Living on Borrowed Time: Lessons of the Soviet Economy’s Collapse

By William Easterly and Stanley Fischer

The ill-fated Soviet experience teaches us that capital accumulation directed by planners may achieve rapid growth in the short run, only to run into precipitous declines in returns to capital and a collapse of growth.

In 1980, a conference was convened at Airlie House, in Virginia, with the theme “The Soviet Economy: Toward the Year 2000.” The participants predicted an average annual Soviet growth rate of 3.15 percent between 1980 and 2000. “Recent Soviet economic growth has been slower than it used to be, but slower growth has characterized all economies recently, and the USSR has no monopoly on serious economic problems.... At a time when many countries, West and East, are troubled by inflation... or government deficits, the economic problems of the USSR (however unique their underlying causes) cannot seem so unfamiliar or incurable”—this was the prevailing view among many leading experts on the Soviet economy, according to the editors of the subsequent conference volume.

Why did this assessment turn out to be so mistaken only a few years later? Why did the Soviet economic system finally prove inviable after many years of rapid growth? The grave crisis in many successor states has understandably distracted attention from these retrospective questions. Yet analysis of the roots of the Soviet economic collapse—besides being intellectually fascinating—is full of lessons for every country, including those that emerged from the dismantled USSR.

Clandestine Underachievers

Let us look at the Soviet economic performance before the collapse. According to Western estimates, in the period 1960-89 yearly per capita economic growth in the Soviet Union was 2.4 percent, slightly exceeding the median world growth rate. Thus, growth rate by itself does not give much of a clue as to why the system was destined to fall. But if we relate results to the amount of effort expended to achieve them, the Soviet growth performance no longer looks so respectable. The Soviet Union, with one of the highest investment rates in the

What’s Inside...

Proposal for Currency Board in Russia
Currency Board prophets, Professor Hanke and Schuler adopt their concept to Russia’s specific circumstances. (page 4)

Quotation of the Month: “The Mafia privatized 50 to 80 Percent of All Shops, Hotels, and Services in Moscow.”
Excerpts from Claire Sterling’s new book offers surprising facts about the emergence and power of the Russian Mob. (page 6)

Structural Reforms in Bulgaria: How to Reverse Decline?
Bulgaria’s economy and currency are in relatively bad shape—the statistics conceal the sea changes taking place in this country whose communist leaders in the late 70s mailed over applying for membership in the Soviet Union... (page 8)

Letter to the Editor
Commenting on recent articles in Transition on fiscal centralization in China and Viet Nam, David Gesselquist warns: advising more rigorous central control over taxes and financing could incapacitate regional and local governments, the catalysts of reform in many countries. (page 11)

Economic Agenda of the Hungarian Socialists: Transition Interview
Imre Szekeres explain the intentions of the HSP, frontrunner of the ‘94 election. (page 12)

Milestones of Transition (page 13)
World Bank/IMF Agenda (page 16)
Conference Diary (page 19)
New Books and Working Papers (page 21)
Bibliography of Selected Articles (page 26)
The World Bank/PRDTE

world over 1960-89, could only manage growth roughly at the global average.

We can take the analysis further by using studies that statistically relate per capita growth performance to various factors such as educational enrollments (good for growth) and population growth (bad for per capita growth), as well as physical investment (good for growth). These statistical regularities can be used to predict what Soviet growth should have been, given its level of education, population growth, and investment, if it had been a typical economy. In fact, all these factors should have boosted economic growth, as the Soviet Union had a high investment rate, extremely low population growth, and an impressive secondary enrollment ratio, one of the highest in the world. Since the Soviet growth rate was only average, there is a large negative residual. (The residual is the difference between the predicted estimate and the actual outcome.) Clearly, the Soviet economy was not typical. Controlling also for country size and repeating this exercise for other countries yields a striking conclusion: the USSR had the largest negative growth residual, and hence was the world's most underachieving economy between 1960 and 1989.

In the 1950s, the Soviet growth residual was still positive. Early growth theorists, impressed with Soviet economic performance, cited it as proof that long-term growth was not affected by inefficient resource allocation. Popular seers like John Kenneth Galbraith predicted convergence of economic performance and managerial styles between East and West. (Galbraith did not see much difference between U.S. corporate bureaucrats and Soviet managers.) But the Soviet growth residual became negative in the 1960s (figure 1). Soviet growth then deteriorated further in the 1970s and 1980s, even compared with the global economic slowdown at that time. How did the Soviet economy go from being the hope of the future in the 1950s to the underachiever of the 1960s through the 1980s?

**Defense Overkill?**

One popular idea is that the USSR's spending on its large defense establishment, which accelerated with Afghanistan and Star Wars in the 1980s, was the straw that broke the planners' backs. While there was some evidence that defense spending contributed to the Soviet slowdown, the effect is very modest. According to Israeli economist Gur Ofer, defense spending in the USSR increased from 2 percent of GDP in 1928 to 16 percent by 1980. But most of this increase occurred before 1960, that is, before the economic slowdown. The intervention in Afghanistan and the response to the challenges of Star Wars increased defense costs by only about 1.6 percent of GDP between 1979 and 1987, according to defense expert Dmitri Steinberg. For the overall period 1960-87, only about 0.15 percent of the growth slowdown can be attributed statistically to increased defense spending.

**Extensive Growth?**

The most popular hypothesis put forward in the economics literature for the Soviet growth slowdown is the extensive-growth hypothesis: the Soviets relied exclusively on capital accumulation as a source of growth instead of turning to the technologically driven productivity growth that is allegedly the source of Western economic development (including Japan and the newly industrialized economies of East Asia). The ratio of the Soviet capital stock to output rose dramatically over time, which supports the conventional wisdom on extensive growth. Unfortunately for the extensive-growth hypothesis, however, the Soviets' rising capital-output ratio was not so unusual. Many countries have rising capital-output ratios, including such notable nonfailures as France, Japan, and Korea. What made the Soviet experience unusual was not extensive growth itself, but the low payoff to extensive growth.

**Investment from Above**

Why was the payoff so low? Martin Weitzman, Professor of Economics at Harvard University, suggested many years ago an arcane but important reason. In Western economies, capital (for example, machinery and equipment) can substitute rather easily for labor and thus sustain growth even when the labor force is not growing. The ease of substitution in the Soviet Union as well as in Western economies can be estimated statistically. Weitzman found, and we have confirmed with more recent data, that capital was an extraordinarily poor substitute for labor in the Soviet Union. Whereas machines could replace labor in the West, the Soviet economy seemed to be constrained by technology that almost required constant proportions: one machine, one worker.

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Figure 1: Soviet growth residuals from the 1950s through the 1980s

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We can now understand why Soviet growth was rapid early on, then declined so precipitously. In the beginning, capital was scarce: not all workers had machines. Giving a machine to a worker without one will have a very high payoff, and the payoff will stay high as long as there are workers without machines. Eventually, however, all workers will have machines and the returns to additional machines will fall off to virtually nothing. This is exactly the pattern we see in the Soviet industrial sector, for which we have estimated the return to capital since 1950 (figure 2). The rate of return to capital was high and constant during the period of rapid growth in the 1950s. But with the saturation of the labor force with capital, a precipitous decline in returns set in after 1960; by the mid-1970s, the return to new investment in Soviet industry was essentially zero. We find a similar pattern for the rest of the Soviet economy.

Why is it that capital could replace labor relatively easily in market economies, while the Soviets were stuck with an almost fixed-proportions economy? We can speculate—although more research is needed to confirm or refute these speculations. In Western market economies, an extraordinarily broad range of capital goods was available to economize on labor requirements, including not just human but physical capital and intangible capital as well—organizational and entrepreneurial skills and software for inventory control and production scheduling. This broad range of capital goods sprang up because market incentives led to the exploration of every conceivable type of capital that could be useful in production.

Soviet investment from above, on the other hand, was limited to the narrow range of goods that planners could direct and control—usually heavy machinery, for physical capital, and formal schooling, for human capital. It is plausible that it was a lot easier for the West to substitute a drill press plus computerized inventory control system for a worker than it was for the Soviets to substitute simply another drill press for a worker. It was the Soviets’ inability to replace workers with machines, rather than the excessive accumulation of machines per se, that was their undoing.

Message to Policymakers

What lessons can be learned from the ill-fated Soviet experience? The rapid Soviet growth in the 1950s teaches us that high investment can hide a multitude of economic sins. The underachieving Soviet growth rates of 1960-89 show that the wages of sin have to be paid all too suddenly and unexpectedly.

We have linked the severity and rapidity of the Soviet growth decline over 1960-1989 to the inability of planners to replace labor with efficiency-improving capital, in contrast to the labor-saving successes of the rich variety of human and physical capital goods in market economies. Since administratively directed capital investment programs continue to be a feature of many countries, the lessons of the Soviet growth debacle are still relevant today—not least in the former Soviet republics themselves.

Could it have been different? Looking back, it is tempting to believe that the system could have been reformed successfully if reform had started earlier, say in the 1960s. But remember that the Kosygin reforms in the 1960s did not succeed in reversing the growth slowdown. The system of investment from above was living on borrowed time.

At the conclusion of the American Civil War, Union General Ulysses S. Grant paid tribute to the people of the Confederate States “who had fought so long and valiantly, and had suffered so much for a cause, though that cause was, I believe, one of the worst for which a people ever fought.” We can only hope that the peoples of the former Soviet Union, who are the victims of one of the worst economic systems of modern times, will have a brighter economic future.

This article is based on W. Easterly (Macroeconomics and Growth Division, World Bank), and S. Fischer (M.I.T., Cambridge, Massachusetts), “The Soviet Economic Decline: Historical and Republican Data,” World Bank Working Paper no. 1284, 1994. To order: Ms. Rebecca Martin, the World Bank, Room N-11059, tel. (202)473-1320, Email: Growth@WorldBank Org@Internet.
Currency Board To Eliminate Inflation in Russia?
New Approach of Steve Hanke and Kurt Schuler to Monetary Reform

“Stability is not everything, but without stability, everything is nothing.”
(Karl Schiller, West Germany’s Finance Minister between 1966 and 1972.)

For over two years, inflation in Russia has rarely been less than 15 percent a month. The Central Bank of Russia—by granting large credits to the government and state enterprises at very negative real interest rates—has perpetuated their soft budget constraints and the resulting economic waste.

The historical record of central banking in Russia is one of inflation and inconvertibility. But there is a way to end extreme inflation: establishing a new monetary institution, a currency board. The currency board system has an excellent record of providing sound currencies and has worked well in conditions as difficult as those in Russia today.

Why a Currency Board?

A currency board is a monetary institution that issues notes and coins fully convertible on demand at a fixed exchange rate into its “reserve” currency, which can be a foreign currency or a commodity. A currency board holds 100 percent or slightly greater assets in the reserve currency. (If a currency board accepts deposits, they too must be backed 100 percent by the reserve currency.) A currency board earns seigniorage because its liabilities (notes and coins) pay no interest and its assets earn interest.

This definition implies differences between a typical orthodox currency board and a typical central bank.

A typical central bank:
• Does not issue a fully convertible currency. Although the currencies of most developed countries are convertible for current- and capital-account transactions, the currencies of most developing countries are not.
• Does not maintain a truly fixed exchange rate. Instead, it maintains either a floating rate, or a pegged rate that lacks strong safeguards and can be altered rather easily.
• Does not hold foreign reserves of 100 percent. It holds a lower ratio, and that often reduces its credibility and makes its currency vulnerable to speculative attack.

A typical currency board:
• Has no power to increase or decrease the supply of money independently of the wishes of market participants. Its monetary policy is completely passive, rule-bound, and transparent: it merely exchanges its notes and coins for reserve currency, or the reverse, in such quantities as market participants demand.
• Is more credible than a typical central bank. Credibility and arbitrage opportunities cause inflation and interest rates in a currency board country to converge toward the levels of the reserve currency country.
• Can achieve low inflation less painfully than a typical central bank.

Flexible Solutions

A currency board could be established in Russia either to replace the Central Bank of Russia or to issue a parallel currency to the central bank ruble. In outline, the steps necessary to convert the central bank into a currency board would be to:
• Separate the central bank’s currency-issuing functions from its other functions, such as bank regulation.
• Fix an exchange rate with the reserve currency (a possible candidate is the U.S. dollar which already circulates in Russia).
• Obtain sufficient foreign reserves to back the monetary base 100 percent.

Objections and Responses

• A currency board would not be politically feasible if the Russian government were to continue to have large budget deficits. On the other hand, if the government could reduce the deficits, then a currency board would be unnecessary to ensure a sound currency.

The current foreign reserves of the central bank and the $6 billion ruble stabilization fund potentially available from the International Monetary Fund would provide more than 100 percent reserves at the current exchange rate of about 1,800 rubles per dollar.

Rather than converting the central bank into a currency board, it might be more feasible to establish a currency board as a parallel issuer. With a parallel currency, budget constraints would harden more gradually than with a board as a sole issuer. As a parallel issuer, the currency board would issue a fully convertible ruble with an exchange rate fixed in terms of the reserve currency, but floating in terms of the central bank ruble. Under this arrangement, the central bank ruble could, for a time, continue to be used to finance soft budget constraints.

The steps necessary to establish a currency board as a parallel issuer would be to:
• Obtain a fairly large amount of initial foreign reserves (about $1.5 billion). These reserves would not be taken from the central bank. Instead, they could, for example, be borrowed from the IMF ruble stabilization fund or be financed with revenues from privatization.
• Issue notes and coins equal to the initial foreign reserves, and make the notes and coins legal tender. (Central bank notes and coins would also be legal tender at the floating exchange rate between the central bank ruble and the currency board ruble.)
But: Experience indicates that large deficits would not prevent the introduction of a currency board. For example, in Argentina the government eliminated a budget deficit of $6 billion (7 percent of GDP) and a central bank deficit of $6 billion after introducing a currency board-like system in 1991.

- A currency board would require reductions in essential government services.

But: On the expenditure side, many subsidies and military expenditures could be cut further without reducing essential services. On the revenue side, liberalizing oil prices further could increase revenue enormously. A currency board would eliminate the loss of revenue caused by inflation during the lag between assessing and collecting taxes. (The experience of Estonia suggests that essential services can be well provided under a currency board-like system.)

- Eliminating the Central Bank of Russia would deprive banks of a lender of last resort and would leave depositors unprotected.

But: Deposit insurance, if properly designed, could protect the public while avoiding the moral hazards that now exist because the Central Bank of Russia is a lender of last resort. Most currency board systems have achieved great stability without deposit insurance by encouraging branching by foreign banks. Banks with international branch networks have more diversified portfolios and can often better protect themselves and depositors from risks than banks without such networks.

- Russia is too big for a currency board. Because the Russian economy is large and has comparatively little foreign trade, it could not generate the foreign reserves to sustain a currency board. Therefore, Russia would do better with a pegged or floating exchange rate maintained by the central bank.

But: Russians are already acquiring large amounts of foreign assets. Foreign currency deposits are a large proportion of total deposits, and Russians have accumulated large unrecorded sums in assets held abroad and foreign banknotes held in Russia. Besides, currency boards have worked well in other populous, comparatively closed economies.

- A currency board, with an exchange rate fixed to a foreign reserve currency, would represent a type of humiliating colonialism.

But: A fixed exchange rate in itself implies no colonial relationship with the reserve currency. The Hong Kong currency board system links the Hong Kong dollar to the U.S. dollar, but Hong Kong is a colony of Britain, not the United States. Argentina is a fully independent nation, although its currency board-like system links the peso to the U.S. dollar.

Steve H. Hanke and Kurt Schuler

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The Boards: A Concise History of 150 Years

If Russia established a currency board to replace the central bank or be a parallel issuer, it would not undertake an untested experiment—point out Hanke and Schuler in their summary of the history of currency boards. During the 150 years that currency boards have existed, they have operated in more than seventy countries. In every case, they have provided stable, credible currencies that have been fully convertible into their reserve currencies.

Russia itself has had a currency board. During the Russian civil war the anti-Bolshevik government of the Archangel region established a currency board with British support. Research at the British archives confirmed that the currency board was the brainchild of John Maynard Keynes, who at the time was a British Treasury official.

The currency board operated in Russia from 1918 to 1919, and during the fall of the anti-Bolshevik government, it moved to London where it continued to operate until 1920. It issued a currency convertible at a fixed rate into the British pound. Its currency was a parallel currency to other, more inflationary currencies issued in Russia, and was driving them out of circulation in the Archangel region until the government fell.

From about 1900 to 1960, currency boards abounded in Africa, Asia, and the Caribbean. Most existed in British colonies. They were replaced by central banks as the colonies achieved independence and discarded institutions popularly associated with colonial rule. The successor central banks have on average not performed as well as the currency boards in terms of inflation, convertibility, or economic growth.

The most important orthodox currency board remaining today is in Hong Kong. Hong Kong’s record of rapid economic growth is well known, and the currency board has contributed to it. Recently, Argentina and Estonia have established currency board-like systems. Those systems have 100 percent foreign reserves and full or nearly full convertibility. But they lack strong formal or informal monetary constitutions, and hence have had some difficulty establishing credibility for their exchange rates. Even so, they have been successful in providing stable, convertible currencies and in enforcing hard budget constraints on economic agents.

In March 1994, the Lithuanian parliament approved an orthodox currency board system with a strong formal monetary constitution. It entered into force on April 1. Under the new system the litas will be 100 percent backed by gold and sound foreign currencies. The litas and the U.S. dollar will freely exchange at a fixed rate of 4 litas per dollar.
The Russian mafia is the world's largest, busiest, and possibly meanest collection of organized hoods, consisting of 5,000 gangs and the roughly 3 million people who work for or with them. Its reach extends into all fifteen of the former Soviet republics, across eleven time zones and one-sixth of the earth's land mass. It intrudes into every field of Western concern: the nascent free market, privatization, disarmament, military conversion, foreign humanitarian relief and financial aid, and even state reserves of currency and gold.

Rising from the ruins of the Soviet empire, the new mafia has far outclassed the one that flourished under Leonid Brezhnev. The mafia was Brezhnev's solution for a stifling centralized economy; it provided illicit goods and services by stealing from the state, buying protection, smuggling, cheating, and bullying and bribing its way into the Kremlin. It was korruptsiya (corruption) communist-style, a shared monopoly of power between politicians and crooks. Liberated Russia deserves better. But the old-guard politicians are still largely in place—yesterday's crooks are today's free entrepreneurs and korruptsiya has become the curse of a stricken nation. "Corruption," Boris Yeltsin exclaimed last year, "is devouring the state from top to bottom."

In 1991, the year the Communists fell, the All-Union Research Institute of the Soviet Interior Ministry estimated that half the income of an average government functionary was coming from bribes, compared with only 30 percent before 1985. During the late 1980s the Soviet prosecutor-general's office indicted 225,000 state officials for embezzlement, including eighteen who worked for the government's Department to Combat Embezzlement.

These were symptoms of a malignant growth pervading the economy, the banking system, and the body politic. Russia is in such chaos and so broke that few people can stay honest and survive. Even if not all lawbreakers are mafiosi, the mafia swims among them like a great predatory shark, recruiting some, extracting payoffs from others, frightening away rivals. Insatiable and seemingly invulnerable, it swallows factories, cooperatives, private enterprises, real estate, raw materials, and currency and gold—all and told, one-quarter of Russia's economy in 1991, and between one-third and one-half by 1992.

Between 1989 and 1991, communism's twilight years, the mafia's take shot up from less than 1 billion rubles to 130 billion—the size of the Soviet national deficit. "In the next few years, its [gross] will reach 200 billion rubles," A. Gurov [then head of the Soviet Interior Ministry's Sixth Department to Combat Organized Crime] said in 1991. "Organized crime will then control 30 to 40 percent of the country's GNP. . . ." In 1993 ten directors of the country's largest commercial banks were murdered, presumably for failing to extend still more outrageous loans than those they had granted already.

By the start of 1992, soon after the Soviet Union's borders opened up, all of its institutions were gone, including those for law enforcement. The Soviet-wide Sixth Department, created by Mikhail Gorbachev three years earlier to fight organized crime, was dismantled along with all other nationwide bodies. No central authority remained to coordinate police intelligence, order arrests, control 36,000 miles of border, or oversee the movement of people, money, and goods. The only organization fully operational in the new Commonwealth of Independent States was the mafia.

The Russian mafia is richer by far than the forces of the law and much better equipped in weapons, communications systems, and transport. Members are admitted only with a sponsor, and only after proving their valor by killing somebody on orders, preferably a friend or relative—exactly like their Sicilian counterparts. Once in, they risk its death penalties, communicate in a private jargon, and flaunt the tattoos that signal their eternal membership: a spider web for drug traffickers, an eight-point star for robbers, a broken heart for district bosses.

The mafia is organized in something like a classic criminal pyramid. First, at the base, are common street hoods, under gang leaders who run their territory like military boot camps. Moscow, for instance, is controlled by twenty criminal "brigades"—some tribal, others regional, others specialized by trade—totaling more than 6,000 armed thugs. Anybody in business in Moscow (whether in restaurants, food markets, gas stations, flower stalls, newsstands, casinos, beggars' corners at the Kremlin) is "under somebody" who collects a monthly payoff. A level up from the gangs are a "supply" group and a "security" group. The supply group serves as a conduit, ensuring that directives from above are carried out below. The security group is composed of respectable citizens—journalists, bankers, artists, athletes, politicians—who provide intelligence, legal aid, social prestige, and political cover.

On top of the pyramid are the godfathers, the indomitable vory v zakone (thieves-within-the-code); they preserve a "thieves' ideology," administer justice, and plot strategy. There are 700 known godfathers at large or in prison. Guiding rather than governing, they provide most of the brains for their subalterns. They are not absolute rulers over
violently unruly and fiercely competitive gangs. Rather, "each sphere of influence is under their control," according to I. Pavlovich, deputy chief of the Russian Interior Ministry's Sixth Department. Pavlovich says they meet periodically, settle territorial disputes, decide on operations, and make policy. Their power inevitably surpasses the fragile Russian government's. Their edicts are instantly transmitted, unmistakably enforceable, and almost universally obeyed.

Two stories illustrate how the mafia has of late transformed itself into a formidable force. First, in January 1991 the most powerful thieves-within-the-code gathered from all over the country to discuss a financial emergency. Valentin Pavlov, premier of the crumbling Soviet empire, had suddenly withdrawn all 50- and 100-ruble notes from circulation. His plan, he said, was to stop the illegal flow of rubles out of the country and prevent "a river of dirty money" from coming in. Everybody in the mafia kept illicit cash reserves in these notes, which at the time were the largest denominations issued.

"My operational report showed that these thieves-within-the-code—the supermen, the big-time mafiosi—got together to discuss ways of selling off or exchanging the banknotes for new ones or of getting them out of the country," Gurov later said on national television. "The thieves-within-the-code decided where the rubles had to be exchanged or smuggled out. Then they gave permission to set aside a quarter of the entire sum for bribing the administration."

The underworld mobilized overnight. "Black-market currency sharks vanished from Moscow," Gurov declared. The ruble notes were rushed to corruptible state factories and banks in remote regions to be exchanged under the counter. The Konkuret co-op, with only 1,000 rubles in its account, changed 190,000 rubles in 50s and 100s into smaller denominations at the local bank.

A Novosibirsk shop taking in 10,000 rubles per day "contrived to hand in" 240,000 rubles. Hundreds of millions of rubles were washed with little trouble. Unlike the poor, who lost their lifetime savings because they had been hiding their rubles under their mattresses to dodge the tax collectors, the mafia came out very well.

A few months later the godfathers met again to consider Gorbachev's 500-day program for transition to a free market. They liked it. A free market in the USSR meant not only mobility, relaxed borders, and dollars from abroad, but a chance to mount the most colossal criminal buyout in history. For all the wreckage of Russia's economy, it still had the world's richest natural resources. Once privatization got under way, according to Tatjana Kurjaghina, the Interior Ministry's top social economist at the time, the whole country would be up for sale.

Although few realized it at the time, the Russian mafia was about to make a big strategic leap—from merely feeding off the economy to owning it. To prepare for privatization, however, the godfathers needed to impose a new peace among Moscow's eternally warring clans. A truce that they had worked out in 1988, at Dagomys on the Black Sea, had ended in an orgy of bloodshed after barely a year. But the first stage of privatization was an imperative call to order. The logic of peace was inarguable: once inner harmony was restored, the godfathers divided zones of influence and went after the 6,000 enterprises coming up for auction in Moscow. The rules for privatization were fluid, corrupt officials were easily come by, and most Russians, having no money to speak of, could not compete. Within weeks, the Russian news agency Tass-Krim Press reported that the mafia had "privatized between 50 percent and 80 percent of all shops, storehouses, depots, hotels, and services in Moscow."

Today, according to Yeltsin adviser Piotr Filipov, who heads the Center for Political and Economic Analysis, Russia's mafia controls 40,000 privatized enterprises and collects protection money from 80 percent of the country's banks and private enterprises.

Adapted from Claire Sterling's forthcoming book, *Thieves' World*, to be published by Simon & Schuster. (Copyright 1994, Claire II Sterling Associates, Ltd. Printed by permission.) Claire Sterling is an investigative reporter based in Italy.

See also Sterling's recent article, "Redfellas—Inside the New Russian Mafia," in the New Republic, a U.S. weekly magazine.
Structural Reforms in Bulgaria: An Agenda to Move Forward

In 1991-92 Bulgaria implemented both economic stabilization and structural reforms—and made an irreversible turn to a market economy. Since 1992 the pace of structural reforms has clearly slowed, but the country has made further progress in important areas, including the introduction of the value added tax (VAT), the passage of the Privatization Law, and the law on bad loans, and the parliamentary debate on mass privatization.

The World Bank—in conjunction with the International Monetary Fund—has supported the Bulgarian reforms through a $250 million structural adjustment loan (approved in August 1991, and fully disbursed), a $17 million technical assistance loan, a $93 million energy loan, and a $55 million loan for Private Investment and Export Finance (PIEF). And in April 1993 the World Bank, in cooperation with several European institutions, also cofinanced a telecom loan of $30 million. [For more information about International Monetary Fund, Support to Bulgaria, see World Bank/IMF Agenda, page 17].

Structural reforms have been implemented in the following major areas:

- "Free market prices now regulate more than 80 percent of retail turnover. (In contrast, less than four years ago Bulgaria's economy was still controlled

State of a Nation: A Snapshot on the Bulgarian Economy

Debt negotiations. On April 14 negotiators representing the Paris Club of creditors agreed to defer payment on Bulgaria's approximately $1.5 billion government debt. This is the country's third such agreement with the Paris Club. Debt will be rescheduled over eleven years, following a seven-year grace period during which Bulgaria will only pay interest. Previous, unpaid interest installments are being transferred to the principal debt.

Bulgaria also made progress toward concluding a Debt and Debt Service Reduction (DDSR) agreement on its foreign debt to 400 London Club commercial banks. These debts were racked up in the 1980s by the former communist regime. A tentative agreement concluded in mid-April involves the rescheduling of $6.7 billion of the debt principal plus $2 billion in interest owed. Deutsche Bank—which has been chairing the negotiations—confirmed that the deal offered to the roughly 400 creditors would present them with the following options:

- Transform their claims into discount bonds (worth 50 percent of the nominal value).
- Transform their claims into front load interest reduction bonds (to be adjusted in accordance with market rates over seven years).
- Have their claim repurchased by the Bulgarian state (at 25 percent of the nominal value). By mid-May the creditors are to have selected one of the three options, and the settlement is to be concluded by June 30. Finance Minister Stoyan Aleksandrov said his country plans to immediately buy back debt originally worth $1.2 billion.

Total payments to creditors in 1994 may amount to $850 million. With Bulgaria's official reserves reaching around $600 million, foreign financing is essential. Since unilaterally declaring a moratorium on debt in March 1990, Bulgaria has been cut off from Western commercial financing. Foreign investment totaled only $220 million by the end of 1993.

The leva. Since January the leva, the national currency, has depreciated sharply and its exchange rate has sunk to 57 leva to the dollar. According to Bulgarian National Bank President Todor Valchuv, the underlying factors for the depreciation of the leva are rising inflation, shrinking domestic production, the growing budget deficit, political instability, and the lack of external financial support for economic reforms. The central bank has raised the short-term deposit interest rates in several stages from 35 percent to 57 percent. Commercial banks have had to increase their cash reserves and limit their lending.

Economic targets. The Bulgarian parliament has passed a tough budget that limits the 1994 deficit to 6.7 percent of gross domestic product and reckons with a 30 percent inflation rate. To reach this deficit target the government plans to improve tax collection

and implement the new 18 percent, single-rate value added tax that was introduced on April 1. (A shortfall in tax revenues and an increase in expenditure contributed to a budget deficit of 11 percent of GDP last year.) Restitution to former owners of urban property (houses and shops) confiscated under the communist regime has resulted in the return of the majority of retail businesses and cafes and restaurants to private hands. The country is still without a bankruptcy law, and only a few bankrupt companies have been closed down. On the other hand, the government has taken steps to refinance $2.4 billion in bad loans made by banks to state enterprises before 1991. It also issued its first bonds to convert enterprise debt into government debt. The aim is to make companies easier to privatize and to strengthen the banking system.

Mass privatization. Two years after passing a privatization law that envisaged the sale of more than 3,000 companies, the agency responsible for selling large and medium-size companies has completed fewer than twenty transactions and government ministries have sold only 100 small businesses. In August 1993 the Lyuben Berov government adopted a program of mass privatization with the aim of giving citizens a share of national wealth on an equal and just basis; achieving greater efficiency in the management of companies; and establishing the financial preconditions for a national social insurance scheme.
by central plans.) The leva has become a convertible currency on the current account, with a single floating exchange rate. Price controls, however, have been maintained on several products and services, including energy, telecommunications, water supply, and transport. These controlled prices had been increased to bring them closer to world market levels. Prices of electricity, heating, and coal have also been increased, but because of some delays, and the 1994 exchange rate depreciation, further price adjustments for these commodities are planned later this year.

**Trade liberalization** has been carried out in several steps, the most recent being comprehensive tariff reform, followed by replacement of almost all quotas by tariffs. The import-weighted average tariff is 11 percent, and dispersion is low by international standards. Due to domestic shortages, exports of major grain products have been temporarily banned. The prohibitions on grain exports are expected to be phased out by the end of September 1994 and replaced by export taxes. The current temporary 2 percent import surcharge will be gradually lowered to 1 percent next year, and is expected to be phased out altogether by the end of 1995.

**Privatization** has been slower than expected. Still, the legal and institutional framework has been established—the Privatization Law was enacted in April 1992. Initially, important progress was made through restitution; around 60 percent of all claimed property was returned to former owners. Restitution was a major method of privatizing state property. For 1994, a draft program is targeting 320 enterprises, including 70 large enterprises. Also, a mass privatization proposal is under consideration in parliament (see box). The private sector, which had a marginal role in the economy before 1989

Each Bulgarian citizen over the age of 20 is entitled to receive one registered voucher worth 30,000 leva ($600). The voucher is to be paid for in six equal installments from 1999 to 2005, minus the sum paid upon acquisition. The acquisition cost of each voucher is 5 percent of its value, or 1,500 leva, which is to be paid into the national budget as prepaid interest on the voucher. The initial amount received will be used to cover part of the state's privatization expenses. It is also intended to help finance social security costs. Citizens have a choice between two types of privatization: participation in the privatization of twenty-five to thirty enterprises, with a bank acting as a trust (or holding company), or in the direct privatization of one enterprise through the acquisition of its shares.

Experts from the ministries of finance and industry are to draw up a list of around 500 large and medium-size enterprises—with an expected total value of 180 billion leva ($3.6 billion)—to be included under the mass privatization program. These enterprises must have already been transformed into individual joint-stock companies and must not be threatened by bankruptcy. The opportunities envisaged by the scheme would not impair the right of workers to acquire on preferential terms up to 20 percent of the shares of the enterprise in which they are working, as was stipulated by the Privatization Law of 1992.

But two major trade unions, as well as the Privatization Agency and the pro-business Economic Association, have registered their disapproval of the privatization scheme, claiming that the program:

- Makes no distinction between efficient firms and loss-makers.
- Fails to specify the companies that will be privatized. (The target is to sell 320 firms in 1994—or around 10 percent of the state sector—and the plan indicates only the exceptions: "strategic" sectors such as armaments, transport, oil refining, and energy generation will be excluded.)
- Involves trust funds that could themselves become new monopolistic structures.
- Suggests a high minimum application for share vouchers—around 75 percent of the 1993 average monthly wage. (Up to 40 percent of the population is now below the official poverty line.) Facilities aimed at allowing payments to be extended until 2005 do not benefit the significant proportion of pensioners in the population.

To rationalize procedures and further facilitate the participation of employees, the government has proposed twenty amendments to the Privatization Law. The new amended version, however, has not gotten past a second reading in parliament. There is still no consensus within the government on the technical details of the scheme.

**Agriculture.** Agricultural production, which accounts for 30 percent of Bulgarian GDP, is expected to fall by 2 percent in 1993. This follows declines of 8 percent in 1992 and 8 percent in 1991. Output of the three main crops (wheat, corn, and food and fodder grain) has fallen to the levels of the early 1970s. The decline in cereal output has had particularly adverse consequences for livestock. Bulgaria is now a large net importer of foodstuffs.

Fifty percent of Bulgaria's farmland is now in private hands, most of it outside the highly productive agricultural regions. About 25 percent of land has been returned to former owners.

**European Union association.** Bulgaria's prospects improved with the initiation of a European Free Trade Association (EFTA) in February, and the signing of an European Union (EU) association agreement in March. These agreements will come into effect in May (EU) and July (EFTA). The EFTA agreement envisages a ten-year transition to a free trade zone, with restrictions mainly on steel and textiles during this period. The EU agreement, which is similar to those already concluded with Poland, Hungary, and Romania, envisages a ten-year transition to a free trade area and eventual EU membership—although at an unspecified date.

EU countries will fully liberalize trade with Bulgaria in four years, while Bulgaria is to liberalize trade with the EU in nine. Exports of textiles (20 percent of total exports to the EU) and steel—defined as "sensitive" by the EU—will continue to be regulated by separate protocols establishing quotas outside the general liberalization framework.

Compiled from reports of the Oxford (U.K.)-based Oxford Analytica and from various press accounts.
Bulgaria: Major Economic Indicators

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<tr>
<td>Real economic growth</td>
<td>-1.9</td>
<td>-9.1</td>
<td>-11.7</td>
<td>-7.7</td>
<td>-5.0</td>
<td>-2.0</td>
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<tr>
<td>Industrial production</td>
<td>-17.6</td>
<td>-23.3</td>
<td>-21.9</td>
<td>-8.0</td>
<td>4.0</td>
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<tr>
<td>Consumer prices</td>
<td>6.4</td>
<td>23.8</td>
<td>338.5</td>
<td>91.3</td>
<td>75.0</td>
<td>55.0</td>
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<tr>
<td>Unemployment rate</td>
<td>0.0</td>
<td>1.6</td>
<td>11.1</td>
<td>16.4</td>
<td>17.0</td>
<td>18.0</td>
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a. Estimate.
b. Forecast.
c. Public Sector.

Source: Vienna Institute for Comparative Economic Studies (VIW).

Real economic growth has been pressing organizational, technological, and pricing issues. Reforms are under way. The World Bank is well positioned, through future lending, technical assistance, and economic and sector work, to assist the government in developing an energy strategy that will address the most acute problems of these sectors.

The telecommunications, rail, water supply, and environmental protection sectors have been pressing organizational, technological, and pricing issues. Reforms are under way. The World Bank is well positioned, through future lending, technical assistance, and economic and sector work, to assist the government in developing an energy strategy that will address the most acute problems of these sectors.

Bulgaria’s negotiations with its commercial creditors to cut a debt reduction deal could be concluded this year. The country could then be relatively well placed to regain creditworthiness and thus remove a major source of uncertainty and external financing constraint.

An important lesson of the transition process is that stabilization and structural reforms are inextricably linked. Once an economy is successfully stabilized, the economic recovery requires a continued solid macroeconomic environment, implying the relentless pursuit of prudent monetary, fiscal, and income policies, and sincere efforts to keep the exchange rate competitive.

To ensure sustainable growth, the institutional and policy-related obstacles to private saving, investment, and entrepreneurship need to be removed through structural reforms.

*Banking consolidation is on the agenda. New regulations have been issued on capital adequacy, the provisioning of bad loans, and so on. The national bank has started to carry out on-site inspections of some banks, and there are plans to gradually privatize several banks.

*Social welfare programs have been restructured. However, the retirement age, which has already been increased, is still lower than in the market economies. Key issues involve the need for budgetary affordability, for improving targeting to the truly needy, and for improving the efficiency and transparency of transfers.

*Agricultural reforms have progressed simultaneously on both land reform and product pricing. Land reform was undertaken with the aims of reestablishing private property rights by restitution, distributing the assets of liquidated collective farms, and demonopolizing and privatizing agroprocessing enterprises. Restitution is running behind schedule.

Nonetheless, 42 percent of agricultural land preserved for restitution has been distributed so far. To help farmers obtain bank financing, land protocols or temporary land titles can be used as collateral under the amended land law. Clearly, the sooner the process is completed, the sooner and better private agriculture will be able to respond to new market signals in this important sector—one in which Bulgaria has traditionally had comparative advantage in Europe.

Input and output prices of agricultural products continue to adjust to world market levels. Remaining differentials between domestic and world prices seem to be related, in equal measure, to imperfection of the domestic and foreign markets and to explicit government controls. The latter include product price floors, and minimum import prices on some agricultural products. Indirect price controls should be phased out soon, with some minimum prices probably retained.

*Energy restructuring has been centered around price liberalization and institutional reforms. But the prices of electricity, heating, and coal have been increased, and because of some delays and exchange rate depreciation, additional price increases are planned. The World Bank’s energy loan is designed to assist the electricity subsector and to intensify the policy dialogue on pricing and institutional restructuring. The latter effort is aimed at clarifying responsibilities and improving coordination among the various institutions in this important sector.

Zelko Bogetic
Europe and Central Asia
Country Department I
World Bank
Letter to the Editor
Let Them Eat out of Separate Kitchens: Comment on Fiscal Recentralization in China

Mr. Shahid Javed Burki’s recent article (“A New Wave of Structural Reforms in China,” Transition, December 1993, p. 5) includes some controversial statements on fiscal (re)centralization in China. The issue at stake is closely linked to IMF and World Bank recommendations to countries in Eastern Europe and Central Asia, as well as to China, Laos, and Vietnam.

The article states that “the central government’s share of tax revenues has fallen steadily from close to two-fifths of GDP in 1978, to about one-sixth of GDP in 1992. There has been no corresponding decline in expenditure.” In fact, during the period 1978-90, for governments at all levels, revenues (adjusted revenues including fiscal extrabudgetary revenues) declined from 37.1 percent to 23.9 percent of GNP, while total expenditures (adjusted expenditures including fiscal extrabudgetary expenditures) fell from 36.8 percent to 26.0 percent of GNP. Hence, during the period, the budget deficit did not exceed -2.2 percent of GNP except for 1979 and 1980, when the deficit was -5.2 percent and -3.2 percent of GNP, respectively. (“China: Budgetary Policy and Intergovernmental Fiscal Relations,” World Bank report no. 11094, p. 228.) As for central government expenditures, these have fallen from 16.7 percent of GNP in 1978 to 8.8 percent of GNP in 1990. And in 1990 central government revenues came to 9.4 percent of GNP, implying a central government surplus of 0.6 percent of GNP.

These statistics do not support the assertion that the central government, to cover its deficit, had to borrow heavily from the People’s Bank of China, “adding fuel to inflationary pressures.” Indeed, the move toward subnational government fiscal autonomy probably reduced pressures for budget deficits because subnational governments were not allowed to run deficits and the central government’s own budgetary responsibilities narrowed.

Prior to reforms from 1978, government revenues were not so clearly divided and assigned to governments at different levels. Therefore, it does not make much sense to separate out the central government revenues from total government revenues.

From 1978 on, “eating out of separate kitchens” became a guiding principle of reform, meaning that governments at every level (national, provincial, prefectoral, county, and township) were encouraged to take steps toward achieving self-sufficiency, and particularly to collect taxes to cover expenditures. Also, many enterprises were reassigned to subnational governments, allowing competition and markets.

Meanwhile, ministries of the central government retained control over some sectors of the economy through state-owned enterprises (SOEs). These SOEs are the rump of the former centrally planned economy. Since the central government’s SOEs are often less profitable than the rest of the economy, the central government pumps in directed credit. It may be that this credit puts some inflationary pressure on the economy. Instead of shifting tax revenues to the center, an alternate pro-market solution to this situation may well be to cut down efforts for price distortion through central planning, that is, to expand the share of competitive markets.

It is no surprise therefore that conservatives are fighting for more centralized revenues to be able to pour money into the centrally administered portion of the economy while trying to squeeze enterprises reporting to subnational governments. It is clear that a centralization of tax authority—as recommended by many experts—moves exactly against the post-1978 reform objective of gradually establishing “separate kitchens” for subnational governments. Such a shift would tend to put subnational governments at all levels at the mercy of central transfers. This could break the link between taxing and spending, discouraging budget discipline.

Creating discipline in a chaotic economy is offered as justification for recentralizing control over taxes and spending. Procentralization views characterize the advice given to many formerly centrally planned economies. An article on Vietnam in the January issue of Transition (David Dollar, “Vietnam’s Economic Options—Coping with Mounting Resources,” p. 14) advises, “...the central government needs to assert control over public expenditure and borrowing. Otherwise, borrowing and spending by government at different levels and by public firms could take off in an uncontrolled manner and undermine economic control.”

Similar advice has been imposed on Laos. However, arguments for recentralization to control budget deficits and inflation are not convincing as much as central governments can control budget deficits with simple limits on subnational government borrowing (if any limits are needed) and can control inflation through banking reform and monetary policies; direct control of subnational government taxes and spending are not necessary.

Economies in transition have demonstrated a pattern of devolving authority to regional and local governments. This is a common characteristic in former communist countries in Europe as well as Asia. In Asia, authorities in China and Vietnam have, at least through the present, been able to follow consistent devolutionary paths, assigning...
subnational governments authority for SOEs as well as taxing and spending. Vigorous growth has been associated with these reforms, which give more units (enterprises, subnational governments) opportunity to act without central government oversight and approval.

In Eastern Europe and Central Asia, conflicting efforts on the part of some “reformers” to recentralize government authority through national tax reforms and other changes may run counter to the “natural” reform process in which authority over enterprises and government activities falls to workers, users, and local bodies. It may be that efforts to centralize some activities in some transition economies are antireform, contributing to confusion and conflict.

David Gisselquist
Consultant

Who are the Hungarian Socialists and What Do They Want?
Interview with Vice President Imre Szekeres

Imre Szekeres, executive vice president of the Hungarian Socialist Party (HSP) visited the United States in mid-April. He met with leading business people and senior government officials to provide details about the HSP’s intentions if the party—legal successor to the pretransition Hungarian Socialist [communist] Workers’ Party—wins the forthcoming parliamentary elections, on May 8. (Voters will cast their ballots again in the second round, on May 29.) Most recent polls have projected the Socialists—who now define themselves as a Western-style social democratic party—as sure winners. The other major opposition party, the liberal Alliance of Free Democrats (AFD)—a possible coalition partner—is second in the polls. The leading party of the present conservative government, the Hungarian Democratic Forum (HDF) is third. Mr. Szekeres gave a short interview to Transition editor, Richard Hirschler.

Q. There are fears in some business circles that a Socialist or a Social-ist-led government could reverse the transition process....How do you respond to those worries?
A. I would like to dissipate those fears. We want to accelerate the process leading to membership in the European Union, and strictly adhere to our guiding principles, respecting democratic institutions, civil rights, and the principles of a market economy. Our major economic goals include jump-starting growth by 1996-97, curbing inflation, gradually eliminating foreign and domestic debts, cutting the unemployment rate to half from its current 13 percent, and easing social tensions.

Q. What are the means to achieve those targets?
A. First, we are ready to create a more investment-friendly environment to attract yearly about $1.5 billion worth of foreign investment. Incentives would include investment tax credits, free trade zones, and acceleration of bank privatization. We also foresee large-scale development and reconstruction of the infrastructure (housing, roads, utilities) through accelerated sale of concessions to foreign companies. Second, we would eliminate current uncertainties in agriculture and encourage both private and collective farming. Agricultural production could increase annually by 4 to 5 percent. Third, the planned fiscal reform would constrain the state’s role in the economy, increase the maneuvering possibilities of local governments and the private sector, and trim taxes on enterprise profits and personal incomes. And finally, the government will focus more of its attention on social affairs, health, education, and the environment. A complete overhaul of the large budgetary redistribution systems is also on the agenda.

Q. We all know that the code word “reforming the great redistribution systems”—pensions, education, health care, childcare, various family support schemes—will mean a net income loss for many families. Who will support such a belt-tightening program?
A. If we get a broad mandate from the voters, we can ask both wage earners and entrepreneurs to cooperate in breaking the current trend of economic stagnation and growing domestic and foreign indebtedness. We intend to work out a trilateral deal between the government, employers, and employees. With the largest trade union—the National Alliance of Hungarian Trade Unions (MSZOSZ)—actively participating on our side in the election campaign, we expect organized labor to agree to a voluntary wage-restraint measure in order to help create the preconditions for an eventual economic recovery.

If the next government is more sensitive to social needs, better-qualified professionally, and more competent than its predecessor, I see no problem with cutting a deal with the public at large. Under such leadership, Hungary’s international standing could improve, not in spite of but because of a government that includes the Socialist Party—assuming that the new government pursues a predictable, transparent, and stable policy based on national consensus.

Editor’s note: We learned after deadline that in the first round the Socialist Party (HSP) took a lead with 33 percent of the vote. The ruling rightwing HDF dropped to third place with 12 percent, and the liberal AFD took 20 percent. In the forthcoming second round on May 29, the HSP has good chances to win with a landslide, and form a coalition government with the liberals.
Czech exports growth in March led to a small trade surplus in the first quarter, reported the Czech Statistical Office. Last year the trade balance was in deficit. Exports to the European Union (EU), which now account for 42.3 percent of the total, grew by 24.1 percent in 1993. Raw materials and semimanufactures accounted for almost 60 percent of total exports last year, compared with 37 percent in 1989. The 1993 current account showed a surplus of $360 million, due largely to a surplus of $1.1 billion from tourism. Foreign direct investment last year was only 41.7 percent of the 1992 level. Portfolio investment of Western firms reached $1 billion in 1993. The capital account showed a surplus of $2.5 billion.

More data from the Czech Republic:
In 1993 consumer spending grew by 4.1 percent, while GDP fell by 0.3 percent, and industrial output dropped by 5.3 percent. The private sector accounted for 39.4 percent of output, compared with 21.9 percent in 1992. Inflation, currently at 9 percent, is likely to remain below 10 percent this year. The government has forecast 1994 GDP growth of 2 to 3 percent. The unemployment rate stands at 3.5 percent.

Shares valued at more than $5 billion in 861 Czech companies that are being privatized under the second wave of the voucher privatization program have been on offer from April 11 to April 25. More than 6 million Czechs purchased vouchers and registered to bid for shares in the companies slated for privatization when the second wave was launched in the fall of 1993. About 500 companies will be offering more than half their capital. (The first wave, during which some 1,400 companies were privatized in both the Czech Republic and Slovakia, ended in spring 1993.) Foreigners will be allowed to move in, possibly by the end of May, and freely purchase shares, except in banks. Many large companies are sold by a combination of direct foreign ten-

Hungary's finance minister, Ivan Szabo, criticized the central bank, "which could destroy the country's fragile economic recovery if it raises interest rates to help tackle a stubbornly high current account deficit." What Hungary really needs is more foreign investment to help plug the gap, the finance minister said. The National Bank of Hungary has flashed warnings that it will not hesitate to raise interest rates to help rein in the current account deficit, which preliminary data put at between $800 million and $1 billion in the first quarter of 1994. The shortfall hit a record $3.46 billion last year, a performance the central bank says it cannot allow this year if it is to prevent pushing up the $24.5 billion foreign debt.

Hungary's gross domestic product fell by 2 percent in 1993, according to a preliminary estimate by the Central Statistical Office. GDP fell 4.5 percent in 1992 and 10.2 percent in 1991 as Hungary started the difficult transition to a market economy after four decades of communist central planning. In absolute terms, 1993 GDP exceeded $33 billion. Per capita GDP stood at $3,500.

A recent Hungarian-Russian deal settles part of an outstanding $900 million Soviet-era trade debt to Budapest by letting Hungarian companies purchase stakes in Russian enterprises as they are privatized. Hungary's Minister of International Economic Relations, Bela Kadar, said that Hungarian companies are pressing for shareholdings in the Russian energy, vehicle manufacturing, and pharmaceutical sectors. Hungary's proposals imply a debt-for-equity swap worth as much as $500 million, Kadar said.

The Romanian parliament approved a law introducing a tax on land ownership. Although most agricultural land is now worked by private farmers, only 15 percent of the 5.1 million private landowners have received full titles to property returned under a 1991 act. This has prevented them from using their land as collateral to raise capital for seeds and equipment.

The Romanian government announced massive price hikes for gasoline, natural gas, electricity, and thermic energy beginning April 7. A liter of gasoline now cost 450 lei (about 27 cents), up from 400 (22 cents). Prices for electricity also increased by 42 percent, from 28 to 40 lei per kilowatt. Officials predicted that the hikes will result in a general price increase of between 12 and 14 percent. (Romanian consumer prices rose 5.9 percent in February, compared with January.) Prices for train, tram, and trolley-bus tickets are expected to rise soon. The new prices are still far below the Western European average, but the increase is substantial by Romanian standards. The average monthly salary in Romania is about 106,000 lei ($63).

In Romania 1,287,000 people were registered as unemployed in March, Rompres reported. (This translates to 11.3 percent of the work force, up from 11.1 percent in February.) Unemployment was higher among women and young people, who represented some 56 percent and 30 percent of the total, respectively. Between 10,000 and 12,000 people are losing their jobs every week in Romania.

China's Prime Minister Li Peng in his speech to the National People's Congress urged slower and more stable growth, and control of inflation. Li called for GDP growth of 9 percent in 1994—the rate was 13 percent in 1992 and 1993—and set a target for national retail price inflation in 1994 of less than 10
percent, down from 13 percent last year. (Consumer price inflation in thirty-five major cities was an annual 24.5 percent in March, compared with 25.9 percent in February. Rural inflation for March dropped by a meager 0.1 percent from a level of 20.9 percent in February.) Li said the budget deficit is rising and noted among the causes increasing outlays on domestic and foreign debt, less money being collected from state firms, and higher wages to civil servants. The prime minister announced that state firms will no longer have to contribute to funds for transport and energy projects and that Beijing is setting aside funds to handle bankruptcies and dismissed workers. Turning around state firms in trouble is basically the job of the firm itself, he added. (According to official data, nearly 41 percent of state-owned businesses suffered losses in the first quarter of 1994.)

In the first quarter of 1994, China posted a 19 percent gain in exports. China's trade deficit was $1.28 billion, but export growth outpaced import growth for the first time in two years.

China said yesterday it will open more sectors to foreign capital to boost overseas investment. Jiao Sufen, director of the foreign division of the Ministry of Foreign Trade and Economic Cooperation, said the government will permit overseas investors to operate in real estate, retail, finance, insurance, cargo and transportation agency services, and consulting.

In his first decision since being appointed, Poland's new finance minister and deputy prime minister, Grzegorz Kolodko (an economist without party affiliation who heads the Warsaw think tank, Institute of Finance), postponed the reintroduction of a wage tax, as a result of nationwide strike actions of the Solidarity trade union. The government coalition of the Democratic Left Alliance and the Polish Peasant Party was forced to give in, as the social unrest was threatening to wipe out this year's economic growth. The rejected bill on wage structuring and funding would have regulated wages in 6,000 enterprises in which the state owns not less than 80 percent of the shares. Enterprises that exceeded the permitted wage growth ceilings could have been penalized to the tune of 150 percent of the excess amount.

On March 25 the IMF's executive council formally approved the fulfillment of Poland's standby arrangement for March 1993-April 1994. IMF approval clears the way for a 20 percent reduction in Poland's $33 billion debt to foreign creditor governments effective April 1. (The Paris Club reduced Poland's debt by 30 percent in 1991.) Another agreement was reached March 11 with the London Club to reduce Poland's commercial debt of $13.2 billion by 45 percent. Repayment is to last thirty years, until 2024, with maximum annual payments of $400 million. The initial cost will be around $1.3 billion, of which $500 million will be provided by the World Bank and 300 million by the IMF, leaving 500 million to come from central bank reserves. The deal will provide Polish enterprises with access to international bank lending and equity markets.

Good heavens! Do you remember being intoxicated and writing that letter to the World Bank? Well, they sent you a check for $15,000.

From the Hungarian daily Napi Gazdasag

April 1994
President Yeltsin signed Russia's federal budget law in April for the second quarter of 1994. Expenditures are set at 46 trillion rubles, revenues at 28.6 trillion rubles, and the deficit at 17.4 trillion rubles. The central bank is ordered to provide a credit of 10.6 trillion rubles to cover part of the deficit: the credit will be for ten years at 10 percent a year, with repayment starting in 1998. Russia's parliamentary Economic Policy Committee proposed the rejection of the draft federal budget for 1994. In addition to its alleged neglect of military conversion, the draft was said to have reduced allocations to education, training, culture, and basic research, and to have overlooked possibilities for additional revenues. [It is still hoped that the federal budget for the entire year will be ready for the president's signature by June or July.]

Viktor Glukhikh, chairman of Russia's State Committee for the Defense Industries, claimed that the production of military hardware has declined by 78 percent since 1991, and that output in February was 38 percent down from February 1993. If the current draft federal budget for 1994, which allocates 37.1 trillion rubles for the military-industrial complex, is approved by parliament, up to 3 million defense workers could be laid off this year, Glukhikh warned.

According to parliament's Committee on Budget, Taxes, and Finances, the Russian government intends to repay $4.7 billion out of a total of $32 billion due this year in principal and interest on its foreign indebtedness. The total foreign debt outstanding at the beginning of 1994 was put at over $80 billion: this figure excludes debt to East European countries and commercial arrears.

On April 7 Russian Deputy Prime Minister Anatolii Chubais presented a report on the progress to date of voucher privatization and outlined his plans for postvoucher privatization due to start on July 1. By early April, 105 million Russians had invested their vouchers, and Chubais was confident the remaining 45 million vouchers would be invested before mid-June. About 80 percent of the 20,000 eligible large and medium-size enterprises have already been converted into joint-stock companies. Chubais highlighted several features of the postprivatization program, including the transfer of part of the funds derived from privatization to social security purposes and the use of G-7 grants for supporting postprivatization operations.

Russia's Deputy Prime Minister responsible for agriculture, Aleksandr Zaveryukha has warned that spring planting could take place this year "at a low agrotechnical level" and, as a result, that "a significant portion of the crop will be lost." The original official projection of this year's grain harvest was 85 million-89 million tons, but experts have predicted a lower output of just over 75 million tons. The leader of the agrarian faction in the State Duma said he will fight to raise the farm subsidy from 9 trillion to 20 trillion rubles.

The Russian cabinet agreed to a plan allowing state and collective farms to auction off land to their workers as private property. For the first time in the country's history, Russians would be able to acquire title to land. The reform program allows for buying and selling of farm land with some restrictions, including that the land must continue to be used for farming and be owned by people capable of working it effectively. About 14,000 of Russia's more than 250,000 private farms folded in 1993. Agriculture Minister Viktor Khlystun told reporters that although he is optimistic about development of private farms, he believes they will account for only 14 to 15 percent of agricultural land by the end of the decade. [See also Farm Privatization in Russia on the next page.]

The Russian tax authorities began requiring foreign firms to pay a 23 percent tax on investment capital, beginning in mid-April. A presidential decree of January 1994, which orders that taxes be paid on all loans to Russia-based firms (except loans channeled through Russian banks), applies to foreign investors as well. First Deputy Prime Minister Oleg Sokovets has denied the existence of the tax.

Estonia's consumer price index rose in March by 8.9 percent. The monthly increases in January and February were 5.2 percent and 5.5 percent, respectively. The greatest increases were for rents at 18.5 percent; milk and eggs, 13.3 percent; and transport and communications, 9.7 percent. In February the country exported goods worth 1,160.4 million kronor ($86 million) while importing goods valued at 1,311.7 million kronor. Russia received 25.8 percent of the exports; Finland, 20.8 percent; and Sweden, 10.4 percent. Estonia's imports came mainly from Finland (39.0 percent), Sweden (12.2 percent), and Russia (10.0 percent). Farm produce was both the leading export at 25.1 percent, and import at 18.1 percent (not including oil and gas imports through pipelines or exports of electricity). In February Estonia's gold and hard currency reserves increased by 32.5 million kronor to 5,373.7 million kronor ($392 million). The gross income of Estonian families in January declined by 15.6 percent from its December level to 833.12 kronor per family member, with consumption in nominal prices over the same period declining by 18.6 percent to 612.73 kronor per person.

The distribution of privatization checks began April 1 in Belarus. Each check is worth 25,000 Belarusian rubles, and individual entitlement depends on age and length of employment. The average Belarusian will receive 1.5 million rubles' worth of checks ($150). The list of enterprises up for sale was made public in the middle of April, and the sale of assets will begin on July 1. Belarussians who reached the age of 16 by August 3, 1993, qualify for ten checks.

(We appreciate the contributions from the RFE/RL Research Institute.)
World Bank/IMF Agenda

Finally: $1.5 Billion to Russia

On April 20 the International Monetary Fund approved a second drawing of $1.5 billion for Russia under the Systemic Transformation Facility (STF) in support of the 1994 economic reform and stabilization program. Russia's first drawing under the STF, also $1.5 billion, was approved by the IMF on June 30, 1993. The main goals of the 1994 program include further reduction of the inflation rate through tighter fiscal and monetary policies. (The monthly rate of inflation is projected to decline to 7 percent by the end of the year.) The decline in real GDP is to be contained to 10 percent in 1994, compared with 12 percent in 1993. The program calls for a reduced credit expansion which, in turn, requires a significant cutback in the budget deficit. The enlarged government deficit (including the net operations of the federal and local governments and the extrabudgetary funds) is expected to decline from 8 percent of GDP in 1993 to 6.5 percent of GDP in 1994.

The export regime will be liberalized, including the elimination of export quotas, with the exception of certain energy products and nonferrous metals. The centralized export scheme will be phased-out this year and eliminated as of 1995. Government imports will be limited to certain foodstuffs, medicines, and veterinary products. As to the new phase of the privatization program, starting on July 1 auctions of enterprise shares will be conducted on the basis of cash rather than vouchers. Participation of direct foreign investment in the privatization process will be encouraged.

The STF loan will set the stage for negotiations on a $4 billion standby credit. According to Camdessus, those talks will probably begin this summer and will depend greatly on the formulation of the 1995 budget, as well as on Russia's performance in adhering to 1994 budget goals.

How Much Does Russia Need in 1994?

At their April 24 meeting in Washington, D.C., the finance ministers and central bankers of the G-7 group of major industrial nations heard cautiously optimistic appraisals of the state of the Russian economy from Russian officials and from representatives of international financial organizations. Prospects are good for accelerated disbursement of up to $1 billion in World Bank funds that are already in the pipeline. According to the April 25 The Financial Times, Russia will need $34 billion in external finance in 1994, in addition to the new $1.5 billion STF loan.

Farm Privatization in Russia

Russia is moving ahead with a pilot land privatization program promoted by the International Finance Corporation (IFC), the private sector investment arm of the World Bank. In the Nizhny Novgorod region, about 400 kilometers east of Moscow, up to 100 farms will be privatized in the next year. With the support of Regional Governor Boris Nemtsov, five farms along the Volga River have already been privatized with financial backing from the U.S. Agency for International Development and the British Know-How Fund. Under the program, members living and working on the farms are automatically entitled to equal shares of the land. But they have to buy equipment and supplies with bidding certificates, based on their seniority in the collective. The project will move into other pilot regions. (In Russia more than 90 percent of farming is still collectively owned.)

World Bank Loan to Romania

A $175.6 million World Bank loan, approved April 5, will help Romania restructure its cumbersome oil and gas sector. The twenty-year loan, with a five-year grace period, is aimed at developing extraction and restoring some 300 kilometers of oil pipeline. It will help upgrade facilities, introduce new technologies, and streamline regulations. Romania has natural gas reserves estimated at 517 billion cubic meters, and oil reserves approaching 300 million tons. Crude oil and natural gas production decreased more than 40 percent between 1976 and 1991. Crude oil production is expected to decline from a level of 16 million tons in 1990 to 14.8 million tons in 1995. The World Bank loan is expected to encourage foreign investment. A separate Bank loan, also approved April 5, targets Romania's education system. The $50 million loan will fund training in central administration and curriculum development as well as pay for better textbooks and equipment.

Bucharest Negotiates with the IMF

In negotiations with the IMF, Romania announced plans to restrict its budget deficit to 3.6 percent of GDP in 1994 and to take stricter measures to eliminate interenterprise debts, have one-third of GDP. It will strive for parliamentary approval of the liberalization of the foreign exchange market; the introduction of a stock exchange; and accelerated structural reforms, including privatization. These measures are to be implemented in 1994-95, and an immediate loan of $160 million will be provided depending on the result of the IMF reviews in November 1994 and May 1995. Further IMF credits of $900 million will be disbursed over the next eighteen months. (The National Bank of Romania's latest figures indicate a trade deficit of $1.26 billion in 1993. Current account deficits are expected to exceed $1 billion dollars for each of the next five years. Annual inflation was running at 261 percent in March, and monthly figures are rising—8.3 percent in March over a level of 5.9 percent in February.)
Algeria Gets $1 Billion

IMF Managing Director Michel Camdessus proposed that the Executive Board approve combined funds of $1 billion to Algeria in a standby credit and a drawing from the CCFF (comparative and contingency financing facility, a fund that helps out members if terms of trade deteriorate). Earlier, the Algerian dinar had been devalued by 40 percent, to 36 per U.S. dollar. The new discount rate is 15 percent and the bank rate is 24 percent. The official inflation rate is higher than 30 percent. With a yearly population growth of 2.5 percent, 240,000 new jobs annually are needed to keep unemployment below 20 percent of the work force. Algeria’s reform program allows a faster development of the private sector and introduces targeted social measures to alleviate poverty. Algeria expects to negotiate debt relief from the donor countries, and further loans from other multinational institutions. Servicing $26 billion in foreign debt currently takes about 70 percent of the country’s income from oil and gas.

Improving Mass Transport in Kazakhstan

On April 11 the World Bank approved a loan of $40 million to Kazakhstan to support the country’s urban transport program in the major cities. (The loan is for seventeen years, including a five-year grace period, with a variable interest rate, currently 7.27 percent.)

Standby Credit to Bulgaria...

On April 11 the IMF approved a $97 million twelve-month standby credit and a $162 million systemic transformation facility (STF) loan to support Bulgaria’s economic program for 1994. If the economic restructuring continues, the IMF will consider a further $162 million as a next STF drawing.

... and STF Loan to Lithuania

The IMF also approved Lithuania’s request for a second STF loan of $36 million. (An equal sum was provided in October 1993 as a first STF loan, along with a seventeen-month standby credit.) Lithuania’s 1994 program foresees GDP growth of 4 to 5 percent, single digit inflation by the end of 1994, and a current account deficit of $330 million. The budget deficit will be kept at less than 1 percent of GDP, in part by adopting an 18 percent value added tax, effective May 1, 1994. The newly set up (April 1) currency board is expected to help fight inflation and bring about lower interest rates.

World Bank Loan for Power Generation in Jiangsu...

The World Bank has approved a $350 million loan to help China combat acute power shortages in Jiangsu Province, one of the country’s fastest-growing economic regions. The project includes building a coal-fired thermal power plant at Yangzhou, setting up transmission lines, training in financial and management capacity, and implementing environmental programs. Besides providing the $350 million loan, the Bank will also partly guarantee repayment to the Jiangsu Provincial Electric Power Company of a $120 million commercial bank loan for the project.

... Gas Development in Sichuan...

With help from a $255 million World Bank loan approved March 17, China will spend almost $1 billion to develop new gas fields, rehabilitate old wells, and improve gas transmission in the southwestern province of Sichuan. Per

Conspicuous spending

Look, we already have our own beggar...

From the Hungarian magazine Hazitok
capita income in China's most populous province (110 million people) is only half the national average, partly because of an acute energy shortage. The project will finance 100 new wells, gas-gathering and -processing facilities, and seismic exploration. Under the plan, output will also be boosted in almost 200 rehabilitated wells, leading to a total yield, with the output of 100 new wells, of an additional 68 billion cubic meters of gas between 1995 and 2015.

...Water Treatment in Shanghai...

The World Bank approved on March 8 a $160 million loan to help fund a $457 million water treatment program for Shanghai, which with its 14 million residents is the world's fifth-largest city, and one of the most densely populated. The project, which will clean up the area's water supply and environment and ensure safe drinking water for 10 million people, will also receive funding from the city.

...Agriculture on the Songliao Plain...

A wide-ranging plan to boost agricultural production and small-farm incomes on China's Songliao Plain is being supported by an IDA credit of $205 million, approved February 24. The funds will help reclaim wastelands for farm use, establish aquaculture programs, provide new machinery, and improve irrigation and drainage systems. The program is expected to generate almost $200 million in added annual revenue for forty counties on the plain, some of which are among the poorest communities in China. Most of the 2.5 million farm families in the project area now make about $140 a year.

...and Dam Construction on the Yellow River

A World Bank loan to China of $460 million, approved April 14, will help finance the centerpiece of the country's $2.3 billion dam construction plan: a 154-meter-high rockfill dam at Xiaolangdi to control flooding on the lower reaches of the Yellow River and protect more than 100 million people living there. And to improve the livelihoods of 181,000 people who will have to move because of the project, a separate $110 million credit from the IDA will fund part of a half-billion dollar resettlement program. A power station in the dam will eventually generate almost 5,400 gigawatts an hour.

IDA Credits to Laos

Laos will provide new roads, expanded water systems, and better planning in Luang Namtha Province with the help of a $9.67 million credit approved March 15 by the IDA. Laos will improve its only highway linking the agricultural south with the central and northern parts of the country using another IDA credit of $30 million, approved on April 14. The World Bank's forestry loan of $8.7 million will support a $20.3 million project aimed at better managing and exploiting the rapidly disappearing forests of Laos.

$1.1 Billion to Ethiopia

Member nations of the Consultative Group for Ethiopia, at a meeting in Paris on March 7 and 8 chaired by the World Bank, pledged $1.1 billion over the next two years to support Ethiopia's reform program. About $350 million of the commitments will go to balance of payments support; the rest will finance projects in private sector development, health, and education. Ethiopian Finance Minister Alemayehu Daba said that inflation has dropped from 26 percent to less than 10 percent. The country has weathered a currency devaluation of 142 percent without great social strife. Its gross domestic product increased by 7.6 percent during 1993, which Daba attributed to the unleashing of private sector forces.

Ethiopian Gas Project to Save Forests

With a $74.3 million credit from the IDA, Ethiopia will tap into rich natural gas and liquid petroleum reserves near the country's border with Somalia. Residents will be able to draw from the project's community development fund, which will finance local "micro-projects" to spread direct benefits from the project to people living in the area.

Cambodia Gets $773 Million

Thirty donor nations and twelve international bodies, including the World Bank, participated at the second meeting of the International Committee on the Reconstruction of Cambodia. They pledged a total of $773 million in emergency aid. Of the total, $486 million was earmarked for 1994, $271 million for 1995, and an additional $15.77 million was set aside for land mine clearance. The next meeting will be held in Paris in 1995.

Mozambique Tackles Bank Reform

In Mozambique a new project, partly funded by a credit of $9 million from the IDA, will accelerate the process of developing better banks by providing better training for the men and women who run them. Under the program, managers, supervisors, and accountants will learn modern banking practices and how to play their vital role as the country capitalizes on long-awaited peace and elections. Mozambique is the poorest country in the world in terms of per capita income.

...and Rehabilitates Roads and Coastal Shipping

The IDA approved a $188 million loan on April 11 to Mozambique's Second Roads and Coastal Shipping Project. Total cost of the loan is $814.6 million; the Government of Mozambique is allotting $169 million and the rest is coming from donor nations and international institutions. The project includes emergency rehabilitation and maintenance of about 11,700 kilometers of mainly unpaved roads and a road sign program in all ten provinces.
Conference Diary

Forthcoming

Russia-USA: Prospects for Cooperation and Investment in Banking and Financial Markets
May 5-6, The Grand Hyatt, New York
May 9-10, Fontainebleau Hilton, Miami Beach, Florida

The conference is sponsored by the Russian Bankers Association, the Russian Agency of Banking Information, and Global Management & Technology Inc.

The occasion will provide American bankers and financial management specialists with a unique opportunity to meet with senior executives of more than forty major Russian commercial banks, representatives of the Central Bank of Russia and the Russian Bankers Association, and U.S. and Russian government officials directly responsible for formulating policies having a direct influence on U.S.-Russian relationships in the fields of banking and finance, and to establish contacts with potential partners in Russia that could become candidates for American banking and finance activities in the Russian Federation.

Conference topics include the current situation in the Russian economy and prospects for further reform, relevant central bank policies and regulations, a look at Russia's banking system, the current picture in Russia's financial markets, direct foreign investment in Russia, opportunities for higher-yielding investment of Russian funds in the United States, expansion of correspondent relationships and other forms of cooperation between American and Russian banks, opportunities for U.S. financial institutions in the Russian markets, regulations and legislation related to banking and financial activities, and the realities of doing business in Russia for U.S. banks and financial companies.

Key speakers include: Mr. Boris Fedorov, former Minister of Finance in the Russian Federation Government, and one of the leading architects of the reform process in Russia; and Mr. Alexander Khandruev, Deputy Chairman, Central Bank of Russia.


Third Biennial World Countertrade Conference
May 8-11, Philadelphia, Pennsylvania

The conference, which is presented by the World Countertrade organizations with sponsorship from the American Countertrade Association, will cover current thought-provoking issues in today's world economy.

Speakers will address the following topics: East European Markets as Seen by International Trading Houses; Current Countertrade Situations in Russia and the Other NIS; How to Use Turkey and Iran to Work with NIS Asian Republics; The Italian, South African, French, United States, Canadian, and Australian Governmental Approach to Countertrade; The Countertrade Potential in Viet Nam; The Use of Countertrade as an Effective Sales Tool in PRC and Southeast Asia; The Effect of NAFTA. The kickoff speaker will be Jan Dauman, president of Intermatrix.

Information: Mission Secretariat, "Technology on the Volga," P.O. Box 1178, Central Islip, New York 11722, tel. (516) 582-9102, fax (516) 582-2159.

The Socio-Economic Impact of the Transition
May 19-21, Prague

The CERGE-EI conference is cosponsored by the Ford Foundation and the European Community and has important bearing on public policy. A number of economists from the government as well as the private sector will attend. The conference will begin Thursday evening with a reception for participants and members of the CERGE-EI Advisory Board. This will provide an
This conference, organized under the auspices of the European Association for Comparative Economic Studies at the Technical University of Freiberg (Bergakademi), will call for papers that concentrate on the emergence of market rules; market culture and market performance; the history of markets, and the rise and fall of markets in capitalist and postsocialist, as well as in developing, economies. Proposals are also welcome on the following topics: spot markets and hierarchies, economic and social prerequisites for satisfactory market performance, the integration of markets into international markets, the role of the financial system, the implementation of the rules and culture of markets, and the route from informal to formal markets.

Information: Horst Brezinski or Michael Fritsch, Technical University of Freiberg (Bergakademi), Faculty of Economics and Business Administration, Gustav-Zeuner Strasse 8-10, D-09596, Freiberg, Germany, tel. (+49) 3731-51-20-32 or 3731-24-38, fax (+49) 3731-51-27-33.
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The PRDTE unit of the World Bank regrets that it is unable to supply the publications listed.

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William Easterly, Martha de Melo, and Gur Ofer, Services as a Major Source of Growth in Russia and Other Former Soviet States, Policy Research WP no. 1292, 1994, 64 p.
To order: Mr. Chris Rollison, PRDTE, Rm N11-029, tel. (202) 478-4768.

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In Russian cities—given their lack of price signals and economic incentives to recycle land sites over time—the administrative-command process has led to a startling pattern of land use:

- Population density rises as one leaves the city center. (In cities with land markets, the reverse is true; but in Moscow, for example, 17 kilometers outside the city center, the population is as dense as in the heart of Paris.)
- Jobs are highly centralized, as was the pattern in nineteenth century cities. (In contrast, modern metropolitan areas with land markets have multiple, suburban employment centers.)
- Clear and tradable property rights.
- Efficient market-oriented information systems.
- A taxation system consistent with efficient land use.
- Publicized and contestable urban planning decisions.

Two critical issues for the transition cities must be considered:
- How to release land from state control and have it allocated on a competitive basis among prospective efficient users.
- Which institutions and processes will sustain sound urban land markets.


Karen Brooks and Zvi Lerman, Land Reform and Farm Restructuring in Russia, DP no. 233, 1994, 89 p.

Observations from the study:
- The agricultural sector is still predominantly collective. In 1993, 90 percent of the arable land was still in the collective sector. Of the 10 percent in private hands, less than half was titled as private family farms, with an average size of 43 hectares per family; the rest was small private plots owned by workers otherwise employed in the nonagricultural sector or in collective farms, with an average size of 0.28 hectares.
- New collective enterprises look and behave much like their predecessors, the state and collective farms.
- Entrants into private farming need machinery and small loans. Lack of access to machinery services and capital are reported as the main factors keeping producers in collectives.
- Financial pressure on the collective sector [cut of state subsidies; workers leaving the collectives and taking land shares with them] is likely to accelerate...
the shift to private farming and the transformation of remaining collectives into associations of private farmers.

Private farming is not likely to cause productivity to fall. Even if it did, gains from greater growth and faster adjustment out of loss-making activities would compensate for lost economies of scale.


A U.S. move to end preferential (most-favored-nation, or MFN) trade status for China could result in a dislocation of trade flows that "would range from the dramatic to the disastrous, with the associated costs being high for both parties." Tariffs on Chinese-made clothing, for example, would increase three times and on toys, five times. Chinese exports to the United States could be cut by 42 to 96 percent, depending on how readily these exports can be substituted by others. [In 1992 China had a $15.4 billion surplus in its trade with the United States.] U.S. consumers would pay about $14 billion a year more for costlier sub-
stitutes or for the continued supply of Chinese goods at higher tariff rates. China could further liberalize its trade by cutting tariffs, replacing import quotas and licenses with simpler taxes, and removing remaining export controls. [The United States is reviewing China's MFN status on a yearly basis. The next such review is slated for June 1994.]

IMF Publications


Since 1986, Laos has successfully implemented its New Economic Mechanism (NEM). Public enterprises are now able to determine their own production levels, output mix, investment, employment, and wages. Under the new system agricultural procurement prices were freed; farmers began to receive payments in cash for their produce; and the state monopoly over the procurement and distribution of rice ended. Retail prices, except for certain public utilities and domestic air transport, were decontrolled. The private sector was allowed to participate in the production and distribution of most goods and services. A decree was issued to establish the autonomy of private firms and to enable the retention of after-tax profits. The multiple official exchange rates have been unified at a level close to the parallel market rate.

Some of the remaining obstacles to a sustainable growth path:

- Poverty is widespread in rural and remote areas.
- Production base and export base are relatively narrow (export earnings depend mainly on agriculture, timber and wood products and recently, garments).
- Inadequate resource mobilization requires sustained foreign assistance.
- Lack of skilled manpower and well-developed macroeconomic institutions limit absorptive capacity.


CEPR Publications


When selling large state firms to competing foreign companies, government is required to make certain choices: Which is the most appropriate company? How much ownership in the firm should go with the control right? A government's objective is both to maximize sales revenue and to improve efficiency (future value) of the privatized firm. A foreign company, on the other hand, may be interested only in the private benefit of control, which allows early entry to the East European market. (For example, recently several Western car manufacturers acquired majority stakes in East European companies. However, companies may not believe that the acquired factories per se have great potential value.)

But a foreign company might also strive for genuine efficiency improvement, seeking good opportunities to expand and make investments in view of future profits. An efficient foreign company would want to obtain as many shares as possible, since such shares will have a high value, while a firm interested mainly in the private benefit of control would not value owning shares in excess of the minimum.

Governments throughout Eastern Europe have not been successful so far in dealing with loss-making state-owned enterprises. The author argues that in Eastern Europe, past and current losses may have been due to distorted incentives rather than to bad management or outright insolvency. Furthermore, the court system has limited capacity, and it is nearly impossible to remove liquidation bias from the bankruptcy code. Therefore, a laissez-faire alternative—a wholesale application of the bankruptcy proceedings—is not justified.

Instead, major nongovernment creditors of state-owned enterprises, that is, commercial banks, can take the lead in initiating restructuring and the design of a new, viable capital structure. A standard reply to a call for commercial bank involvement in enterprise restructuring, in a manner similar to Western investment bank’s involvement in periods prior to bankruptcy, is that East European banks do not possess the necessary skills. But the issue is: Is there anyone else who is better?

Given the dismal record of government involvement in large-scale enterprises under communism, and long-standing problems of regulatory capture in the West, the government itself is not a good candidate. Successful restructuring should be part of a privatization exercise; the more influence goes to future owners, and the less influence to past owners, the better the odds that the restructuring exercise will not need to be repeated. Assigning such an important role to commercial banks makes financial sector reform commensurately more urgent. If either enterprise reform or bank reform is to have any chance of success, they had better be undertaken jointly. A decentralized, nongovernment approach to dealing with loss-making state-owned enterprises has a chance of success.


The *Economics of New Currencies* [Report of a conference organized by the CEPR and hosted by the Landeszentralbank in Hessen, Frankfurt am Main, June 28-29, 1993], November 1993, London, 226 p.


The economic transformation of Hungary has reached a critical stage. This volume presents some of the local arguments and perceptions that are informing the current debate, along with critical examination of these ideas by an international panel of scholars. Chapters address the privatization program; the reform of financial, tax, and legal systems; integration into the international financial and monetary systems; labor markets, unemployment, and the social safety net; and the political economy of the current economic transformation.

To order: CEPR Discussion Papers, 25-28 Old Burlington Street, London W1X 1LB, tel. (4471) 734-9110.

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To order: Institute for EastWest Studies, 360 Lexington Avenue, New York, NY 10017, tel. (212) 557-2570, fax (212) 949-8043.


To order: Indiana University Press, 601 North Morton Street, Bloomington, IN 47404-3937, tel. (800) 842-6796.


To order: Russian Far East Update, P.O. Box 22126, Seattle, WA 98122, tel. (206) 447-2668, fax (206) 628-0979.

yield positive results and thus to become self-sustaining.

The conclusions of this study, coauthored by editor John Williamson and political scientist Stephan Haggard, also reject widely held views on the politics of reform. It is not true that reform can be achieved only by authoritarian regimes; even newly established democracies (Spain and Poland) have succeeded. Nor is it true that reforms have typically been introduced by conservative governments—most of the successful reforms were engineered by left-of-center or centrist governments.


† † † † †

Newsletters

Business Update, a news source on Russia, Hungary, Poland, and Czech-Slovakia, published by Broadfax, S.A., Geneva, Switzerland.

To order: Christopher H. Lake, Vice President & CFO, Dean & Lake Consulting, Inc., Atlanta, GA, tel. (800) 308-1245, fax (800) 308-1246.

East/West Executive Guide, a monthly legal and strategic guide covering East/Central Europe, Russia, and the Commonwealth Republics.

To order: World Trade Executive, Inc., P.O. Box 761, Concord, MA 01742, tel. (508) 287-0301, fax (508) 287-0302.

Economic and Legal Information from Poland, a newsletter published by the Embassy of the Republic of Poland, Commercial Counsellor’s Office, providing economic, trade, and legal information to those interested in doing business in Poland.

To order: Embassy of the Republic of Poland, Commercial Counsellor’s Office, 820 Second Avenue, 17th Floor, New York, NY 10017, tel. (212) 370-5300, fax (212) 818-9623.


Public Administration and Development, an international journal of training, research, and practice, edited by P. Collins and published by RIPA International Limited.

To order: Sarah Stevens, John Wiley & Sons, Ltd., Baffins Lane, Chichester, West Sussex, PO19 1UD, United Kingdom, tel. (071) 580-7138, fax (071) 580-7140.


To order: Martin Holub, ARA-Praha/New York, 116 West 72nd Street, 16E, New York, NY 10023, tel. (212) 787-7644, fax (212) 787-3146.

Corrections:


On page 8, of the same issue, the location of Brandeis University is in Waltham, Massachusetts.
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To order: Wendy Steavenson or Max Jonson, New York, tel. (212) 388-1500, fax (212) 254-3386.


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