Group of Seven Opens New Lending Windows for Russia

The Group of Seven (G-7) industrial nations (the United States, Japan, Germany, Britain, France, Italy, and Canada) unveiled its financial aid package for Russia in a two-day mid-April meeting in Tokyo of the G-7 finance and foreign ministers.

Silver Lining for Russia's Oil Sector Loan

The World Bank's Board of Executive Directors agreed to revise its "negative pledge clause" rules, clearing the way for export credit agencies to finance oil, gas, and other energy transactions in Russia and other states of the former Soviet Union and in other countries where governments own most of the resources. The Bank is considering a possible $1.3 billion package for Russia to upgrade western Siberian oil fields. The Bank might lend $500 million (subject to the Board's approval, slated for mid-June), the EBRD $130 million, and export credit agencies, perhaps including the U.S. Export-Import Bank, the remainder. The reopening of 1,200 oil wells could boost Russia's annual oil production by 3 percent. The waiver of the negative pledge clause by the Bank's board means the institution "will not stand in the way of collection of collateralized loans guaranteed by the Ex-Im Bank." Traditionally, the World Bank is given first crack at a debtor's overdue debt.

The $43.4 billion aid package—only part of which consists of fresh funding—is designed to back efforts by the Russian government to reform its economy. Components of the G-7 aid package, which include assistance from the World Bank, the International Monetary Fund, and the European Bank for Reconstruction and Development, are as follows:

<table>
<thead>
<tr>
<th>G-7 Aid Package for Russia (billions of U.S. dollars)</th>
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<tr>
<td>Initial stabilization support</td>
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<td>IMF Systemic Transformation Facility</td>
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<td>World Bank import rehabilitation</td>
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<td>Full stabilization program</td>
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<td>IMF stand-by</td>
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<td>IMF currency stabilization fund</td>
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<td>Structural reform and essential imports</td>
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<tr>
<td>World Bank loan commitments</td>
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<tr>
<td>Cofinancing of World Bank oil sector loan</td>
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<td>EBRD enterprise fund</td>
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<td>Export credits/guarantees</td>
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<tr>
<td>Public debt rescheduling</td>
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<tr>
<td>Total</td>
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<td>Source: G-7 statement</td>
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Hungary's Bank Balancing Act
In a large-scale loan portfolio "clearing operation" in March, Hungary's five big state-owned banks traded their bad loans for government bonds. (page 6)

Social Safety Nets In Poland
Coordination of local municipalities and nongovernmental actors to support Poland's poorest and most vulnerable groups is crucial. (page 9)

Quotation of the Month: "Collapse of Communism Created a Corresponding Adjustment Crisis in the West." Western Europe need its own restructuring, warns David March in the Financial Times. (page 10)

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In an annex, the ministers said progress toward macroeconomic stabilization, especially the reduction of Russia's high rate of inflation by bringing monetary and credit expansion under control, was of paramount importance to the success of Russia's economic reforms.

They welcomed the proposal to create an IMF Systemic Transformation Facility (STF) that could provide Russia with up to $3 billion in two tranches, and urged disbursement of the first tranche once Russia made a political commitment to adopt an appropriate adjustment policy, as indicated by a policy statement. The second tranche should be disbursed when there has been satisfactory policy implementation with a focus on monetary policy measures to contain inflation, paving the way for a stand-by arrangement.

The annex went on to strongly encourage the IMF and Russia to develop a stand-by of up to $4.1 billion in more intensive support for economic stabilization. The stand-by arrangement, which should be based on a comprehensive macroeconomic stabilization program, should be implemented as soon as possible and in any event before October 1, 1993. The ministers reaffirmed their commitment to make available a $6 billion currency stabilization fund to boost confidence in the ruble market, once macroeconomic conditions had stabilized.

As a provider of long-term support, the World Bank was well positioned to take the lead in supporting Russian structural and sectoral reform, the ministers said. They urged the Russian authorities to improve their cooperation with the IBRD; to accelerate efforts to utilize existing support by drawing down funds under last year's import rehabilitation loan; and to conclude a $500 million oil sector loan, which has $500 million in IBRD cofinancing, as rapidly as possible. The ministers endorsed IBRD efforts to increase support for structural and sectoral reforms in parallel with the STF, including a second critical imports loan. They welcomed the IBRD's willingness to provide, for the coming fifteen months, up to $4 billion in new commitments in the form of loans to support investment, the strengthening of institutions, and reform in several key sectors such as housing, energy, and agriculture.

The ministers called on the EBRD to set up, in close cooperation with the STF, a $300 million fund (financed half by its own funds) to promote Russian small and medium-size enterprises. They invited other countries to contribute to the fund. The ministers also requested the EBRD to prepare the ground for creating a Russian enterprise bank.

The ministers set up a working group, to report to the Tokyo G-7 summit, to explore how to restructure and privatize large enterprises, possibly by combining bilateral and international financial institution resources. The ministers welcomed the recent Paris Club rescheduling of Soviet debt. Noting the desirability of cooperation between the IBRD and export credit agencies (ECAs), they said they were confident the ECAs could provide export credits and guarantees in the range of $10 billion.

Improvement of access for Russian products to international markets strongly reinforces Russian structural reform, the ministers said, adding that they intend to open their markets and to support Russian GATT membership. On other matters, they called for encouragement of private investment in Russia's energy sector and for improved safety at Russian nuclear power plants. Stressing the importance of technical assistance, they

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**Kyrgyzstan Borrows from New IMF Facility**

Kyrgyzstan became the first borrower under the IMF's new lending window, the Systemic Transformation Facility (STF). The STF was established on April 23 to assist members that are encountering balance of payments difficulties in moving from command to market economies. On May 12, the IMF's Executive Board approved a $23 million STF loan to Kyrgyzstan, as part of a $62 million lending package that also includes a $39 million eleven-month stand-by arrangement.

IMF Managing Director Michel Camdessus described the STF as an instrument for those transitional economies that are committed to reform, but that because of the breakdown of traditional trading arrangements, are not yet in a position to implement a full-fledged, IMF-supported program. Camdessus estimated that between $4 billion and $6 billion could be committed between now and the end of 1994 when the STF lapses, with final disbursements being made in the second half of 1995. (A qualifying member can draw up to 50 percent of its IMF quota under the STF in two equal installments, six to twelve months apart. The first loan can be drawn on approval by the IMF Executive Board. The second loan would be made between six and twelve months later when the country is ready to enter into a full-fledged, IMF-supported economic program.)

Recognizing the difficulties these transitional economies are experiencing, the repayment period under the STF has been lengthened from five to ten years, with four-and-a-half years' grace instead of the usual three, although the standard IMF interest rate, which is currently just less than 6 percent, will apply to outstanding borrowing. To borrow from the STF, which is being financed from the IMF's general resources, a member will have to satisfy the IMF that it is working to solve its balance of payment problems and will move as soon as possible toward an IMF-supported economic program. Significant policy actions will be expected, in particular, convincing actions to stabilize monetary conditions in countries where inflation has been unacceptably high, or is accelerating. The STF is designed to assist the states of the former Soviet Union, most other members of the former CMEA, and countries that had substantial nonmarket trading ties to the CMEA.
tance of technical assistance, they urged the World Bank to activate the consultative group process.

**Statement of the World Bank following the G-7 meeting:**

Since August 1992 the World Bank has made commitments totaling $760 million to Russia, including a rehabilitation loan to finance critical import needs for the health, transport, and agricultural sectors, and loans to support privatization and strengthen social protection services. As a result of extensive economic and sector work and project preparations over the last two years, we have already established the capacity to expand our assistance substantially. However, the development of a larger lending program is contingent on the Government of the Russian Federation stabilizing its economy by bringing inflation under control and making further progress on the structural reform agenda.

Additional [World] Bank assistance, in the form of technical assistance, investment and adjustment lending, would be in the following sectors:

- **Enterprise reform**, including privatization and the creation of a competitive economic framework.
- **Infrastructure**, including housing and transport, by rehabilitating critical road networks and supporting construction of housing to meet the urgent needs for the relocation of labor.
- **Agriculture**, by helping farmers to grow food more efficiently and by supporting farm privatization, price liberalization, land reform, and improvements in marketing and distribution and in agroindustries.
- **Social safety net**, by strengthening programs and institutions for poverty alleviation and social protection, supporting local governments strongly affected by enterprise restructuring, and providing training as necessary.
- **Energy**, by supporting the oil and gas industries (which offer the best prospects for financing the restructuring of the economy over the next decade through increased export income). This includes providing critical equipment and well workovers to increase production.
- **Environment**, by helping the [Russian] government plan more effectively its cleanup of air and water pollution.
- **Financial sector reform**, by strengthening financial institutions and payment systems.

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**Meditation on Uzbekistan’s Reform**

**How to Support Gradual Transition**

Defining property rights, privatizing state assets, and supporting private sector activity—together with a move toward open markets—are central elements of transition from plan to market. The economic transition process is intimately tied to the direction and speed of any political and social transition that precedes or accompanies the economic reform—as the experience of many transitional countries shows. These factors, then—rather than simple economic theory—are extremely powerful in shaping economic transition. An international perspective can help understand the likely shape of the process in Uzbekistan.

**The Wide Spectrum of Reform**

- **Fast reformers.** At one end of the reform spectrum are the “advanced” East European countries. Here, political transition meant essentially throwing off the yoke of postwar communist occupation. This radical political development created a “window of opportunity,” which, coupled with the strong attraction of Western Europe and a relatively high degree of exposure to and familiarity with market economies, cleared the way for radical reform processes. These involved an almost immediate move toward open markets and the establishment of private property rights. These steps, together with the restitution of smaller properties and other measures, resulted in the rapid growth of new private firms that have begun to absorb labor on a scale large enough to substantially offset the continued decline in state employment.

Even within the relatively homogeneous East European context, privatization strategies have differed widely from one transitional economy to another. Hungary, for example, at first rejected a voucher scheme in favor of case-by-case sales (often to management), while the Czech Republic took the lead with the voucher scheme. Political transition in Hungary was a relatively gradual process and this has encouraged a relatively smooth transition of ownership and management relations. The relatively sharp transition of what was once Czechoslovakia—and especially of the Czech Republic—was one that put priority on the creation of “new owners” (to a large extent, the mutual investment funds that have concentrated vouchers). And in Poland the voice and power of employees has been far stronger than in the other two countries—evidence of the power of labor movements before and during Poland’s transition.

- **Russia’s transition is a different—in some sense an intermediate—case.**

The progressive diminishment of state control over the economy gave rise to powerful spontaneous pressures to appropriate state property. The choice of privatization mechanism—“top-down” methods, ministries transforming themselves into joint stock con-
cerns, "bottom-up" methods—has been at the initiative of the privatizing firms. (See Transition, vol. 4, no. 2, March 1993.) And although vouchers have been introduced in an effort to make the privatization process more fair and less likely to be reversed, it is undeniable that "insiders" (especially managers) of the transforming firms have played a powerful role in the process. Russia's political revolution has still not resulted in the emergence of a new dominant elite but the number of entrepreneurs with a stake in a private economy has increased explosively, limiting the potential for a return to the past.

- **Gradual reformers.** At the other end of the reform spectrum from Eastern Europe is China with its strong emphasis on maintaining a "two-tier" model, that is, one that combines plan and market, political and social stability. The reform of property rights in China has been a gradual and incomplete process, lagging behind reforms in marketization. China still has no framework for private property rights, although "pseudo-private" property rights have been created, particularly in agriculture and rural industry.

State industry is still regulated by central plans, though on a progressively smaller scale. Contracting systems are extensively used for management, fiscal revenues, and foreign exchange, and there may be a change of heart regarding privatization (see Transition, March 1993, p. 6). But concern for preserving social stability has prompted the authorities to maintain (increasingly ineffective) controls on internal labor movements.

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**Gold, Oil, and Cotton: Breaking out of Uzbekistan's Monocultural Economy**

Privatization of the Uzbek economy—according to successive laws passed by the country's legislature—should follow a step-by-step process starting with small- and medium-size enterprises. Most enterprises will become state-owned joint stock companies or collective corporations. According to the most recent survey of the Uzbek National Bank for Foreign Economic Activity, by mid-1992 about 600 small private businesses had been set up in industry, retail trade, and public catering; and 10,000 private farms were operating in agriculture. (The same publication notes that in 1991 about 1.4 million people were employed in the private sector, of a total labor force of 8.3 million.)

Uzbekistan's current Foreign Investment Law was signed in July 1991. By early 1993 about 400 joint ventures were established. The first joint gold mining deal was struck with the U.S. Newmont Mining Corporation. Gold production is by far Uzbekistan's most valuable resource: in 1989 it had reached about 90 tons, almost 30 percent of the Soviet Union's estimated total output of 280 tons. In 1991 Uzbek gold output dropped to 70 tons, but production fell even more sharply in the two other main gold-producing states, Russia and Kazakhstan. It is thought that as much as 60 percent of Uzbekistan's gold output might have been sold to Russia in 1991-92.

In 1991 oil output totaled 2.8 million tons, while oil consumption reached 12 million tons. About 75 percent of current oil consumption is imported from Russia. The unfavorable balance might improve soon, thanks to the recently found rich reserves in the Mingbulak oil field of the Fergana Basin. Under a twenty-eight-year production-sharing agreement, the Stan Cornelius Consortium (a U.S. company), in a 50-50 joint venture partnership with Uzbekneft (a local oil and gas company), has formed Uzbek Petroleum International, which plans to extract an estimated 5 million tons annually once production is on stream.

Although oil earnings could provide the Uzbek economy with much-needed revenue, food production must be increased if the republic is to avoid dependence on Russia and Ukraine. Uzbekistan currently imports 80 percent of its grain requirement from those countries.

About 60 percent of the Uzbek population of 22 million is rural-based, and agriculture accounts for 40 percent of GDP. As a consequence of Uzbekistan's monoculture and cotton dependency, about 2 million people—or about 25 percent of the working population—are now unemployed. Sixty percent of the total population is less than 18 years old, with that figure subject to a very high 2.5 percent annual growth rate potential—suggesting the possibility of increasing unemployment.

Raw cotton used to be Uzbekistan's major tradable asset. But cotton output, which accounted for about 60 percent of the 8.3 million tons produced in the Soviet Union in 1989, dropped to around 3 million-4 million tons in 1992. Moribund irrigation systems built in quasi-desert areas, and related ecological problems caused by pesticide overuse and the shrinking of the Aral Sea, reduced cotton monoculture areas to less than 1.5 million hectares in 1991-92.

The Aral Sea, located between Uzbekistan and Kazakhstan, was once the world's fourth-largest lake. But since the early 1960s, the lake has been shrinking dramatically—its water level has fallen about 15 meters and its surface area has shrunk from 68,000 square kilometers to about 37,000 square kilometers—and the salinity has tripled because water from the Amu Darya and Syr Darya, two feeding rivers, has been diverted to irrigate cotton and rice in the region. A broad plan called the Aral Sea Environmental Assistance Program (ASEAP) received the endorsement of Uzbekistan and four other interested states—Kyrgyzstan, Tajikistan, and Turkmenistan—as well as aid-donor governments and international agencies. The endorsement was the result of a late-April Washington conference sponsored by the World Bank, the UNDP, and the UN Environment Program.

Top-down Process?

In Uzbekistan the planning structures of the past are still in place, and the state retains its ability to intervene extensively in the economy—if necessary, through state orders. It has increased control over certain sectors while liberalizing others. One of the government’s main concerns in preserving state control is to maintain social stability. In its view, massive layoffs would promote instability, as would the sudden privatization of land. Indeed, the property concepts in current law are still those of the reform-socialist Perestroika era.

All this suggests that privatization and the reform of property rights in Uzbekistan is going to be a slow, “top-down” process, with a phased move toward open markets. There is no strong constituency for rapid reform, and no “window of opportunity” argument for promoting fast reform. Officials in Uzbekistan have studied the experience of China, and it is likely that some of the Chinese reform strategies—such as the two-tier price system—will be implemented as mechanisms of progressive reform. (President Islam Karimov warned recently that economic chaos and social unrest would result if the government failed to tightly control the reform process. He announced that Uzbekistan’s goal is a “socially oriented market economy.”)

This could mean a long period of state control of Uzbekistan’s large-scale industries, particularly the production of oil, gas, and petrochemicals. It is likely that larger firms increasingly will be controlled through management contracts. These contracts could motivate management to improve performance and to restructure their companies. However, the government would like to achieve “managed competition” in larger-scale industry, and seems to bow to demands that enterprices continue their social role. Both of these factors could be major obstacles to effective restructuring.

Thus, liberalization might come first in small-scale activities and in sectors that are not seen as strategically or economically important. Foreign investment is already strongly welcomed, but in practice the environment for private business is still relatively controlled. Critical bottlenecks slow the growth of the private sector, including:

- Inadequate access of independent private firms to input supplies (including foreign exchange for imported inputs), because of controlled allocations and the wide coverage of state orders.
- Restrictive licensing practices, including by ministries and public companies, where a direct commercial interest in limiting competition.
- Inadequate legal protection against arbitrary public actions, both because of the scope of social concerns expressed in the Enterprise Law and because of the absence of an impartial court system.
- Absence of space for offices and other business premises because of tight government control on commercial real estate.

Some Suggestions

Defining property rights and introducing enterprise reform could help Uzbekistan achieve macroeconomic stability and accelerated development. International finance institutions could play a role in supporting the Uzbek government’s reform efforts. A few specific suggestions:

- Evaluate the financial condition of the larger state enterprises, as a first phase in restructuring. This is necessary both to stem the losses that will only become more serious as the constraints of liberalized markets are felt and to adapt to new patterns of production dictated by the breakup of the planned FSU economy. (The evaluation of certain key sectors—gas, petrochemicals, and cotton—would be appropriately carried out through the ministries.) Evaluations of the portfolios of the Industrial and Agricultural Banks could give rise to mechanisms to contain loss-makers, as part of financial sector modernization.
- Provide financial support to cushion the effects of layoffs in the state enterprise sector, including small-business grants, separation packages, retraining, and so forth.
- Introduce initiatives to enable decentralized and private business to grow rapidly, contribute to output, and absorb labor. The experience of other countries has shown this to be vital in offsetting the decline of the state sector.
- Facilitate the privatization process. Specifically, target:
  - larger firms, where such issues as corporate governance, attraction of foreign partners, and basic business capacities (cost accounting, inventory management, marketing) are crucial;
  - smaller firms, where the question of moving away from the prevailing mode of collective employee purchase and ownership, and toward competitive auction processes, is now important;
  - real estate, both residential (where substantial initial experiments have taken place but further steps are needed) and commercial (where privatization has barely started).
- Educate the public about privatization and its benefits through a broadly based public relations and education program. Provide information on the implications of privatization, not only to the enterprises concerned but to the public at large. Render a public accounting of the privatization process at periodic intervals to increase awareness and encourage a general appreciation of the process as equitable. This will require, among other things, wider computerization and the creation of data bases. And improved information will, in turn, facilitate the privatization process itself.

Alan Gelb
PRDTM, The World Bank
Getting Rid of Bad Loan Portfolios

An IMF-World Bank joint technical delegation recently visited Hungary to study the possibility of providing financial and technical support for restructuring the Hungarian financial sector.

In September 1992 the Hungarian banking system's estimated classified (bad) debts reached about 260 billion forints—nearly 17 percent of total loans, or 10 percent of the GDP. Roughly 110 billion forints of loans have been tied up in bankruptcy or in liquidation proceedings. (Loans in Hungary are considered bad when borrowers fail to service the debt for at least one year, or fall into bankruptcy or liquidation.)

On March 20, 1993, in a move orchestrated by the Hungarian Finance Ministry, Hungary's state-owned commercial banks and savings cooperatives got rid of their bad loans (both principal and overdue interest payments)—amounting to 102.6 billion forints (about $1.2 billion)—by trading them for interest-bearing twenty-year government bonds worth 79.4 billion forints ($918 million). The five biggest banks, the Hungarian Credit Bank, the Budapest Bank, the Commercial and Credit Bank, the Hungarian Foreign Trade Bank, and the National Savings Bank, traded in bad loans worth 85.7 billion forints for government bonds worth 66.7 billion forints.

The bonds cover two-thirds of the 152 billion forints in lost assets submitted for compensation by the 14 banks and savings cooperatives in December 1992. The ministry refused to issue bonds for about 20 billion forints of the reported loans, because it concluded the loans were not in such bad shape. Another 30 billion forints in loans were withheld by the banks themselves in anticipation of higher returns from trying to recover the loans rather than from accepting the bonds.

The taxpayers (that is, the budget) will absorb the overwhelming cost of the balance-clearing operation, less a special stabilization tax, which the banks have to pay for the bond-for-loan swaps. The exercise was designed to improve the banks' financial condition and to prepare some banks for privatization.

This is the second time the Hungarian government has assisted the banks. In 1991 the government guaranteed 50 percent of about 20 billion forints in debts inherited by the state-owned banks. Much of these debts were holdovers from the National Bank, which was split in 1987 when a two-tier banking system was created: a new Central Bank and four specialized banks.

The Finance Ministry will pay an estimated 10 billion to 12 billion forints in bond interest annually. The interest is tied to yields on 90-day treasury bills, now running at around 14 to 15 percent. Ultimately, the Hungarian parliament must decide on a way to finance the balance sheet-clearing operation—in other words, how to finance the loan consolidation. The corresponding law will be submitted to the Hungarian legislature by June 30.

The Finance Ministry is designing a scheme to recapitalize banks with another round of bond-for-loan swaps later in 1993, after consultations with the World Bank and the IMF. The operation would relieve the banks of more non-performing assets and help recover debts from delinquent borrowers—an estimated 2,000-3,000 companies.

Ideally, these swaps will put banks in a position to grant loans at affordable rates to creditworthy clients who can expand their businesses, create jobs, and thus invigorate the economy. Currently, cash spreads are high: banks are strapped with bad loan provisions and are using most of their liquid funds to buy government bonds to finance the budget deficit, projected to top 250 billion forints for 1993 (see box). Some experts argue that cleaning up bad loan portfolios may not address the causes of the bad loans, such as bank mismanagement. Seeing their bad loans consolidated yet again with public money, the banks might get the wrong signal and interpret the bond-for-loan swaps as a ticket for continuing imprudent lending practices.

Cleaning up bad loan portfolios is therefore closely correlated with the need to attract strategic private investors to inject capital into the Hungarian banks. Outside investors would strengthen the banks with more capital, better management, modern technology, and diverse financial products. Privatization of two large commercial banks—Budapest Bank and the Hungarian Foreign Trade Bank—is slated for this year, though the process may take longer than expected. Several laws are likely to change, such as the rule that foreign investors can hold no more than a 25 percent stake in a Hungarian bank. Thus, speeding up the privatization of at least the most attractive, capital-strong banks is of major importance.

The scheme also involves restructuring the enterprise borrowers—the ones who accumulated those bad debts. All loans purchased from the banks have been transferred to the state-owned Hungarian Investment and Development Corporation (MBFRt), which is working out various restructuring programs particularly tailored to the 115 major loss-makers. (The MBFRt is a wholly owned subsidiary of the State Holding Company [AVRt]). The government is designing strategies for rescheduling the debts, and for restructuring, or maybe even liquidating, the borrower companies covered under the scheme. At the same time, the government is looking for ways to improve bank management and supervision, and considering amendments to regulations and laws that would contribute to the early resolution of nonperforming loans and prevent a recurrence of bad debt.

Based on World Bank reports, and articles from the Hungarian economic weekly HVG and Budapest Week.
Hungarian Miracle: High Savings and Low Investment

Domestic savings in Hungary (the savings of individuals, companies, and government institutions) have increased steadily in the past three years-reaching $12.3 billion (1,045 billion forints) by the end of 1992, almost one-third of that year's gross domestic product. The growth of personal savings (savings of individuals) was particularly dramatic, reaching almost 15 percent of disposable income in late 1992, compared with only 4 to 6 percent in the 1980s. Economic uncertainty has been cited as the main reason for Hungary's high rate of personal savings, which in late-1992 accounted for 584.3 billion forints, 56 percent of total domestic savings.

Real interest rates on personal savings (adjusted for inflation), however, were negative in 1991 and 1992. In 1992 the 21.6 percent inflation rate compared to 17 percent returns from deposit accounts, and nearly 18 percent yields from government bonds with a 360-day maturity. Still, even though the real net value of their savings fell, many Hungarians were concerned about the threat of unemployment and continued to save. (This is in contrast to the West, where recessions almost invariably result in lower rates of personal savings.)

Besides the concern about unemployment, what other factors explain the continued relatively high rate of personal savings in the face of higher inflation in recent years? According to experts:

- Many wealthy households save a sizable portion of their income. (Growing income differentials though have caused the number of savers to drop in recent years; in 1980 some 82 percent of Hungarians were regular savers, but by early 1992 this had dropped to 38 percent, according to Heti Vilaggazdasag, the Hungarian economic weekly.)
- Bank deposit statistics do not distinguish small businesses from private individuals. The high levels of saving recorded are largely attributable to the growing success of small businesses. The number of small businesses employing about 20 people has been increasing steadily. In January 1993 they comprised 79.2 percent of all firms (compared with 75.2 percent in January 1992 and 62.1 percent in 1991). In the same period the proportion of businesses employing more than 300 people fell to 2.4 percent (from 3.8 percent in 1992 and 8.0 percent in 1991).
- Convertible currency deposits amounted to 151.9 billion forints of the 584.3 billion forints in total personal savings in December 1992. Deposits from outside Hungary are growing, particularly from Serbia and Russia. The Hungarian "underground economy" is also expanding.

Where have the savings gone?

In 1993 an estimated 230 billion forints ($2.7 billion) will be needed to finance accumulated debts, the budget deficit, and debts run up by the Social Security Administration. (It is also estimated that in the 1993 government budget, short- and long-term debt payments will amount to 16 percent of the government's total expenditures.) Under the banking law, the Hungarian National Bank is allowed to finance only 60 billion forints of the total budget deficit; the rest is to be financed by the Hungarian financial market. Thus, the government's financial needs are crowding out private investors just when credits could play a large role in the expansion of the private sector. Before October 1992 the Finance Ministry had issued three- and six-month treasury bills once every two weeks. (In 1990 and 1991 floating-rate treasury bills worth 67.2 billion and 76.2 billion forints, respectively, were issued in this way.) Since October 1992 the Finance Ministry has been operating on the assumption that inflation has slowed down sufficiently to permit the issuance of longer-term, fixed-rate government bonds that will mature in two, three, four, or five years. Securities amounting to a value of 200 billion forints were issued in the period December 1992 to February 1993.

Since the state-owned banks were suffering from chronic excess liquidity, they have been the main buyers of government securities, which paid relatively high rates and posed no financial risk. Experts are now debating whether to allow foreign investors to participate in the Hungarian treasury bill market. The increasing volume of secondary trading in treasury bills means that in August 1992, for instance, 95.6 percent of the Budapest Stock Exchange's turnover was in treasury bills. Multinational corporations have already tapped into the large Hungarian savings pool. In 1992 Nestle, McDonald's International, Levi Strauss, Crédit Suisse First Boston issued bonds in Hungary, which were oversubscribed. Their guarantees were attractive for investors, including the state-owned banks.

Yet the issuance of these bonds highlighted a glaring weakness of the Hungarian financial market: it is not geared to private enterprise, even though the private sector contributes one-third of Hungary's GNP and more than half its exports. Multinational corporations, which already have easy access to funds in the international financial markets, have had no difficulty in attracting Hungarian investors, and the appearance of these multinationals on the Hungarian financial market has hurt Hungarian private investors. It is much easier to provide funds for an internationally established company than to aid the Hungarian private sector by setting up a corporate bond market. Even the London-based European Bank for Reconstruction and Development, designed especially to channel western funds to eastern Europe and to the Soviet successor states, is keen on tapping into Hungary's pool of domestic savings. In October 1992 the bank's board decided that it would issue Forint-denominated bonds to help raise funds.

The need to finance the budget deficit, the fact that the Hungarian banking system has remained basically state-owned, and the tendency for banks to follow overcautious credit policies toward private investors, all these factors keep interest rates despite the relatively large pool of savings—prohibitively high for prospective private investors and entrepreneurs. These rates prevented entrepreneurs from utilizing domestic credit to expand (continued p. 8)
Sleepless Nights in Budapest

The Hungarian government redesigned its program to clean up bank balance sheets several times to try to make it almost cost-free. Meanwhile, privatization agencies and other interested parties ask who will manage the big weak borrowers whose loans fill the banks’ portfolios? Sorting out the mess is causing sleepless nights all over Budapest. What keeps the players up at night?

**Bank of Budapest, Hungarian Credit Bank Commercial and Credit Bank:** Is it better to keep a questionable loan or swap it for an illiquid bond? Maybe we should just forget this whole credit consolidation plan...

**State Property Agency and State Asset Holding Company:** We’ve already got the companies with the bad loans. Why should we hand them over to the HIDC? We’ll fix ‘em up ourselves. How if they’re only postpone those bank sales...

**Big 6 Accounting Firms:** This credit consolidation scheme is an OAAAP. How will we ever prepare 1992 bank financial statements?

**Hungarian Investment and Development Bank (“Super Work Out” Bank):** Up to 153 billion forints of bad loans? If the banks can’t fix ‘em how can we? And anyway, who’s going to fund us?

**J.P. Morgan (Hungarian Foreign Trade Bank Adviser):** We already have buyers for the HFTB and we don’t even have an office in Budapest. How did we get so lucky?

**Postbank (Non-participating):** Whew! (Zzzzzz...)

**ERD and International Finance Corp:** Should we buy some of the banks’ bad debts? Is there gold in them there hills?

**World Bank:** Is this scheme equitable to all the banks? Besides, if we support it, how do we make sure the banks don’t make more bad loans?

**Hungarian Economy:** What’s another 10 billion forints in financing costs for consolidation bonds when you’re already financing 200 billion a year? Let’s see, inflation’s 22% a year...

**Ministry of Finances:** Whatever we do, what will the IMF think?

**Eligible Hungarian Banks Other Than the Big Four:** We’re so confused.

**Credit Suisse First Boston (State Asset Holding Co. Adviser) and Salomon Brothers (Bank of Budapest Adviser):** If the government would just forgive those darn debts, we could sell the banks pronto.

**Economic Policy Group of KPMG Peat Marwick (Privatization Advisers from Washington D.C.):** We thought this was supposed to work just like the Resolution Trust Corp.
Targeting social benefits to the poorest and most vulnerable groups in Poland—a society accustomed to universal service delivery—is an undertaking rife with political obstacles. Most responsibility for targeted assistance is delegated to local governments. And yet it was only in March 1990 that elected local governments were constituted, and it is not yet clear that they have the financial or administrative capacity to provide for the increasing numbers of poor, particularly those in the depressed industrial regions that face widespread unemployment.

The Social Assistance Act of November 1990, which replaced a system of state-sponsored charities that formerly cared for the poor, assigns local governments the responsibility of identifying vulnerable groups, delivering benefits, and providing a significant share of the financing. Anyone with income falling below the “social minimum” is eligible for assistance. The eleven categories of eligibility include homelessness, unemployment, disability, and alcoholism. The new law assumes there is pervasive poverty and unemployment and that social assistance will become a nationwide benefit of last resort.

The design of assistance programs depends on who heads the local social assistance office, and on that person’s relations with the local government. Political competition, parochial rivalries, and the inexperience of council members can all impede the functioning of the social assistance centers. The high level of autonomy given to social workers—and their lack of professional training—present implementation problems. It is instructive to look at two social assistance centers, one in Warsaw, Ochota municipality (gmina), the other in rural Karchew.

Ochota has about 200,000 people, many of whom once depended for employment on the now insolvent state-owned Ursus tractor factory. Ochota’s unemployment rate of 5 to 6 percent is high for Warsaw, where the average rate is 2.2 percent. Nevertheless, the Ochota social assistance office has had to seek out its clientele and advertise its services. This is partly because, under socialism, only the “dregs” of society were presumed to need social assistance. But the office’s clientele is now changing. Increasing numbers of younger people in their early thirties, unable to cope with the changing system, are joining the pensioners, the disabled, and the families of alcoholics.

The Ochota office has tried to establish a broader concept of social assistance, that is, helping people to help themselves rather than providing cash handouts. This has been hard for people used to waiting for the government to provide services when they are in need.

Ochota is relatively wealthy, with the resources to hire skilled staff and implement most of the provisions of the Social Assistance Act. But the director of Ochota’s social assistance office cited difficulties in finding trained staff. Although 70 percent of her staff have college degrees, none is specifically trained in social work. In the past, working in a social assistance office was considered an “easy” job requiring no technical education. This is gradually changing—the Social Assistance Act requires that all social workers have professional degrees by 1995—but the shortage of skilled staff persists, particularly in remote or less wealthy communities.

In contrast to the Ochota example is Karchew, a small town of about 16,000 people in the rural environs of Warsaw. Four thousand people live in the Wogie housing complex and commute to jobs in Warsaw; 6,000 live in rural areas; and the rest live in the town proper. Those living in the housing complex make the most demands on the social assistance office and have the highest expectations; in contrast, the office must seek out rural people to learn their problems. This is difficult logistically as the rural people live far away and the office has use of a car only one day a week, which is typical for assistance offices in rural areas.

The director of the office was able to find a small but talented staff. But she has had trouble with the newly elected town council, which has tried to control the office’s finances and day-to-day management. The social assistance office is financed primarily by the central government: of its 1992 budget, 1 billion zlotys came from the State and 350,000 zlotys from the gmina. Many council members, most of whom have no higher education, feel that those funds should be going to build roads or parks rather than to social assistance.

Differences in local governments’ capacity, the inexperience of new local authorities, and resource constraints in depressed areas with high levels of structural unemployment should all be given equal consideration when implementing a safety net in Poland. Encouraging nongovernmental actors to complement the efforts of the municipalities will be critical. One way to foster capacity-building in the weaker gminas without imposing a centralized solution would be to establish a fund, similar to Bolivia’s Emergency Social Fund, to provide technical and financial assistance in response to the requests of local government or nongovernmental organizations.

This article is based on a paper by Carol Graham, “The Political Economy of Safety Nets during Market Transitions: The Case of Poland,” published in RPS No. 3 (PRDTM), The World Bank, January 1993. The paper is part of a research project on Social Expenditures in Central and Eastern Europe (see Transition, December 1991) managed by Branko Milanovic. To order papers in this series, contact Sabah Moussa, The World Bank, PRDTM, Room N11-017, tel. 202-473-9019, fax 202-676-0439.
Quotation of the Month: “Collapse of Communism Created a Corresponding Adjustment Crisis in the West”

In 1989-90 a triumphant wave of western liberal capitalism crashed onto the beachhead of Central and Eastern Europe, washing away communism's rusty hold. Three years later, the western part of the continent is caught in the backwash of its own previous success. The fall of the Berlin wall, the unification of Germany, and the unraveling of the Soviet empire were cathartic events for which the west was immensely grateful, and immensely unprepared. Western Europe reacted by trying, through the Maastricht Treaty, to hasten the move toward EC unity—a movement first launched in the 1950s and in recent years accelerated by the process of creating a single European market. This was always a debatable choice; in retrospect, it looks like the wrong one.

West European politicians gave priority to deepening integration rather than to spreading it eastward. They failed to realize that the collapse of communism would create a corresponding crisis of adjustment in the west. They did not anticipate that the Maastricht plan to replace the deutsche mark with a European currency would become an obstacle rather than a catalyst for the reconstruction of Europe.

Across western Europe the upheavals in the east have changed the mood of nations. Would the withering of British self-confidence during the past few years have been quite so severe had the post-Thatcher recession not coincided with the end of the UK’s cold war role as a guardian of a divided Europe? In Italy the eastern earthquakes have contributed to the splintering of state and party structures that for so long held the country in the grip of corruption. And in France, the diminishment of President Francois Mitterrand’s public standing was hastened by his futile attempts at the end of 1989 to hold up German unification, and his underestimation, at the time of the hardliners’ coup in August 1991, of the forces of reform in the Soviet Union. These setbacks to European hopes derive from a common economic reality. High Bundesbank interest rates aimed at restraining the inflationary pressures of German unification have been a principal cause of the European recession. It could be as deep as the one in 1975 (the last year EC economies contracted), and more damaging.

The Maastricht Treaty precepts for an economic and monetary union (Emu), designed to lay down a path for economic convergence and budgetary rectitude, have so far produced neither. The treaty set targets for fiscal deficits and indebtedness that were to serve as conditions for determining which EC countries could participate in Emu later in the decade. However, as a result of recession-induced increases in social outlays and cuts in tax receipts, average EC deficits this year will amount to between 5 and 7 percent of gross domestic product, well above the 3 percent target. Although the Maastricht targets are not meant to be reached until 1996 or 1998, a number of countries (including Germany) are likely to continue diverging from them during the next few years.

Western Europe’s economic difficulties would be bad enough if they were...
merely cyclical. But the EC’s falling competitiveness shows they also embody an important structural element.

Many EC countries, led by Germany, have for several years been registering falling shares of international export markets for manufactured goods. The trend is linked to Europe’s high labor costs and technological shortcomings compared not only with the United States and Japan, but also with the emergent capitalist economies of Southeast Asia. The EC ran a trade deficit of $90 billion with the rest of the world last year—roughly three times its 1985-90 (annual) averages. High production costs partly reflect the burdens of running generous welfare systems that—for both economic and demographic reasons—are becoming impossible to maintain.

Mr. Jacques Attali, president of the European Bank for Reconstruction and Development (EBRD) has suggested the establishment of a pan-European common market to bind the economies of eastern and central Europe with the western economies. Attali has also proposed that these countries participate in formal political collaboration with the EC—ideally, through immediate full membership. Professor Alan Winters, an international trade expert at Birmingham University, fiercely criticizes EC import restrictions in sectors such as steel, agriculture, and textiles. Countries in eastern and central Europe have made impressive strides in switching trade toward the west. But the run-down of traditional industries has been much greater than expected.

Allowing for anticipated modest recovery in 1993, the combined real GDP of Hungary, Poland, and the Czech and Slovak republics at the end of this year will be roughly 20 percent less than in 1988. By contrast, even after zero or perhaps negative growth this year, the European Community can expect its GDP at end-1993 to be 8 to 9 percent greater than in 1988.


**Milestones of Transition**

**Russian** oil output is reported to have fallen by at least 15 percent in the first quarter of 1993 compared with the same period in 1992. The Ministry of Economics claims that output was 85.4 million tons, and the Ministry of Fuel and Energy puts it at just less than 89 million tons. First quarter output in 1992 was 104 million tons. Meanwhile, petrol prices reportedly doubled to 70 rubles per liter in Moscow, and further price increases for public transport and heating are expected, due to the gradual reduction in state subsidies for oil prices.

**Russia**’s total trade volume in 1992 was down to $80 billion, an 18 percent drop from last year, according to a report of the Russian Ministry of Foreign Economic Relations. Exports declined 12 percent to $45 billion, and imports plummeted more than 20 percent to $35 billion. The State Customs Committee announced new restrictions on the amount of rubles citizens may take out of and bring into Russia. A limit of 500,000 rubles may be taken into or out of another state in the ruble zone; and 100,000 rubles may be taken into or out of the Baltic States, Ukraine, or other foreign countries.

The unemployment rate in the Czech Republic has been dropping steadily over the past months and fell to less than 3 percent in March, according to the Ministry of Labor and Social Affairs. The unemployment rate in Prague was 0.3 percent in March. However, the ministry expects an 8 percent unemployment rate nationwide this year—with levels as high as 28 percent in certain regions—owing to the privatization process and the new law on bankruptcy. The Czech National Bank’s foreign currency reserves have increased by $424 million since the beginning of the year, and amount to more than $1 billion.

Hundreds of Czech companies are bracing themselves for a tide of claims from creditors when a new bankruptcy law comes into effect. Western consultants estimate up to one-third of the 1,500 companies sold last year through the voucher privatization program are technically bankrupt. The companies’ immediate problem is large debts that make them vulnerable to bankruptcy proceedings under the new law.

**Slovak** Minister of the Economy Jaroslav Kubicka disclosed on April 8 that the country’s hard currency reserves decreased from $250 million in January to $20 million–$25 million by early April. The number of Slovak unemployed increased by more than 45,000 in the first three months of this year, reaching a total of more than 300,000. While the overall unemployment rate is now 12.1 percent, there are regions with unemployment levels of up to 20 percent.

**China**’s industrial output leapt to 744.1 billion yuan ($130 billion) in the first three months of this year, up 22.4 percent compared with the first quarter of 1992. The increase was one of the highest recorded since Deng Xiaoping launched China’s economic reforms in 1979. The private sector saw the highest growth, with the output of rural industries jumping 76.9 percent. Urban retail prices rose 15.7 percent (annual rate) during the first quarter of 1993. A spokesman for China’s Statistical Bureau said consumer prices had been driven up by uncontrolled capital construction and rapid money supply expansion.

**China**’s economy will continue to post robust growth for at least the next two years, bolstering the export-focused economies of nations throughout the region, according to the Asian Development Bank’s latest annual outlook. The bank projected China will import up to 25 percent more goods this year and next year to satisfy demand for high-technology capital goods. Merchandise imports reached about $63 billion in 1992. China recorded economic growth of 12.8 percent last year, among the highest in the world. Its growth rate
The World Bank/PRDTM

is expected to remain in the double digits this year and next, the ADB said. However, bottlenecks in transportation, energy, and raw material production will slow the expansion.

The U.N. Economic Commission for Europe (ECE), in its annual Economic Survey of Europe, predicted growing unemployment across the former communist countries of Europe in 1993 and urged the West to focus aid on preserving popular support for reform. The U.N. group also called on Western governments to keep their markets open for goods from the East and to use trade as a stimulus for recovery on both sides of the continent. Unemployment is expected to start rising rapidly in all the former communist economies as privatization gets under way and bankruptcy laws are brought into effect, according to the ECE report.

The Hungarian inflation rate rose 0.8 percent in March from its February level, compared with an increase of 1.9 percent one year earlier, a government official announced. The consumer price index in the first quarter of this year rose 9.5 percent, against a 14.0 percent average rise in the past three years.

Lithuanian Prime Minister Adolfo Slezevicius hosted talks with his Estonian and Latvian counterparts on April 17 to discuss cooperation in trade. Lithuania signed an economic agreement on trade for 1993 with Latvia and expects to do the same with Estonia in the near future. Estonian Prime Minister Mart Laar also expressed his country’s willingness to help Lithuania introduce its new currency, the litas.

Polish industrial production in the first three months of 1993 was 5.4 percent higher than in the comparable period of 1992. Productivity rose 10.1 percent, according to a report in the Warsaw financial paper, Nova Europa (April 20), which quoted government figures. The report also notes, however, that Poland is suffering from a growing deficit in foreign trade, which reached $345 million in the first two months of 1993.

The Romanian Private Ownership Fund announced on April 21 that it will go ahead with its program to create a nation of shareholders, with priced pre-share voucher packages given to more than 15 million citizens at 135,000 lei ($225) each. The coupons, with a total value equivalent to almost $3.5 billion, account for stakes of roughly 30 percent in about 6,200 enterprises, which will gradually be placed in public hands as part of privatization legislation adopted in 1991. The major (70 percent) stake in these enterprises is retained by the State Ownership Fund. The two funds will eventually function as Western-type mutual funds. Initially, the government wants to encourage citizens to trade their coupons for shares in 2,600 small enterprises that are up for privatization through worker-management buyout schemes. A senior executive with the Private Ownership Fund said that until the stock market is opened, the funds will give regular quotations for pre-share vouchers, starting from their nominal value. Every three months, the funds will publish quotations for the vouchers, whose value would depend on the performance of the companies listed for privatization. The stock market is planned to open in 1984.

Four million Romanians have become land owners as a result of a land reform program that began in 1991 after the collapse of communist rule, an official survey showed. Some 90 percent of the total area of 9,127,381 hectares of farmland that was to be distributed has now been allocated to owners, the survey said.

Bulgaria’s gross domestic product fell by 7.7 percent in 1992, but the rate of decline slowed sharply from the previous year, the National Bank said. The Central Bank estimated that the private sector accounted for at least 15.6 percent of GDP in 1992. Bulgaria’s GDP declined by 16.7 percent in 1991.
$750 Million to Support Poland

The World Bank is supporting Poland’s reform efforts with a $450 million enterprise- and financial-reform loan and a $300 million agricultural loan, both approved in early May. The $450 million loan is to help speed privatization of ailing state-owned banks and enterprises, especially the 2,000 most-troubled firms, which mainly operate in heavy industry (including steel, chemicals, and shipbuilding). By selling off enterprises, the project will cut the demand for loans from state banks. The plan will also encourage the privatization of the banks themselves and improve bank supervision.

The agricultural loan will assist the privatization and restructuring of Poland’s sugar, poultry, and potato industries. It will also support privatization of state-owned farms, establishment of a new Rural Development Fund to help rural villages improve local infrastructure, and reorganization of the Ministry of Agriculture. (When Poland started its reform program in 1980, private farmers already owned 75 percent of the farmland, and the country produced enough food to meet its needs. But almost 85 percent of Poland’s agroindustry is controlled by inefficient, state-run firms.)

A Shot in Hungary’s Arm

Hungary’s health care and social insurance systems will receive a lift from two World Bank loans totaling $223 million, approved on April 20. The first loan, for $91 million, will help Hungary improve health services. Hungary will launch a national campaign aimed at cutting back on smoking, alcohol use, and unhealthful diets. The government also plans to switch the health care focus from curative hospital care to preventive medicine and primary care. Though Hungary already spends a lot on health care, life expectancy (65.1 years for men, 73.7 years for women) is much worse than in Western Europe (71 years and 77 years, respectively). Hungarian mortality from cardiovascular disease is nearly the highest in the world. The second loan, for $132 million, will support Hungary’s plans for making the social insurance system more financially sound and efficient and for improving the quality of client services. Technical assistance, training, computers, equipment, and teaching materials will be financed by the loan.

Donors Cite Progress in Nicaragua

Nicaragua’s efforts to achieve sustained growth and to reduce poverty won support in Paris in early April at a meeting of aid donors representing 17 countries and 11 international organizations. The fourth World Bank-sponsored Consultative Group for Nicaragua supported the government’s medium-term reform plan, with pledges made at the meeting amounting to about $750 million. (Last year’s meeting of this group of donors pledged more than $600 million in assistance.) The key elements of Nicaragua’s reform program include further cuts in the size of the state sector to encourage private sector development, measures to alleviate the present climate of uncertainty, continued reforms in the tax regime and financial system, modernization of labor markets, and poverty alleviation.

Transport Loan to Romania

The Romanian government will make its transport network more efficient with the support of a $120 million World Bank loan. The project will repair some 1,100 kilometers of national roads, improve border posts,
pay for road safety equipment, provide technical assistance, and provide other urgently needed equipment and spare parts.

$12 Million to Armenia

The World Bank's first loan to Armenia (which became a member in September 1992) supports the Armenian government’s new three-year $17.2 million economic reform program with $12 million. The program will finance experts, computers, and training. The European Community is cofinancing the project with $1 million, and the U.S. Agency for International Development is providing $3.7 million. The loss of Soviet markets, combined with a total trade and energy blockade on Armenia, caused the country's output to fall by 45 percent in 1992. With the help of a further $250 million World Bank loan, China will launch an environmental protection project in the Jiangsu Province and the municipalities of Changzhou, Suzhou, Wuxi, and Zhenjiang. Local authorities will strengthen environmental planning and management. Another $420 million in World Bank loans will contribute to improving the Chinese rail system, streamlining management, and expanding and modernizing railway technology. World Bank loans to China in fiscal year 1992 totaled $2.5 billion; in fiscal year 1993 the loans will exceed $3 billion.

$20 Million to Mozambique

The government of Mozambique will begin its postwar reconstruction efforts with support from an IDA credit of $20 million. The funds will be used for pilot activities to support decentralized rural economic recovery.

Bulgaria's Telephone Network: Dense But Obsolete

Bulgaria has launched a new $339.8 million program to beef up its archaic telecommunications sector (which was designed in the 1930s). The World Bank, for its part, has approved a $30 million loan to Bulgaria on April 13. Bulgaria boasts the highest telephone density of any East European country. In 1990, almost one in every three Bulgarians had access to a telephone, a rate comparable to that of Spain and Ireland, and about twice the East European average. But more than 600,000 of the 8.8 million Bulgarians still wait for telephone link-up; most users cannot dial long distance directly; and only 25 percent of calls get through. In upgrading the system, more than 123,500 new digital lines will be laid, mainly for businesses, and about 1,700 kilometers of long distance optical fiber cables will be put in place in Sofia.

The World Bank loan will help the project by financing new digitalized networks and a computer-based information system. It will also fund technical assistance for improving the Bulgarian Telecommunications Company, incorporated as a joint stock company in December 1992. So far, the World Bank has granted a $250 million loan for structural adjustment and a $17 million loan for technical assistance. The telecommunications project is cofinanced by the European Investment Bank, the European Bank for Reconstruction and Development, and the Bulgarian Telecommunications Company.

IFC Opens Office in Germany

With the aim of developing closer contacts with German medium-size industries for more active investments in Eastern Europe and the countries of the former Soviet Union, the International Finance Corporation (IFC) opened an office in Frankfurt. Since the fall of the Berlin Wall, the IFC has mobilized about $2 billion for investments in the region as well as supported numerous projects with $500 million from its own resources. For further information, contact Alexander Graf Keyserlingk at IFC, Messeturm, D6000 Frankfurt-am-Main 1, Germany, tel: 4969-975-447, fax: 4969-97544-900.

New IMF Member: Macedonia

The former Yugoslav Republic of Macedonia became the 176th member of the IMF on April 21. The new member's quota is SDR 49.6 million, or $70 million. The IMF opened the way to membership of successor states by ending the membership of the former Yugoslavia on December 14, 1992.
For the Record

Determinants of Poland's Output Decline
April 8, Washington, D.C.

A panel discussion in the IMF Visitor Center, focusing on a recent study by Eduardo Borensztein and Jonathan Ostry (IMF Working Paper 92/86, 30 p., titled: "Structural and Macroeconomic Determinants of the Output Decline in Poland: 1990-91"). The authors, having analyzed employment figures and sector-specific factors, found little evidence that structural changes were behind the output decline in 1990-91. Nor did they find that available resources were limited to sectors whose relative output prices had risen. In their view, both supply-side and demand-side factors had their role in the output decline; for example, both energy price increases and tight credit conditions influenced industrial output in 1990-91.

East European Trade with the EC: Why So Sensitive?
April 27, Brussels

At a CEPR joint lunchtime meeting with the European Centre for Advanced Research in Economics, Institut d'Etudes Européennes, Alasdair Smith (Professor of Economics at the University of Sussex) presented results of recent research on European Community trade with Eastern Europe. Smith stated:

* The sectors in which the EC retains trade barriers against East European products are important to the EC economy, but trade starts from such a low base that rapid growth can be accommodated without undue discomfort to the Community.

* Employment and production decline in the Community generated by gradual structural change should not be confused with the effect of East European competition. Employment in EC agriculture declined 3.8 percent annually between 1970 and 1980 and by 3.3 percent annually between 1980 and 1990. EC employment in ferrous metals declined by more than 30 percent between 1980 and 1989, while employment in textiles, clothing, leather, and footwear dropped by almost 9 percent between 1986 and 1990. The shock of competition from Eastern Europe is significant, but well within the range of the normal experience of economic change.

* The Community's reliance on "contingent protection" means that any product is potentially sensitive. Whenever some group of EC producers is damaged by competition from the East, contingent protection is threatened or, often, implemented. Sensitive products are not defined by criteria that refer to particular structural adjustment problems within the EC but reflect a mixture of competitive threat and regulatory capture.

* EC reliance on contingent protection could act as a deterrent to development of new export industries in the postsocialist economies, forcing these countries to switch to insignificant industries with no economic rents to lose.

Professor Smith's remarks were based on an article written with Jim Rollo, "The Political Economy of Eastern European Trade with the European Community: Why So Sensitive?" Economic Policy, no. 16, April 1993, available from Cambridge University Press; The Edinburgh Building, Shaftesbury Road, Cambridge, CB2 1BR, tel: 44223-325806.

Forthcoming

Banking, Currency, and Taxation in Hungary
May 20, Washington, D.C.

Hungarian-U.S. Business Council Conference in the U.S. Chamber of Commerce Program. Includes an overview of Hungary's Financial Sector; Multilateral Development Banks' Project Financing; Access to Export-Import Bank and Trade Financing; Sources of Offshore and Domestic Investment Capital; Foreign Exchange Transactions in Hungary; Technical Assistance Priorities for

Conference on the Economic Transformation in Russia June 14-15, Stockholm

International conference, organized by the Stockholm Institute of East European Economics to assess achievements and failures of the Russian transformation process, as well as to outline new policy options. Invitees include leading economic reformers of the Russian government, prominent representatives of the academic world, and senior officials of the World Bank, the IMF, and the EBRD. Topics include: Macroeconomic Stabilization; Privatization: A Progress Report; Problems of Foreign Trade Regulation; Adjustment of Enterprises; Social Development; The New Role of the State; and The Economic Debate. Information: Stockholm Institute of East European Economics, Stockholm, Sweden, fax: 468-316-422.

Summer Crash Course on Russia and the CIS July 25-30, Harvard University, Cambridge, MA

This year's program at the Harvard University will include lectures covering politics, history, literature, social trends, and economics in Russia and other states of the former Soviet Union. The lectures will be given by faculty members of Harvard University, among them Timothy Colton (professor of government and director of the Russian Research Center); Donald Fanger (Slavic and comparative literature); Marvin Kalb (press, politics, and public policy); Edward Keenan (history); Richard Pipes (history); Jeffrey Sachs (economics); Roman Szporluk (history); Adam Ulam (government, emeritus); and Celeste Wallander (government). Associate fellows of the Russian Research Center who will speak include: Walter Connor (political science); and Marshall Goldman (economics). Topics focus on the Russian Revolution, Russia under Stalin, Russian contemporary foreign policy, Russia's relationship with former republics of the USSR, transforming centrally planned economies into market economies, and the condition of the military and armies of the Commonwealth of Independent States. Information: Kim Thomas, Harvard University, Russian Research Center, Archibald Cary Coolidge Hall, 1737 Cambridge Street, Cambridge, MA 02318, tel: 617-495-8900.

New Books and Working Papers

World Bank Policy Research Working Papers:

Cheryl W. Gray and William Jarosz
Foreign Investment Law in Central and Eastern Europe WPS 1111, 1993, 21 p.

One of the most remarkable developments in Central and Eastern Europe has been the region's opening to foreign direct investment. States in the region saw foreign investment climb from minuscule amounts in 1989 to more than $7 billion in 1992. All Central and Eastern European states have enacted new laws on foreign investment as well as related legislation in areas such as taxation and company and environmental law. Specialized foreign investment laws can play a useful role during the transition to a market economy, sending a strong signal to foreign entrepreneurs that the host country is serious about economic reform and is willing to work with investors to establish mutually beneficial arrangements.

Foreign investment laws are also often used to target special incentives to foreigners and create an island of legal development that may differ from—and sometimes outpace—other legal development. In this way they tend to create investment "enclaves." But to the extent that an enclave separates foreign investors from domestic investors, it can quickly outlive its usefulness.

The incentives it fosters may not only bleed domestic treasuries, but may also lead to bureaucratic structures that complicate the investment environment and elevate information and transaction costs for foreign investors.

As quickly as possible, the transforming economies should put domestic and foreign investors on an equal footing. This may well mean that foreign investment laws are no longer needed. The Czech and Slovak Federal Republic was the first CEE country to abolish specific foreign investment legislation in favor of a broad commercial code covering all investors.

In the design of investment laws to date, the CEE countries have perhaps paid too much attention to preferential tax schemes, ignoring other costs foreign investors face. Policymakers should focus on reducing uncertainty and transaction costs.
through clear and simple legislation, contract enforcement, arbitration and other alternative dispute resolution mechanisms, stronger protection of property rights, dissemination of information on laws and on business opportunities, and an end to unnecessary bureaucratic intervention. Complex regulations not only increase investor uncertainty but divert bureaucratic resources that the host country cannot afford to squander.


Nancy Birdsall
Social Development Is Economic Development

The author points out that social development not only improves human welfare directly, but also contributes to economic growth. Faster progress in social development is possible, and can be done within the bounds of reasonable budgets. For addressing the political and administrative challenges of delivering social programs, especially to the poor, there is no single solution. However, as a general pattern, countries making rapid social progress are providing universal access to basic services, such as primary education, primary health care, and family planning; many rely on private and community initiatives rather than a highly centralized public sector. In one way or another they have exploited market incentives, either by permitting a large private sector to provide services to those able to pay, for example, in secondary and higher education in South Korea, or by emphasizing community initiatives and financing as in Thailand, China, and Indonesia.

The rapidly increasing involvement of the World Bank in lending for social or human development provides an indication of the growing awareness of social programs as good investments. World Bank lending for human development programs increased an average of $1.1 billion a year in (fiscal years) 1987-89 to $3 billion in 1990-92. Over the past three decades, lending has broadened beyond provision of physical infrastructure for schools, health clinics, and training centers to lending in broad support of investment programs, including for adjustment and reforms in the social sectors. Projects now cover the full range of education, population, nutrition, women in development, and employment services.


Milan Cvikl, Evan Kraft, and Milan Vodopivec
The Costs and Benefits of Slovenian Independence

It is still too early to reach far-reaching conclusions on independent Slovenia's economic prospects, especially to talk of a specific "Slovenia model." Slovenia is ethnically homogeneous, culturally and historically compatible with the West, and close to (and somewhat protected from) friendly Western neighbors. Still, Slovenia's experience may offer insights for other new postcommunist economies.

Despite the obvious short-run costs of the brutal breakup of Yugoslavia's federal structure, Slovenia's medium and long-run economic prospects are fairly good. Declining trade with the successor states of former Yugoslavia dims Slovenia's short-run prospects. But in the long run it may benefit from speedier integration with Western Europe. For one thing, Belgrade is no longer reallocating Slovene resources to subsidize federal projects and to support the less-developed regions of Yugoslavia.

From the Russian daily Pravda.
via. Furthermore, local autonomy has given Slovenia a chance to introduce a new currency and achieve macro-economic stability. Secession can be beneficial if the new state is more homogeneous and functions more coherently than the old state.

Not all newly independent states would face the costs Slovenia has faced. In the Czech-Slovak breakup, for example, political risks and refugee costs (or rather, the costs of migration) were much smaller. The Czech Republic may also expect short-term costs but long-term gains.


Other World Bank Publications:


IMF Working Papers:

Bankim Chadha, Fabrizio Coricelli, and Kornelia Krajnyak
Economic Restructuring, Unemployment, and Growth in a Transition Economy

Transition is accompanied by labor reallocation as production is restructured. The paper show that this labor reallocation is likely to involve significant unemployment costs, and also that these costs are rising over time. Only after the transition process has reached a critical mass will restructuring be accompanied by a decline in unemployment. The paper emphasizes the policy trade-offs between the goals of containing unemployment and speeding up the restructuring process: some governments delay crucial decisions (such as the implementation of bankruptcy laws) for fear of generating unemployment; others take the opposite tack, overstressing unemployment “targets” in an effort to ensure “fast track” restructuring.

Robert A. Feldman and Rajnish Mehra
Auctions: Theory and Possible Applications to Economies in Transition

The paper surveys the literature on auctions to shed light on the advantages and disadvantages of various auction techniques. It assesses the application of alternative auction techniques to government securities, credit refinancing, foreign exchange, and state assets in the context of privatization. Auctions offer a simple way of determining market-clearing prices where markets may otherwise not exist and of allocating the auctioned items efficiently. On balance, uniform second-price auctions are the preferred technique. They are relatively simple, perform well in terms of the expected revenue to sellers, and may offer considerable gains in promoting economic efficiency. Whatever the choice of auction technique, auctions should be run on a competitive basis with safeguards against monopoly positions.

Other Recent IMF Working Papers:

Linda S. Goldberg
Exchange-Rate Unification with Black Market Leakages: Russia 1992

Linda S. Goldberg
Foreign Exchange Markets in Russia: Understanding the Reforms

Other IMF Publications:

No. 2. Moldova, 93 p.


Other Publications:

Shafiqul Islam and Michael Mandelbaum, eds.

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