1991: $600 million from the extended credit facility and $500 million from the compensatory and contingency financing facility to help cover the rise of fuel prices.

Soviet officials recently announced that retail prices would rise following the January 1 increase in the wholesale prices of several goods. This is because it is impossible for the Soviet economy to maintain the current level of subsidies, expected to cost up to 150 billion rubles in 1991. Energy and wood prices were doubled in early January, and those of metals went up 50 percent. (Additional decrees established a central fund to help enterprises adjust to the market and imposed a 5 percent tax on retail sales). Anatoly Komin, deputy chairman of the state committee on prices, hinted at possible increases of between 50-70 percent on cars, radios, television sets, refrigerators, and washing machines.

A new technical assistance law to create Soviet foreign currency exchanges came into effect January 1. This will allow licensed banks and brokers to deal in foreign currency, in an effort to make the ruble convertible. Establishment of several stock and commodity exchanges already has been announced. The Russian Republic stock exchange, was set up in Moscow in November, with the Ministry of Finance and several so-called commercial banks as founders. The Leningrad stock and commodity exchange, with a director appointed by the local city council, is organized on lines similar to the Swedish stock exchange. An all-Soviet agro-business commodities exchange was registered in Ryazan, with state construction and supply organizations as the major founders and shareholders; this exchange will deal in farming goods and produce. A commodity exchange serving the Volga region has been set up also. It will be a long time before any significant volume of business occurs on these exchanges, however, warns the Oxford Analytica.

On January 3, the Soviet Federation Council approved an economic agreement for 1991 that aims to preserve links among the Soviet republics and to stabilize the Soviet economic and social situation. The accord envisages the creation of extra-budgetary funds to stabilize the economy and calls for a coordinated policy on price formation that will ensure free competition. The accord further supports the introduction of new wholesale and retail prices and tariffs, as of January 1, and suggests policies on wages, employment, and migration, as well as on minimum provisions in the social sphere. Foreign economic policy will be pursued jointly through a union-republican currency committee. Loans and credits will be made on behalf of the Soviet Union in agreement with the republics, and republics will be able to borrow and lend independently. Federal and republican budgets would draw resources from Soviet taxes, among other sources. President Gorbachev said a key element of the agreement was finding a way to compensate regions that produce raw materials for their lower revenues, compared with the manufacturing regions. This would mean a better deal for the Russian republic. Russia and the other republics have agreed to increase their contributions to the central budget in return for tighter controls over spending.

The new constitution of Mozambique commits the country to market economies. Parliament has accepted the principle of private property, and the government is encouraging foreign capital to invest in infrastructure. The latest estimate of the national debt is $4 billion. At least 80 percent of the country’s imports and 65 percent of the government budget are financed by foreign aid. The government’s Economic Recovery Program has helped to stabilize the value of the currency and boost industrial and agricultural production, but higher fuel costs are likely to jeopardize these improvements.
THE ECONOMY OF THE USSR: A STUDY UNDERTAKEN IN RESPONSE TO A REQUEST BY THE HOUSTON SUMMIT

Experts from the four international organizations have undertaken a detailed study of the Soviet economy, have made recommendations for its reform, and have established criteria by which Western economic assistance could effectively support such a reform, as requested at the Houston Economic Summit in July 1990. Seven major industrial democracies and the Commission of the Common Market were the summit participants.

The old planning system has broken down but has not been dismantled. Not a single centrally-planned economy qualifies as successful in modern times, and attempts to enhance performance under the old system have proved counterproductive. Since there is no chance to introduce reforms gradually, the authorities should move rapidly toward a market economy, according to the report’s recommendations—delay in the implementation of reform would lead to an even greater and longer decline. A social safety net should be in place at the start of the program because the decline of output and employment seems unavoidable initially.

Economic stabilization and structural reform should be addressed simultaneously. Budget deficits must be reduced, excessive money holdings absorbed, the credit supply stringently controlled. Positive real interest rates must be introduced. At least for the transition period, an incomes policy seems indispensable. Rapid and comprehensive price and trade liberalization is necessary (with the exception of a few key industrial items; for example, oil and gas prices could be adjusted to world level over a three-year period). In the near term, government subsidies of rents and some essential consumer goods may continue. The ruble exchange market for current account transactions could be unified within a year.

These steps must be accompanied by the dismantling of the state control mechanism that prevents competition and efficient use of resources. Smaller firms should be privatized quickly, and ownership reform in larger enterprises should begin with commercialization of the enterprises, the imposition of hard budget constraints, and opening up of foreign trade. The authorities need to introduce wide-ranging legal, trade, and financial reforms and thoroughly change the agricultural, energy, and distribution systems. As to foreign help, technical assistance is required, and there is a case for humanitarian assistance, provided internal distribution problems can be solved. There is also a need for well-defined programs in the environmental and energy areas. On the other hand, balance of payment constraints, imposition of hard budget constraints, and foreign assistance would be effective only after implementation of the systemic reform program is under way.

The study is available at the World Bank Book Store, 701 18th St. NW, Washington DC 20433

Gordon Hughes

Apart from a number of damaged areas, argues the author, the general level of exposure to major pollutants in Eastern Europe is not high by comparison with the OECD countries. The process of general economic reform, together with the energy conservation induced by higher energy prices, will reduce emissions by nearly 50 percent even without specific environmental policies, claims the paper.

A modest fraction of general investment in industrial modernization will deal with the remaining problem of current emissions, provided that sensible systems of environmental controls are enforced. Cleaning up the waste of past industrial activity can be tackled over an extended period.

Gordon Hughes is Professor of Economics at the University of Edinburgh, Scotland.

George M. Von Furstenberg
PARETO-OPTIMAL PRIVATIZATION FOR GAINING POLITICAL SUPPORT
Indiana University, Bloomington, Center for Economic Model Research, WP No.90-050, 1990, 50p

So far no politically successful approach to rapid privatization has been found in Eastern Europe, and there is a high risk of coordination failure and a political impasse. The paper explores the possibilities of building broad support for privatization by instituting a Pareto-optimal process from which many will gain and no one with a politically legitimate claim can initially lose.

Both the government (in the name of future taxpayers) and those (management and workers) who hold a direct stake in the assets to be privatized should be compensated, with the general public made beneficiary of the value that remains.

Subscribers can be insured against being made worse off if they only have to pay for the shares of the formerly socialist enterprises or asset-trusts if the papers turn out to be worth reselling. Payment would be made by means of a first-time stock transfer or conversion tax equivalent to the strike price set in a call option on shares.

Measures of this kind can help gain strong political support that in turn, could speed up the process. Brisk progress in privatization is necessary.
progress in privatization is necessary because much of industry, suddenly called to compete in an open economy, is a rapidly wasting asset.

The author is Professor of Economics at Indiana University, Bloomington.

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Jerry M. Silvermann
PUBLIC SECTOR DECENTRALIZATION: ECONOMIC POLICY REFORM AND SECTOR INVESTMENT PROGRAMS

Conventional wisdom suggests that participatory management and decentralization are likely to succeed only if they are accompanied by concerted efforts to build local capacity. On the other hand, improving local public sector management capacity can be a protracted, costly, and uncertain process.

A more fruitful approach is to consider the capacity required for effective decentralization in the context of a generally more limited role for the public sector. Within their more limited role, local governments might be granted expanded functions, compared to their current part in substantially centralized systems, yet must take on considerably fewer responsibilities than those normally assigned to them in any system of active decentralization.

Even with a dramatic reduction of the public sector's role, professional and technical staff will still be required by both the central and local governments. The public sector thus will continue to suffer from a scarcity of professional staff. The present dilemma of public sector employment is whether to maintain the relatively uniform conditions and terms of service or choose the labor market approach.

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New Books and Working Papers

Michael Burda and Stefan Gerlach
Exchange Rate Dynamics and Currency Unification: the Ostmark-DM Rate

Clive Crook and Daniel Franklin
Eastern Europe in Transition
The London-based foundation commissions and publishes original papers by independent academic and other experts on key topics in the economic and social fields. Orders and inquires should be addressed to: SMF, 194 Regents Park Road, London NW1 8XP.

Poland: Economic Management for a New Area

An Agricultural Strategy for Poland
World Bank, Washington, 1990

Athar Hussain and Nicholas Stern
On the Recent Increase in the Death Rate in China
Papers of the China Program can be obtained from Lella Alberici, London School of Economics, Houghton St., London WC2A 2AE; tel: 405-7686, ext. 3016.

Frederic L. Pryor
East European Economic Reforms: the Rebirth of the [Farming] Market

Candidates for the Post

From the Soviet magazine Krokodil
On the World Bank/IMF Agenda

Special Soviet Status?

At a press conference earlier this month, IMF Managing Director Michel Camdessus said: "The Soviet Union is not yet a member of the International Monetary Fund, although one day it may apply. In the meantime, it has been proposed that the IMF consider a special association status for the Soviet Union so that it can receive advice and technical assistance from us. We are working on that proposal. On the occasion of the special study, we have established fruitful cooperative relations with the Soviet authorities." (The managing director was referring to the study the IMF recently prepared in response to a request from the Houston Summit, and which involved the World Bank, the OECD, and the new European Bank for Reconstruction and Development. The study analyzes the Soviet Union's economic problems, recommends reforms, and establishes criteria for financial assistance (see page 12).) Camdessus further noted that the Soviet authorities "told us that they had learned a lot [from the study] and had taken great advantage from this dialogue. Going to a market economy after 70 years of command economy is an enormous and complex business, and the IMF has long experience in this field. It certainly would be a good thing to establish a kind of relationship which would allow us to extend all forms of technical assistance in the area of our comparative advantage, to institutionalize the kind of yearly consultations on economic policies we have with all our member countries, and catalyze technical assistance from all available bodies. ... And I see not only the Soviet Union taking advantage of that, but the whole membership, because ... with the participation of the Soviet Union, our judgment of the world situation would be certainly better."

Aid for Mozambique

The World Bank has announced that an agreement has been reached in Paris to grant $1.2 billion in aid in 1991 to famine-hit Mozambique, "mainly in the form of gifts and support for the balance of payments." The IBRD-chaired donors' meeting pledged $400 million in debt relief, including $19 million in writeoffs and $761 million for food and other projects. Many donors have recognized that further debt reduction is crucial; some countries have already canceled all or part of Mozambique's debt with them. In another development, IDA has pledged $53.7 million to improve the country's education services. Mozambique officials have said that the recent rise in oil prices would add $50-$60 million to the country's annual oil bill — equivalent to 70 percent of export revenues. Budget expenditures have been affected by a reduction in annual aid, estimated at $100 million, from Eastern Europe.

World Bank Loan to China

The World Bank and the International Development Association have approved a $114 million loan and credit for the development of rural enterprises in Jiangsu and Jilin provinces and for the Shanghai Municipality. The 20-year $50 million World Bank loan includes a five-year grace period. The loan carries a variable interest rate — currently 7.72 percent — linked to the cost of bank borrowing. The $64.3 million IDA credit is for 35 years, including a 10-year grace period. The credit carries an annual interest rate of 0.75 percent on the disbursed balance only. Among other things, the program will enable selected township and village enterprises to acquire new technologies and management systems and to train managers and technicians.

Clean-up Efforts in Eastern Europe

The World Bank expects to lend $8-$9 billion to Eastern European countries over the next three years, with up to 15-20 percent directed to environmental concerns, said Eugenio Lari, European Director of the World Bank. Contributing to the cleanup, projects to modernize industry, change energy consumption patterns, and conserve resources could account for 40 percent of all Bank funding to the region in the next three years. Officials estimate that the economic and human toll exacted by the degradation of the region's environment is equivalent to 5-15 percent of annual economic output in Eastern Europe. Poland, with its far-reaching economic reforms and severe pollution, will be the largest beneficiary over the next three years, garnering commitments of as much as $1 billion a year. Czechoslovakia and Yugoslavia will receive up to $600 million annually, Hungary and Romania $400 million, and Bulgaria about $300 million.

Lending Rate Cut

The IMF's Board of Directors has decided to cut interest rates charged to borrowers. As of November 1, 1990, borrowers will be charged 8.78 percent of a rate based on the short-term borrowing costs of five major governments, down from the previous 9.13 percent. The move could save debtor nations about $100 million a year. For the week of December 3, the unadjusted interest rate charged by the IMF was an annual 8.27 percent. The decision to change the interest rate formula reduces that to 7.95 percent.

Negotiations in Sofia

An IMF delegation recently visited Sofia for a final round of talks on a loan for Bulgaria, according to the official BTA news agency. The two sides discussed the possibility of compensation for Bulgaria because of the rise in oil prices and looked at the possibility of long-term credits.

Romania Withdraws

Romania has withdrawn 80 million SDRs from the IMF to meet the country's needs from now through summer. The withdrawal was made a week after the government announced it needed an injection of foreign funds to avert an economic collapse. Shortages and price hikes have fueled recent anti-government protests in the country.
Conference Diary

Transition from Communism
December 3-5, University of Maryland, College Park, MD

"Polish-American Conference on the Political Economy of the Transition from Communism," organized by the Center for the Study of Post-Communist Societies, with the University of Maryland and the German Marshall Fund. Participants included academics from Poland, scholars, and U.S. government officials.

Managing Inflation
December 17-18, Sofia, Bulgaria

Conference on "Managing Inflation in Transition," organized by the World Bank (EDI, National Economic Management Division) with the National Bank of Bulgaria, for Bulgarian policymakers and academics. Topics included control of high inflation, role of price, and incomes policies.

Comparative Studies
December 28-30, Washington D.C.


Forthcoming Conferences

Agricultural Issues

Eleventh Agricultural Symposium organized by the World Bank’s Agriculture and Rural Development Department and Training Division, on Agricultural Issues in the Nineties. Participants will discuss, among other topics, Polish, Soviet, and Chinese agricultural developments.

New World Order

"From Cold War to Cooperation: Dynamics of a New World Order" International Development Conference, organized by the IDC in collaboration with the Society for International Development (U.S.) and the SID Washington Chapter. Topics include: a new world order, the issues the U.S. must face; Perestroika and pluralism southern style; changing East-West rivalry to East-West cooperation with the South. Senior officials of the World Bank will be among the speakers and panelists. (IDC, a non-profit educational organization since 1952, is a forum for American organizations and individuals concerned with world-wide development, with special attention to developing nations. Address: IDC, 1401 New York Ave. N.W., Suite 1100, Washington, D.C. 20005)

Privatization
February 8, 1991, Louvain, Belgium

Conference on “Privatization in Eastern Europe — The European Horizon” at the Catholic University, Louvain, to review progress and the major problems of privatization in Poland, Hungary, Czechoslovakia, and the eastern part of Germany. The conference will cover questions on the impact of the privatization process on integration into the European economy. The experience of the German Treuhand and other privatization agencies in particular countries will be reviewed by academic specialists. For more information, contact: Prof. Marvin Jackson, Director, Louvain Institute for Central and East European Studies, Blijde Inkomstraat 5, B-3000 Louvain, Belgium. Telephone: 32-16-285340, fax: 32-16-285344.

Public versus Private Enterprises
April 4-5, 1991, Liege, Belgium

International conference of the Centre International de Recherches et d’Information sur l’Economie Publique Sociale et Cooperatives, University of Liege. Groups will discuss privatization issues, performance measures and comparisons, incentive schemes, and mixed markets.

Transformation

Annual Bank Conference on Development Economics organized by the World Bank PRE, at the Bank. Topics will include the transformation process in the socialist economies and the role of governance in economic development.

The Baltics: Gateway to the Soviet Union?
May 10-13, 1991, Middlebury, Vermont

The spring seminar will discuss the Baltics’ evolving role as a bridge between the Soviet Union and its foreign investors and trading partners. Among the 40 guests invited are the prime ministers of Estonia and Latvia, Georgia’s president, and the vice president of the Russian Republic.

For information, contact: George Bellerose, Director, Geonomics Institute, 14 Hillcrest Avenue, Middlebury, VT 05753; telephone: 802-388-9619.
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