Development Based on Participation—A Strategy for Transforming Societies

by Joseph E. Stiglitz

Many development strategies have focused narrowly on economics. But this focus on economics has led to a confusion of means with ends: higher GDP is not an end in itself but a means to improved living standards and a better society, one with less poverty, better health, and improved education. Furthermore, past strategies have confused cause with effect: to some extent, the changes in society that may be called modernization are as much a cause of the increases in GDP as a result. Development itself is a transformation of society, a societywide shift to new ways of thinking that cannot be accomplished through enclave-based growth in a dualistic economy.

Lessons of History

Past strategies failed to give sufficient prominence to this transformative role of society. The development models popular in the 1960s saw development as simply solving a complicated dynamic problem, which would improve the efficiency of the allocation of resources, and lead to accumulation of capital (either through transfers from abroad or through higher savings rates at home). Less-developed countries were portrayed as identical to more-developed countries, except for this lack of capital and possibly certain inefficiencies in resource allocation.

The same fallacy pervaded the philosophies of the 1970s and 1980s. The central role that government played in planning and programming was seen as part of the problem of development rather than as part of the solution. This perspective held that governments claimed too large a role for themselves, one for which they were intrinsically unsuited. The solution, then, was to rely heavily on markets and, in particular, elimination of government-imposed distortions associated with protectionism, government subsidies, and government ownership. In the 1980s, the focus shifted to macroeconomic problems, to "adjustment" of fiscal imbalances and misguided monetary policies. Given the macroeconomic imbalances, it was impossible for markets to function properly.

All three of these development strategies saw development as a technical problem requiring technical solutions—better planning algorithms, better trade and pricing policies, better macroeconomic frameworks. They did not reach deep
down into society, nor were they based on a belief that a participatory approach was necessary. The laws of economics were universal: demand and supply curves and the fundamental theorems of welfare economics applied as well to Africa and Asia as they did to Europe and North America. Time and space, in the view of these strategies, did not bind these scientific laws; therefore the technical approach was the appropriate one.

As remarkable as the narrow focus of these approaches was their lack of historic context. They failed to recognize that:

- Successful development efforts in the United States as well as many other countries had involved an active role for government.
- Many societies in the decades before active government involvement—or interference, as these doctrines would put it—failed to develop. Indeed, development was the exception around the world, not the rule.
- Worse still, capitalist economies before the era of greater government involvement were characterized not only by high levels of economic instability, but also by widespread social and economic problems. Large groups, such as the aged and the unskilled, were often left out of any progress, and left destitute in the economic crashes that occurred with such regularity.

Defining Events

Three events of the past quarter-century are beginning to shape views on development strategies:

First, the collapse of the Soviet-style socialist economies and the end of the Cold War. Some have focused on a single lesson that emerges—the inefficacy (and dangers) of a large government role in the economy. From this, some jump to the opposite conclusion: that reliance should be placed wholly on markets.

But there are two broader implications of the end of the Cold War: the ideological debates should be over, and there should be agreement that while markets are at the center of the economy, governments must play an important role. The issue is one of balance, and where that balance is may depend on the specific characteristics of the country, the capacity of its government, and the institutional development of its markets.

Second, many countries that followed the dictums of liberalization, stabilization, and privatization but still did not grow. The technical solutions were evidently not enough. An economy needs an institutional infrastructure. While the banks in East Asia lacked adequate supervision, the banks in Russia not only lacked that supervision, they did not even perform their core function of providing capital to new and growing enterprises. Russia turned ordinary economic laws on their head, managing to reverse the usual tradeoffs between equity and efficiency. Moving from inefficient central planning to decentralized market mechanisms, shifting from inefficient state ownership to private property, introducing the profit motive, and similar reforms should have increased output, though perhaps at the price of a slight increase in inequality.

Instead, Russia achieved a huge increase in inequality, at the same time that it managed to shrink the economy, by up to a third according to some estimates. Living standards collapsed with GDP levels, as life spans became shorter and health worsened. All too late, it was recognized that without the right institutional infrastructure, the profit motive—combined with full capital market liberalization—could fail to provide incentives for wealth creation and could instead spark a drive to strip assets and ship wealth abroad.

Third, the rapid growth of the countries of East Asia, which showed that a reduction of poverty, widespread improvements in living standards, and even a process of democratization could accompany successful development. East Asian governments failed to follow many of the dictums of the usual consensus early in their development. Rather than giving the economy over to an untrammeled private sector, for example, governments started some highly productive steel mills, and, more generally they pursued industrial policies to promote particular sectors.
Governments intervened in trade, though more to promote exports than to inhibit particular imports. And they regulated financial markets, engaging in mild financial restraint, lowering interest rates, and increasing the profitability of banks and firms. They put heavy emphasis on education and technology, to close the knowledge gap between them and the more advanced countries. While the impact of individual policies remains a subject of dispute, the mix of policies clearly worked well.

Indeed, the present crisis notwithstanding, it is clear that East Asian countries have succeeded in transforming their societies over a span of several decades. Even with a few years of zero or even negative growth, their per capita GDPs at the turn of the century will be a multiple of what it was a half-century ago, and far higher than those of countries that have pursued alternative development strategies. Moreover, poverty rates will be a fraction of what they were a half-century ago, literacy will remain nearly universal, and health standards will continue to be high.

**Keys to Success**

These defining events have led to a recognition that the old technical solutions are sorely lacking. Policies that are imposed from outside may be grudgingly accepted on a superficial basis, but will rarely be implemented as intended. Development cannot be just a matter of negotiations between a donor and the government. Excessive conditionality of foreign donors reinforces traditional hierarchical relationships, rather than involving large segments of society in a discussion of change—and thereby catalyzing change in ways of thinking. Development must involve and support groups in civil society; these groups are part of the social capital that needs to be strengthened, and they give voice to often-excluded members of society, facilitating their participation. Our research shows that development projects with higher levels of participation are in fact more successful, probably in part because those projects make fewer erroneous assumptions about the needs and capabilities of beneficiaries.

Given limits on resources—including the administrative capacities of the Bank and of developing countries—we need to identify areas where the government's limited actions can have large-scale effects, and areas where lack of action can have disastrous effects. Although the priorities will differ from country to country, there are some common elements:

- **Education** is at the core of development. Without it, a country cannot attract and build modern industries, and cannot adopt new growing technologies as rapidly in the rural sector. But most fundamentally, if development represents the transformation of society, education is what enables people to learn to accept, and to help engender, this transformation.

- **Infrastructure**—particularly communications and transportation—is vital for the conduct of business in the modern world. Much of the infrastructure can be supplied privately, provided that the government establishes the appropriate legal and regulatory environment. Doing so must be given high priority.

- **Health** is also vital: an unhealthy population cannot be a productive labor force. A basic standard of health should be viewed as a fundamental human right.

- **Knowledge** enriches the human spirit, and, like education and health, leads to a more productive society.

- **Openness** to the outside world—especially through foreign direct investment and trade—brings with it the new knowledge about production technologies and effective institutions that is vital to the development transformation. Note, however, that openness to short-term capital brings with it no such ancillary benefits, but does carry considerable risk—as the Asian crisis countries have discovered.

- **Capacity-building**—in the end, a successful transformation must come from within the country itself. To accomplish this, the country must have institutions and leadership to catalyze, absorb, and manage the process of change, and to manage the changed society.

Many of these elements have begun already to take shape. Within the World Bank and the development community more broadly, there has been increasing attention in recent decades to issues of health and education, and a move beyond measures of GDP to look at life spans and literacy rates. We have recognized the importance of economic security, and stressed the creation of safety nets.

There has been a growing consensus on the objective of democratic, equitable, and sustainable development. Here, I have tried to argue that the whole is greater than the sum of these parts, and that successful development must focus on the whole—the transformation of society.

Deflation: A New Challenge for China’s Policymakers
by Chi Fulin

Through its effective anti-inflation policy, China has staged a successful economic soft landing and thus was relatively well protected from the Asian financial crisis. However, beginning in the second half of 1997, several signs of an economic decline became apparent, such as the steady drop of commodity prices, sliding consumption, a decline in investment, and a rising unemployment rate. The writing is on the wall; China, stepping out of the shadow of inflation, is confronted with the problem of deflation.

Deflationary Dangers Ahead

Deflation is usually marked by two important features: a steady drop of commodity prices and a decline of monetary supply. Although commodity prices have fallen steadily in China, the GDP increased by 7 percent in 1997, and there was no drop in the money supply. However, certain signs of deflation do exist in China’s economy: commodity prices have fallen steadily for 11 months and the volume of national consumption has decreased; enterprises are running at 60 percent of their full capacity; enterprise stocks reached 3,000 billion renminbi, representing 40 percent of GDP. The supply of major products exceeds demand, and the average supply-demand ratio has deteriorated to about 90 percent. All these suggest that China has to face a new situation—economic deflation. Besides the already mentioned economic slowdown, and the negative impact of the Asian financial crisis on China’s export industries, the deflation has been intensified by the following factors:

- Monetary stimulus lacks a clear focus. The increase in money supply did not accelerate enough industrial restructuring; new investments, which were targeted to stimulate final demand, mostly increased redundant production capacities.
- Essential macroeconomic policy measures have been delayed too long. If investment had been stimulated properly or encouraged a year earlier, deflation probably could have been avoided.
- The economic performance of state-owned enterprises is too poor to produce adequate tax revenue for the state or increased paychecks for employees; in other words, both state and consumer purchasing power is cramped.
- Farmers are unable to achieve meaningful gains in their income through more intensive agricultural production because of drastic increases in production costs (machinery, fertilizers, and so on).
- Reforms in housing, health care, education, and pension systems have persuaded Chinese consumers to save more. It has also slowed consumption.

How to Overcome Deflation?

Deflationary tendencies are still intensifying in China, discouraging enterprises from expanding production and investment, and risking a deterioration in unemployment and interruption of market-oriented activities. Therefore, the fight against deflation has become the focus of current macroeconomic policies. To maintain an economic growth rate of 8 percent, and compensate for decline in exports and for relatively low domestic consumption, the government has decided to introduce measures to stimulate investment, primarily through its own program to spend more on infrastructure development.

The government’s extra spending is being financed through issuing treasury bonds. It is an expedient way of raising money, although it has its limitations. In order to ease the burden on public finance, investment should be mobilized from the whole society. First and foremost, enterprises should be motivated to invest. The root of insufficient effective demand is that enterprises are not interested in expanding their capacities. If this trend continues, economic decline is almost unavoidable.

At present, the investment and finance systems in China are no longer favorable either to large, nonstate enterprises, or to small and medium-size enterprises, forces that in recent years spearheaded economic growth. As recently as the first quarter of 1998, China’s industry is estimated to have grown by 8.2 percent, with 25 percent of the growth produced by the state sector and 75 percent attributable to nonstate enterprises. The nonstate sector is faced with an increasingly constricted channel for raising funds, as banking becomes more and more regulated. Due to the costs and risks of providing loans, banks tend to form closer relationships with large, state-owned enterprises, and with key sectors and regions. At the same time, opportunities for the nonstate sector, as well as the small and medium-size enterprises, to raise funds by issuing stocks and bonds in the capital market are slim. Such obstacles to acquiring financing are a key factor hampering investment and hence development of the nonstate sector and small and medium-size enterprises.

The current investment environment poses additional problems for the fight against deflation. For instance, there are few investment projects with good economic prospects; loss-making enterprises suffer further blows because of the steady fall in commodity prices; small and medium-size enterprises are subject to heavy taxation and collection of nonbudgetary fees. In the process of stimulating demand to pull up the economy, attention should be given not
only to the government’s purchase demands, but also to fostering investment in enterprises, especially in the nonstate economy. Several obstacles impede the expansion of rural demand:

- Farmers have low levels of income and consumption.
- Rural infrastructure is expensive and inefficient (for example, the electricity tariff is extremely high). This limits farmers’ demand for consumer durables.
- Capital goods are expensive and of inferior quality.
- Many township enterprises do not operate efficiently, which reduces the income of farmers.
- Governments at various levels indulge in unreasonable fee collections and put a heavy burden on farmers.

**Proposed Measures**

In a global environment where network economy and knowledge economy are developing by leaps and bounds, investment opportunities have become scarce in a host of traditional industries. Investment policies should target opening up the infrastructure sector so as to gradually enlarge the scope of stockholding enterprises. Providing the right incentives will help avoid earlier miscalculations in which several state-owned enterprises, in a blind pursuit of rapid development, imprudently created parallel capacities, regardless of market demand.

Reasonable investment and fund-raising systems should be established through reforms. For instance, interest rates should be differentiated, depending on the borrower’s financial standing, replacing the present single rate system. Special arrangements can be made to facilitate lending to the nonstate sector as well as to small and medium-size state-owned enterprises. The government’s role as regulator should be separated from its role as owner. This way, the market can allocate resources better, alleviating the burden on public finance.

Reconstruction of small and medium-size cities should be the focus of investment for the 1999. The migration project along the Three Gorges and rehabilitation of the flooded areas along the Yangtze River present time-sensitive opportunities and challenges for investment. Demand—and consumption—by the huge rural population should be further expanded, through development of local infrastructure and reform of the investment and financing regime. Construction in small townships should be accelerated. The nonstate sector should be encouraged to invest in the high technology and information industries.

Without the growth of consumption, investment can never cycle on its own. If consumption is to get a boost, a priority must be housing reform. People badly need housing, yet some residential buildings lie idle in the market. And though the government has issued a series of reform packages, some of these have produced little effect. Clearly, a mortgage credit system needs to be implemented. Moreover, consumption credit for consumer durables should be initiated. Credit for the purchase of cars should be provided to support development of the auto industry as a new economic growth point.

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**The “D” Word: It Can Be Both Good and Bad**

Deflation is the opposite of inflation: prices in goods and services rise under inflation, and decline under deflation. Too many goods are chasing too little money. As prices decline, many companies—producing goods and services—find their profits squeezed to the point where they cut wages and, eventually, workers. Falling prices also mean that borrowers must repay their debt with money worth more than at the time of borrowing. These and other factors can accelerate the decline in prices, and the downward spiral can lead eventually to a major depression.

There is good deflation and bad deflation, however. In U.S. economic history, “bad” deflation characterized the 1930s: mass destruction of purchasing power, wage cuts, failures. The basic problem was that supply exceeded demand. But the United States also experienced good deflation from the end of the Civil War to the end of the 19th century. The railroads opened new markets and spurred the industrial revolution. Cottage industries gave way to mass production. The result was massive growth. Wholesale prices declined by 46 percent. Most wages fell a bit during the period but prices fell faster than wages. The standard of living improved.

Economists relate current deflationary trends not just to the global effects of the East Asian crisis—characterized by overinvestment, overcapacity, and falling prices. Japan has basically been at zero inflation for some time now. New issues of treasury bonds are carrying negative interest rates. Other factors that strengthen deflationary trends include declining military expenditures, following the end of the Cold War, and governments’ efforts to cut deficit spending. In addition, the continuing enterprise restructuring, improvements on the technological front, and revolutionary innovations in retail trade (including car sales) have all contributed to drastic cuts in costs and prices.
China's Development Zones—Learning From Their Success
by Michael Ellman

An interesting example of a successful local state entrepreneurship is provided by the Kunshan Economic and Technical Development Zone, established in 1985 in Jiangsu province, about 50 kilometers (30 miles) inland from Shanghai. (Kunshan is now administratively a city, with about half a million inhabitants.) By November 1998 the zone had attracted about $4 billion in foreign direct investment from 420 companies, mainly wholly owned subsidiaries of overseas companies. These subsidiaries and joint ventures with foreign firms have provided 30,000 jobs, more than half of the 58,000 total. The zone's exports are running at about $1.2 billion annually. It has become a major source of income for Kunshan, generating about half of the city's budget. What explains this success and does it have any lessons for Eastern Europe and the former Soviet Union?

### Explaining Factors

- **Easy access to the world market.** Shanghai is an international gateway that can be reached quickly by road, water, and rail transport.

- **An efficient, helpful “one stop” bureaucracy.** The Kunshan Zone competes with other special zones/industrial parks in China that are also trying to attract foreign investment. While Kunshan does not offer superior tax concessions, it does concentrate on providing good services. Although, like many such zones, it initially aimed to attract hi-tech industry, investment mainly supported the development of low-tech industry in the area. Nevertheless, local authorities accepted this, and made the best of what was on offer.

- **Low labor and other costs (for example, land).** European firms can hire production workers in the zone for $200 a month including social charges, which is perhaps 10–15 percent of labor costs in Western Europe. Furthermore, labor productivity is high (in modern, purpose-built factories, which produce relatively simple products, are managed by Western personnel, and run at full capacity) and does not appear to be noticeably lower than in Europe.

At the end of 1994, Chinese entrepreneurship was boosted by the following:

- Five national special economic zones.
- Fourteen coastal open cities, which included 260 special economic zones under the jurisdiction of cities and counties.
- Six open cities along the Yangtze River.
- Eighteen open cities that are inland provincial capitals.
- Thirty open cities along border regions.
- Thirty economic and technical development zones (currently there are 32 of these).
- Fourteen free trade zones.
- Thirteen frontier economic cooperation zones.
- Fifty-two new- and high-tech development zones.
- Eleven national tourist zones.

- **Readily available infrastructure.** In addition to its prime location, the Kunshan Zone provides land, water, sewerage, electricity, and other energy sources. Customs, banking, and telecommunications facilities are also available. The authorities are prepared to offer ready-made factories (purpose-built ones are also possible) and labor (although companies, if they wish, can recruit workers directly).

- **Stable labor relations.** Recently in two Kunshan Zone factories, young graduates, in one case, and production workers, in another, demanded higher wages from their foreign employers. In both cases the local party secretary intervened and warned the employees that there was no shortage of job applicants outside the factory gates. At the same time, he urged management to improve wages in due course. The situation calmed down, strikes were avoided in both enterprises, and after a while, wages were increased.

- **Chinese-style fiscal decentralization, which ensures that a substantial share of the income generated by development zones flows to the municipal authorities.** Although corruption is a serious problem in China, officials of the Kunshan Zone, operating within the framework of an official national policy of opening China's economy to the world market, and subject to party discipline, have devoted themselves to municipal (and as a result, regional and national) development.

### Relevant Lessons

Are there any relevant lessons from the Kunshan Zone development for Eastern Europe and the former Soviet Union to bear in mind? It is perhaps worthwhile to step back and recall the final years of the Soviet Union. At that time, obvious locations for similar economic zones would have been in the regions of Leningrad, Odessa, or Nakhodka. Although there was a lot of talk in the perestroika period...
about creating Kunshan-type zones, nothing much happened on the ground. What were the constraining factors?

- The Gorbachev leadership, impatient to see results, changed its economic policies frequently in response to disappointing outcomes of previous initiatives, without allowing for the necessary time lag between economic policy changes and results. In contrast, China's Kunshan Zone was set up in 1985, but its success became obvious more than 10 years later. This example of Chinese gradualism would not have appealed to the impatient perestroika leaders.

- Political instability in 1989–91 frightened off foreign investors.

- The lack of any attempt to create an efficient, friendly, one-stop bureaucracy interested in municipal, regional, and national development had a dampening effect. Officials at all levels in the Soviet Union used the freedom they gained during perestroika to further their personal interests.

- The inability of the municipalities in greater Leningrad, Odessa, and Nakhodka to create the requisite infrastructure for industrial parks. The Soviet Union failed to use effectively its significant assets to attract foreign direct investment—highly skilled labor (scientists, engineers, computer programmers), abundant natural resources, and a sizable home market. As long as the Soviet Union remained intact, its military programs and state security apparatus hindered Russian scientists' involvement in FDI projects. As for natural resources, the prospect of selling off the national heritage to foreigners and of creating competition for domestic producers proved politically untenable, while high infrastructure costs and low raw materials prices were further obstacles. And the domestic market, though it did attract some foreign direct investment, was mainly served by imports. Investors sought to avoid the risks involved in attempting production in the Soviet Union.

Two additional points have relevance for Eastern Europe and the former Soviet Union states:

- **Location is important.** The Kunshan Zone would be inconceivable in one of China's western provinces. Physical access to the world market, preferably by sea, is an enormous economic benefit. This suggests that areas along the Baltic sea, and to a lesser extent the Adriatic, might also have been able to create such zones. In addition, such areas as northwest Russia, western Poland, western Czech Republic, and western Hungary—which are near the eastern border of the European Union—might also have been able to support such an initiative. Although these regions, unlike China, did not have the advantage of very low labor and other costs, they did have the advantage of easy access to the very large EU market and to EU sources of supply. On the other hand, as the transformation process progresses and the entire national economy opens up to foreign investment, there is less need for special enclaves where only foreign direct investment is welcome. Such zones are likely to figure most strongly in the early stage of transformation.

- **Private land ownership is not important.** In Russia there has been a heated debate on private ownership of land. Kunshan's Development Zone shows that private land ownership is not necessary for successful economic development. Abundant foreign direct investment flows to China, despite the fact that all land belongs to the state and foreign firms cannot buy land, but must rent it or buy a lease (for up to 70 years).

**Under What Category?**

As far as economic policy is concerned, Kunshan Zone fits into none of the normal categories. There is no "planning," since the state does not dictate which firms come to the zone (they choose to come) nor what they produce when they get there. Development has not come in response to the "market," since the zone was initiated by local state authorities that had set up both the physical and the crucial administrative and bureaucratic infrastructure. There is no "industry policy" involved, since the zone was not an initiative of the central government and the state does not determine which firms or sectors benefit from it, nor what they produce. And it can't be called the product of "regional policy," as the zone's creation is not the result of central government efforts to stimulate development of a particular region. Rather, the zone is an example of a municipality using its natural advantages (location, cheap labor, and effective governance) to create a physical and administrative environment in which the market can flourish. The success of China's Kunshan Development Zone shows that local state entrepreneurship, can play an important positive role in economic development.

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How to Do Business—Chinese and Western Negotiation Cultures
by Theresia M. Tauber

Negotiation style is based on general assumptions, behavioral patterns, and norms of the negotiator’s culture. Chinese and various Western cultures developed their respective patterns and norms for very good reasons. Living conditions differed and so did the norms that were necessary to help the communities survive in those particular conditions.

Basic Differences: Roots in History

In Western cultures, with their Jewish, Christian, Greek, and Roman backgrounds, people developed norms based on laws, rules, and regulations that apply to the individual. They desired justice to be “blind,” for example, disinterested and impartial. In Eastern cultures, on the other hand, under the influences of Confucian, Daoist, and Buddhist thinking and tradition, people developed norms based on whatever was necessary to maintain good relations within their group (a village, in the old days; a business unit, later on). To them, justice should be not “blind” but open-eyed, with a clear understanding of the situation at hand—with all of its implications, its players and their relationships, and the consequences of the quarrel’s outcome for the whole group. This basic difference between “rules” and “relationships” leads to three more tendencies:

- Group thinking versus individualism.
- People focus versus task focus.
- Elaborate versus flat hierarchies.

Today these differences still lead to different assumptions and behaviors in business. Most basically, both sides want security for their transactions. Unfortunately, the ways of getting security and reassuring the other side of one’s goodwill are different due to the divergent roles that rules and relationships play. (Table 1 presents some tips for both sides.)

<table>
<thead>
<tr>
<th>Table 1. Take “rules” and “relationships” into account</th>
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<tbody>
<tr>
<td><strong>Advice to Chinese Negotiators</strong></td>
</tr>
<tr>
<td>Lay down the basic points of your mutual business in contract form early on. This will signal your serious interest. Have the points internally clarified because the Western side will be stunned by a later change.</td>
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<tr>
<td>If Westeners start with the most critical issues, this is probably a positive signal. They want to get the biggest problems out of the way early on to make sure there really is a common base and they are not wasting their time on a hopeless case.</td>
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<tr>
<td>If your partner mentions a legal requirement in his home country, there is not too much hope for a way around. Western laws don’t give much leeway.</td>
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<td>Westerners believe that a signed contract makes it easier to design new actions around that invariable fact. The idea of renegotiating a written agreement is appalling to them and creates deep mistrust.</td>
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Group Thinking versus Individualism

When Chinese and Western delegations meet, they will find their structures different. Westeners will be more willing to voice individual opinions, whereas Chinese will not openly contradict their group. (See table 2.)

Both cultures, it should be noted have, problems with efficient team work: Westeners, because individuals can act like “lone wolves”; Chinese, because the group thinking applies to long established in-groups and not to a delegation that recently and only for technical reasons has been put together.

People Focus versus Task Focus

To varying degrees, Westeners are more task- than people-focused, with Germans and Swiss being the extreme. In their eyes, small talk is superfluous.
Table 2. Take the role of individual and group into account

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<tr>
<th>Advice to Chinese Negotiators</th>
<th>Advice to Western Negotiators</th>
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<tbody>
<tr>
<td>If you want the other side to take seriously certain members of your team, arrange for enough speaking time for those members. Those who keep silent will be underestimated.</td>
<td>Stop at once any internal dispute in front of a customer or potential partner! Think in advance of little signs that any member of the team can make to indicate &quot;we need a time-out.&quot; And watch during the negotiations for those signs.</td>
</tr>
<tr>
<td>If you feel you get along better with a certain member of the other team, you may contact this person as a &quot;troubleshooter&quot; when necessary. This individual will then feel responsible to act as a mediator. (Without acting against core interests of his or her team!)</td>
<td>If you do feel particularly in sync with a certain member of the other team, however, don't show it openly. It would endanger that person's position in the team, and he or she might even be taken out of the delegation.</td>
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They think that arguments for agreeing to a deal must be based on rational facts. And they believe that what a customer wants most of a sales or service representative is expertise and promptness. People-focused persons use small talk as an important base for business. Mutual acquaintances, the giving of "face," and mutual dependence are more reliable to them than figures. They look for representatives with whom they can have a trusting relationship. They assume that all Westerners are technically capable of serving them, and it is more important to them to know whether and how someone is willing to do them that service.

While negotiating, the difference between task- and people-focused partners also shows in the way they deal with the concept of "face." (See table 3.)

| Elaborate versus flat hierarchies |

Typically, negotiators from each cultural background believe that the other approach will make decisionmaking processes much longer and results less reliable. The Westerner is frustrated because after each round, the next highest level on the Chinese side must also be convinced. The Chinese is frustrated because many equals on the Western side have to consent, a process that seems to take longer than the decision of a powerful boss. The fact is that both cultural systems have fast and slow phases in their decisionmaking process. Unfortunately, these phases occur at different stages, so the whole process takes much longer than when only one culture is involved. (See table 4.)

**Some Final Hints**

For the Chinese: The argument that "This is done (not-done) this way in China" should be used only when it is based on reality. More and more, Westerners have prepared their trip to China carefully and can tell when you have used this argument for tactical reasons. They will consequently mistrust you in all other things you say.

For Westerners: The argument that "This is internationally accepted practice" should be used only when it is based on reality. More and more, Chinese are extremely aware of international business procedures and see through your bluff.

For both sides: Reciprocity is generally well received, both in wording and in the

Table 3. Take the role of "facts" versus "face" into account

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<th>Advice to Chinese Negotiators</th>
<th>Advice to Western Negotiators</th>
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<tbody>
<tr>
<td>Take into consideration that loss of face is not so much feared by Westerners. Most often, they will not concede important points only to save face.</td>
<td>Do not unwittingly allow others to lose face. This hurts a Chinese more than you think and more than he or she shows. They will consequently hold you in very low esteem.</td>
</tr>
<tr>
<td>Expect Westerners to make you lose face without even knowing it, since they are not so familiar with that concept. Tell them that what they said or did is considered rude in your culture but add politely that you are sure they did it unintentionally. Westerners will be glad about your openness and gratefully accept this important piece of information.</td>
<td>Expect Chinese to purposely try to make you lose face, particularly when your business relationship is not yet sound. If you want to maintain the relationship, show that you understand the concept and insist that a certain thing your partner wants you to do is unacceptable because it would make you lose face in your company.</td>
</tr>
<tr>
<td>A Westerner who calls something you want to specify in a contract &quot;nonsense&quot; most probably does not intend to insult you but believes he is helping you avoid a mistake (Westerners do that among themselves, too.) Ignore this comment or point out that it is not good form in your culture.</td>
<td>If the other side wants something that is nonsense, in your opinion, but does not harm you, accept it. There is no need to hurt the other side. Just explain to your boss at home why the clause is in the contract.</td>
</tr>
</tbody>
</table>
handling of a contract. Around the turn of the last century, unequal treaties were forced upon the Chinese by Western imperialists. Ever since, reciprocal clauses have been important to Chinese negotiators and should be included whenever possible. When it comes to fulfilling the clauses of a contract, Westemers will only maintain their original interest in keeping their word if they experience that their Chinese partners do the same with their obligations.

To sum up; While both cultures-Eastern and Westem—are basically well adapted to the needs of their people, problems arise when the two sides meet. There are no general rules as to who should accept whose preferences. Each meeting will develop its own microculture. It is crucial to smooth this process if negotiations are to succeed. It is thus necessary to get to know the specifics of the other side in order to develop a strategy for successful talks.

### Table 4. Take the role of hierarchy into account

<table>
<thead>
<tr>
<th>Advice to Chinese Negotiators</th>
<th>Advice to Westem Negotiators</th>
</tr>
</thead>
<tbody>
<tr>
<td>You will meet fewer levels of hierarchy than you are used to. Whoever is sent by a Westem company to negotiate in China is normally fully authorized to make the necessary decisions, even if he or she is still young.</td>
<td>You will meet more levels of hierarchy than you are used to. Each one will expect a few concessions from you. Make sure to parcel them out so that everybody will be satisfied. The top leader will decide, but not against strong negative feelings from his or her subordinates.</td>
</tr>
<tr>
<td>In order to help your counterpart understand your position within your company, give him or her an organizational chart showing the structure of your business unit. Westemers get confused by too many important titles.</td>
<td>Expect impressive-sounding business cards (almost everybody is a director or vice director) and translate your own position description into a compatible version.</td>
</tr>
</tbody>
</table>

The author has built up the intercultural China and Asia training program at Siemens in Munich, Germany. (Email: ttw@t-online.de) She thanks Dr. Marec Bela Steffens (also at Siemens) for sharing with her his experience as a successful negotiator in China. See also his short guide to negotiating in China, forthcoming in the China Economic Review, January–February 1999.

## Voucher Privatization with Investment Funds: A Sure Way to Decapitalize Industry

by David Ellerman

There has been rough consensus among postsocialist reformers and their Westem advisers that voucher privatization was the quickest and most politically popular technique for achieving mass privatization. However, without intermediaries this method would spread ownership too wide and thus create a problem of "corporate governance." So the thinking goes that voucher privatization needs to be augmented by voucher investment funds to provide the corporate governance necessary for restructuring the privatized enterprises.

**Western Models**

In a developed market economy such as the United Kingdom or the United States, where economic institutions have had time to evolve, one finds two extremes, the mutual fund ("unit trust" in the UK) and the (venture capital) holding company, which have rather opposite institutional logics. Mutual funds hold a diversified portfolio of shares with only a small percentage from any given publicly traded company. The funds exercise no direct corporate governance over companies. They are the very model of the passive institutional owner that lives by the "Wall Street Rule" of voting with one's feet. Exit is preferred to voice. Holding companies operate in a diametrically opposite way. They hold all or almost all the shares in a portfolio company so that they will reap most of the capital gains from the development and restructuring of the company. They epitomize the active owner that exercises voice rather than exit.

The voucher investment funds have been envisioned by postsocialist reformers as a mixture of mutual funds and holding companies, a chimera with no direct counterpart in an evolved market economy. Western-style legislation restricting any mutual fund's share in a single company (for example, a 20 percent maximum) has been enacted in most voucher investment fund regulations as if the funds were mutual funds. But in
the next moment, the voucher funds are described as the vehicles for restructuring the voucherized enterprises as if the funds were holding companies.

Obstacles to Good Governance

There are substantive reasons why the voucher investment funds will have trouble functioning in the way mutual funds operate in the West. Most of the shares owned by the voucher funds have no real market. In the West only a small percentage of these companies qualify to be publicly traded and an even smaller percentage would qualify in the transition economies. Yet the voucher privatization programs have corporatized medium-size to large socialist enterprises of almost any quality, and have issued their shares in return for vouchers. The voucher funds thus have a portfolio full of shares that are essentially illiquid at any significant price ("junk shares").

But the funds probably will not operate as restructuring holding companies either. Unlike the typical holding company, which owns the majority of shares in its portfolio companies and thus stands to profit significantly from its investment in restructuring the companies, a voucher investment fund may own 20 percent, or at best 30 percent, of shares in a portfolio company. Thus, if the fund spent the time, effort, and financial resources to restructure the company, it would see 70 to 80 percent of the capital gains accrue to other, free-riding shareholders.

In light of the regulations restricting voucher fund stakeholding in companies, then, the funds have little economic motivation to undertake time-consuming and costly restructuring. Yet the incentive is even weaker than this restriction would suggest. A given fund may have thousands of individual shareholders (citizens who exchanged their voucher for a share in the fund), so control is in the hands of the fund management—typically a separate fund management company. The fund management company’s fee is usually set by regulation as a fixed percentage of the portfolio’s net asset value, rather than being linked to profits or increases in the value of the portfolio. If, for example, a fund owns 30 percent of a company, and the fund management company is entitled to a 3 percent fee, then a $100 increase in the value of the portfolio company increases the management company’s fee by a mere 90 cents, or 3 percent of the 30 percent.

As it has turned out in the Czech Republic and in Russia, fund management companies have found other, more lucrative ways to utilize their power without undertaking the difficult job of restructuring. One way is simply by collecting directors’ fees for sitting on the boards of scores of portfolio companies. Another prominent method of siphoning or tunneling value out of portfolio companies has been through special contracts and nontransparent side deals with firms related to the fund management companies. The profits made through these bypass firms are not shared with other owners of the portfolio company, not to mention the citizen-shareholders of the fund.

As these examples illustrate, problems of corporate governance abound. Since the individuals running the investment funds are not stakeholders but are employees of separate companies contracted to manage the funds, and since they will gain little from the increased profitability of funds, they lack the proper incentives to provide effective corporate governance, the very reason they were hired.

Investment funds find the trading of shares, transfer pricing, and nontransparent equity transactions far more lucrative than striving for profits and dividend payments through efficient governance. Indeed, profits and dividends have been an insignificant source of fund income so far. These arrangements not only reduce the incentive to restructure; they may provide a disincentive. Selling a controlling stake to a strategic investor would remove the board sinecures for the fund managers and their friends. And significant restructuring would probably involve exposing and eliminating the special side deals and bypass arrangements for the fund management company.

Investment and Disinvestment

Postsocialist enterprises typically require serious restructuring if they are to produce profitable products that people will want to buy at prices people are willing to pay. The hope that Western firms would become involved on a large scale and would provide funds and the necessary expertise has, in most postsocialist economies, not been realized. Rather, Western investors have preferred “greenfield” investment to the restructuring of existing companies. There have been a few exceptions, notably in Hungary. But most postsocialist firms have been unable to find Western strategic investors.

The alternative to direct strategic investment is portfolio investment. There has been some modest Western portfolio investment in Central European and Russian investment funds. The Polish mass privatization has tried to design funds to be managed by “Western experts” who would restructure the companies in their portfolio. But this approach has not met expectations because of the large number of firms in each portfolio, the distance of the fund from the day-to-day challenges of restructuring a company, and the typical lack of industrial expertise on the part of the fund managers. The investment funds tend to be managed by
Czech Economy: Downgraded Banks but Improved Outlook

On November 5, Standard & Poor’s (S&P) reduced the Czech Republic’s long-term local issuer credit rating from AA to AA-, the long-term foreign currency issuer credit rating from A to A, and the short-term foreign currency rating from A1 to A2. Despite the downgrade, the Czech Republic still enjoys the best rating among the Central European transition economies. The agency also lowered the ratings of the country’s three major banks—Komercni Banka, Ceska Sporitelna, and Ceskoslovenska Obchodni Banka. The banks’ downgrades followed their exposure in two areas:

- Domestic corporate borrowers, whose reliability is now weakening as industrial performance begins to show signs of deterioration.
- Negative external developments—events in Russia and potential problems in Slovakia, where the new government faces major difficulties as it begins to implement long-delayed economic reform.

Despite the recent deterioration of the financial state of Komercni Banka and Ceska Sporitelna, in particular, the government has been reluctant to confirm its original intention to provide support to the banks if it is needed.

The country’s downgrade came as a result of recent deterioration in the Czech economic and financial environment. The major problems, together with signs of improvement, are as follows:

- Insufficient efforts to reform the legal system, leading to low foreign investor confidence. But: The first lawsuits claiming mismanagement were recently filed against former managers of failed investment funds. This is a significant step toward showing foreign investors that the country is improving the quality of its legal process. The government is committed to designing an incentive package intended to attract higher levels of foreign direct investment. While the package has not yet been drafted, tax breaks and other incentives are already being granted to selected investors on a case-by-case basis. Improvements in the transparency of capital market operations and reform of the legal system are essential to reviving investor interest, but have long been delayed.
- Slow progress in the privatization of the banking sector, resulting in continued inefficient capital allocation, and insufficient restructuring of major enterprises, many of which are owned, through investment funds, by the state-owned banks. This leaves exports vulnerable to external developments, particularly a global economic slowdown. But: Finance Minister Ivo Svoboda recently emphasized the need to accelerate banking privatization. The government plans to begin the sale of Ceskoslovenska Obchodni Banka (CSOB), to be completed by mid-1999. Slovakia has large debts in this bank, but because of the change of government in Slovakia and improvements in bilateral relations, Prague now has a better chance for a settlement. Sell-off of Ceska Sporitelna would follow in mid-1999. The other state-owned bank, Komercni Banka, is also targeted for privatization by 2000. However, the poor state of the banks and the dire need for substantive restructuring could delay the sales. (The banks' bad loan portfolio equals 20 percent of the Czech GDP.) The government must decide whether to undertake this restructuring itself, incurring high costs but with the benefit that a higher price can then be secured, or sell the assets quickly at cheaper prices. The IFC and the EBRD are planning to invest several hundred million dollars to boost the Czech government’s banking privatization program. The IFC board has approved a potential $75 million equity investment alongside a strategic investor in CSOB, the country’s fourth biggest bank. The EBRD is also considering investing in CSOB, possibly even before full privatization; and it has already bought an 11.8 percent stake in another Czech bank. The IFC and the EBRD are focusing on the banks because they believe their long-delayed privatization will not only strengthen the banking sector before EU membership and help prevent an Asian-style bad debt spiral, but will also help restructuring of the industry.
- The government’s worsening budgetary position, the result of continued recession and the growing indebtedness of the public sector. Real GDP fell 1.7 percent year-on-year in the first half of 1998. But: The draft budget for 1999 assumes a deficit of 31 billion koruny ($1 billion)—its level should not exceed 2 percent of GDP. In October, consumer prices fell 0.2 percent month-on-month, putting year-on-year inflation at 8.2 percent. The foreign trade balance is also improving. In response, the Czech National Bank (CNB) in mid-November cut the two-week repurchase rate by 1 percent, to 11.5 percent, the third cut from a 15 percent level in January. Lower interest rates and the moderate budget deficit are expected to ease the current economic recession during the first half of 1999. Moreover, provided interest rates continue to fall, the interest rate differential between the koruna and hard currencies such as the dollar and deutsche mark will be lower, enabling a gradual depreciation of the koruna. A weaker koruna would boost Czech exports, which are highly price-sensitive, further stimulating recovery.

*(Based on reports of Oxford Analytica, the Oxford, U.K.-based International Research Group)*
such professionals as financial analysts, lawyers, and accountants, who have little or no managerial or technical experience in industry.

In the Czech Republic and in Russia, the shares in the funds' portfolios were acquired in return for citizens' vouchers invested in the funds. The capital necessary to start up the funds and the fund management companies was provided by the founders, or by loans, and was usually spent on equipment, premises, staff salaries, and advertising. The costs of advertising were high as each fund sought to distinguish itself from the others in the frenzy to attract citizen vouchers. These costs were eventually recovered from the firms themselves. The real impact of these "investment" funds was the disinvestment of the firms in their portfolio. Thus, capital for restructuring is probably the last thing that could have been expected from voucher investment funds. The argument that voucher funds were important for "capital market development" turned out to be false.

Almost nothing was left to pay dividends to the funds' citizen-shareholders, who soon realized that the value of their "national patrimony" was being siphoned off by this layer of financial intermediaries. The political fallout has been serious.

In summary, the long-term consequence of voucher privatization with investment funds is a de facto real sector decapitalization in favor of short-term rent seeking by fund managers. This takes place through board sinecures and lucrative side deals with portfolio companies and through financial market manipulation. In the absence of strong corporate governance from the funds and lacking stable ownership of their own, many enterprise managers exploit the postsocialist version of the "separation of ownership and control" to seize what they can in the form of salaries, bonuses, perquisites, and side deals. This two-sided grabfest by fund managers and enterprise managers—together with the accompanying drift, stagnation, and decapitalization of the privatized industrial sector—may prove the most prevalent result of the strategy to achieve voucher privatization with investment funds.

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Readers' Forum

Destructive Force of Russia's Treasury Bonds
by Anatoliy Zheleznyak

On August 17 in Russia, the Kiryenko government and the central bank announced temporary suspension in the redemption of treasury bills (GKOs)—the short-term government bonds. In the course of a few weeks the financial structure of the country collapsed: major banks were paralyzed, stock exchanges shot down, tax collection came almost to a halt, the ruble's exchange rate fell by two to three times, consumer prices shot up by one-and-a-half to two times, and many people once again lost their savings. The struggling economy was delivered yet another blow as the state of its dying industries became even more desperate, thousands of small and medium-size firms went bankrupt, and unemployment increased dramatically.

Thus, the August events revealed the enormous role played by the GKO mechanism in the country's financial, economic, and political systems. The collapse of the GKO caused a quick and pervasive disintegration across the whole system. How to explain the destructive force hiding behind these "peaceful" bonds?

In the 1980s and 1990s the leading elite in Russia managed to privatize (or grab) most of the nation's economy. A unique social group emerged, the "new Russians." They were able to get financing and access to budget funds, and founded privileged banks with close ties to government authorities. Such banks include Oneksim Bank, Menatep, InkomBank, and dozens of others. These financial oligarchs, together with newly emerged natural monopolies—such as Gazprom, and UES Russia, the electricity giant—have become the real masters of Russia. With the collapse of the Soviet system, the oligarchs gained unlimited freedom of action, and took advantage of it as they not only divided the economy between them but also carved up the political power.

In other words, privatization of both property and power in pseudo-democratic Russia was carried out by unlawful and criminal methods from the outset. Sometimes the tactic was direct appropriation—former directors of plants assumed private ownership, acting on the principle that "what you protect, you own." In other instances, property and wealth were embezzled, sometimes secretly, sometimes openly, and sometimes with the use of arms and violence. Deceit and theft, corruption and extortion, terrorism and gangsterism, these are the cornerstones of post-Soviet Russia's economy and politics. Close ties were forged between the "new Russians," who stole state property, and their "brothers in arms," who grabbed state power. Thus,
politics and business, private and state-owned, merged. Property yielded power and power commanded property, and each opened up opportunities that were previously unavailable.

In recent years one of the most effective tools used by the financial oligarchs to appropriate government money has been the GKO, the short-term government debt instrument invented in 1993. The GKO mechanism works like this: The state (to be exact, the Ministry of Finance, with central bank participation) borrows heavily from the "privileged" commercial banks, with redemption periods of up to one year, and at interest rates that range from 20-50 to 100 percent annually. This, in an environment with almost suppressed inflation! That's how government assets end up in private pockets. The privileged banks obtain not only unusually high interest payments, but also a guaranteed profit. State resources become more and more depleted, and inevitably the moment arrives when all federal government proceeds must be used to pay GKO debt.

A government that has delayed salary payments to doctors, teachers, and the military for months and years, that has reneged on every commitment to both its people and the international community, that has lied routinely in its dealings with others, had never—until August 17—failed to make its GKO debt payments since inception of the GKO bond mechanism.

The average Russian (excluding the "new Russians") for a long time couldn't afford to buy bonds as the minimum purchase was set at 100,000 rubles. Only on July 10, when the state was close to defaulting on its debt, was the minimum purchase lowered to 10,000 rubles ($1,500 at that time). Thus was the middle class finally offered the opportunity to lend money to an already sinking state. The question arises: Why did the Finance Ministry, always desperate for money, for five years shun investors, except the privileged banks? By attracting thousands of small "unorganized" lenders, it could have borrowed more money, at less ruinous interest rates. Why didn't the government do it?

The criminality of the GKO mechanism has been exposed through another development. The August incident was used by the banks as camouflage for a grandiose deceit. The leading banks, citing the moratorium on GKO payments, used the state's bankruptcy to suspend all payments to their clients: small banks; small and medium-size enterprises; and individual investors—mostly from the middle class, the very cross-section of society on whom optimists have pinned their best hopes for Russia's future. The banks used their available resources instead, to speculate with foreign currency. Thus, many of their clients suffered heavy losses and went bankrupt. Individual depositors were allowed to transfer their frozen accounts to the quasi state-owned Sberbank (savings bank) but had to take huge losses.

And the bankers? The financial crisis is generating monetary emission and the newly printed rubles will flow to these privileged banks.

The GKO mechanism thus brought together three sets of players: the privileged banks, as lenders; the state; and the people, the taxpayers. The state persisted in paying huge interest rates to the banks out of the federal budget, which was funded by Russia's tax-payers. Toward the end of 1998, the state's monthly payments due to redeem maturing GKOs would have amounted to 20 billion rubles—more than total tax proceeds in the precrisis months! Obviously, the Russian economy is neither market nor centrally planned; it became an economy of deception and theft.

The author is a sociologist in Kharkov, Ukraine. The complete version of this article in Russian is available from the author: Email: zheleznyak@yahoo.com.

Translation by Vitaly Kartamyshev is greatly appreciated.
Banks and stock markets can only perform their intermediating role effectively—that is, allocate capital—if critical reforms are implemented in the real economy of a transition country. Effective corporate governance and an enforceable commercial code provide basic conditions for a flow of information that ensures the effectiveness of stock markets and bankruptcy procedures. These issues are addressed in the following summaries of William Davidson Institute working papers.

Why Do Stock Prices in Emerging Markets Move in Tandem?
by Randall Morck, Bernard Yeung, and Wayne Yu

On a recent visit to China, we were given access to a tape of Chinese stock price data. To our great surprise, we found that nearly all of the stocks move together—called comovement—either up or down, on any given day. This is not what stock prices are supposed to do. The economic purpose of a stock market is to channel capital to companies that should grow and away from companies that should not. This is because a firm’s cost of capital falls when its stock price rises and vice versa. The efficient markets hypothesis holds that shareholders’ opinions about firms’ future prospects affect stock prices and thereby allocate capital among firms. If the prices of all companies in the economy rise and fall together, the stock market may be failing in its role as an information processor and microeconomic capital allocation device.

Subsequently, we compared the degree of stock comovement across 40 countries using weekly and biweekly stock returns data for 15,920 firms. In rich countries, on average, just over 50 percent of stocks move in the same direction. In poor countries, the fraction moving together is economically and statistically significantly higher.

In other words, comovement of stock prices is negatively correlated with per capita GDP. The result is not an artifact of market size, for the stock markets of small, rich countries, such as those of Denmark, Ireland, and New Zealand, exhibit little comovement; while the stock markets of large, less-developed countries, such as those of Brazil and India, exhibit substantial comovement. Both individually and jointly, country size, various Herfindahl indexes (measuring industrial concentration), and various macroeconomic volatility measures all fail to account for the finding. Comparing firms’ returns on assets also fails to explain why stock prices move or do not move together on the stock exchange.

We also find that a high level of legal protection for public investors is correlated with more firm-specific price variation, consistent with the view that such protection encourages the capitalization of firm-specific information into stock prices.

Our results suggest that simply establishing a stock market in a low-income country is unlikely to improve its microeconomic allocation of capital. Stock markets appear to channel capital selectively across firms only in economies that have relatively honest governments and relatively high levels of protection for public investors’ property rights over their investments.
The relationship between entrepreneurs looking for funds to establish new firms and outside investors who provide the funds is fundamental to all economic systems. The need for outside financing creates two economic inefficiencies. First, with debt outstanding, the borrowing firm may continue to operate when it should be liquidated. This happens because in liquidation the creditor receives everything and the manager is removed and receives nothing, whereas if the firm continues, the manager can extract benefits from running the firm. The second source of inefficiency is in the financing stage, where some valuable projects are not financed because the inefficient liquidation policy described above is anticipated by the creditors.

A well-designed bankruptcy law should aim at minimizing the cost of these inefficiencies. As such, the bankruptcy law has to address the following issues:

- It should facilitate liquidation whenever creditors receive information indicating that liquidation is optimal.
- It should prevent excess liquidation by creditors.
- It should provide managers with incentives to liquidate the firm voluntarily when creditors fail to discover that continuation would result in inefficiencies.
- It should structure the distribution of the cash flow in liquidation to maximize the ability of the firm to finance valuable projects.

To focus the discussion, we concentrate on the following three representative economic systems:

1. In a market-based system, most corporate financing is done through the capital market. Therefore, the relationship between creditors and firms is relatively distant; creditors obtain most of their information from the financial markets and their own independent investigations of the firm’s affairs. Managers cannot see and do not have control over the information processed by creditors. Therefore, managers do not have a strategic advantage relative to creditors. Moreover, the quality of the information that is available to creditors increases as capital markets become more efficient. (An example is the U.S. economy.)

2. In a bank-based system, most corporate financing is done through banks and other financial institutions. Banks take an active interest in firms, usually by having representatives on the board of directors and maintaining veto power over certain activities. Managers are likely to have a good idea of the information creditors are processing at any time. Thus, managers have a strategic advantage; they can preempt creditors by filing for bankruptcy first if they learn that the creditors have sufficient evidence to file for bankruptcy. On the other hand, managers can avoid bankruptcy if they learn that creditors don’t have sufficient evidence to file for it. (Germany and Japan are good examples of such an economic system.)

3. In an underdeveloped system, the financial markets, financial institutions, and accounting systems are not yet developed. There are no reliable information collection entities, such as rating agencies and financial analysts. As in a bank-based system, most corporate financing is done by banks and other financial institutions. But information transmission in the economy is poor, so creditors are unlikely to have access to information. Managers in such an economy do not have a strategic advantage and creditors are unlikely to collect sufficient evidence to file for bankruptcy.

Based on these considerations, our proposed optimal bankruptcy laws for various economic systems are as follows:

1. In developed countries with a market-based system like that in the United States, where information acquisition technologies are well developed and most financing is at arm’s length, bankruptcy law includes both a creditor chapter and a debtor chapter.

2. In developed countries with a bank-based system like that in Germany or Japan, where information acquisition technologies are well developed and most of the financing is done through banks, bankruptcy law includes only a creditor chapter. The rules governing this chapter are biased in favor of banks and other creditors and give no protection to the manager. In such economies bankruptcy law should protect debtors (without requiring a legal procedure similar to Chapter 11 of the U.S. bankruptcy law).

3. For countries with an underdeveloped system with poor information acquisition technologies and concentrated financing, such as the transition economies, an optimal bankruptcy law should include both a creditor chapter and a debtor chapter, but with a stronger bias toward the borrowing firm than in the case of a market-based system.

The authors, Elazar Berkovitch and Ronen Israel, of the University of Michigan, disseminated their paper “Optimal Bankruptcy Laws across Different Economic Systems” as William Davidson Institute Working Paper no. 143.
The Trap of Not Letting “Too Many” Banks Fail
by Janet Mitchell

In recent years banking crises have afflicted many countries throughout the world. Regulators' responses to these banking crises have varied widely, ranging from multiple bank closures (Argentina, United States) to widespread bank rescues (Bulgaria, Czech Republic, Hungary, Japan, Norway, Sweden). Why do regulators in some instances apply tough policies to troubled banks and in other instances rescue many of them? This paper argues that the notion of “too-many-to-fail” explains multiple bank rescues. If too many banks in an economy are financially troubled, the social costs of closing all of them may exceed the costs of rescuing them.

Yet regulators may realize that they risk being trapped in a “too-many-to-fail” situation, and they may take measures to eliminate this risk. One such measure is to weaken bank regulation. By weakening regulation (for example, definitions of bank solvency), regulators diminish their own ability to detect troubled banks but simultaneously increase the credibility of the threat to be tough with financially troubled banks that are actually discovered. Becoming soft in regulation can permit regulators to be tough in banking crises. Indeed, early in the U.S. savings and loan crisis, regulators weakened solvency requirements so that fewer banks would qualify as insolvent. In Japan an early regulatory response to the banking crisis was to relax rules for banks to qualify for advantageous tax treatment for loan loss provisions.

Regulators' responses to banking crises thus depend on a number of factors, including how the banks themselves have handled their bad loans; what type of banking regulation was in place prior to the crisis; and the total number of banks suffering financial distress. Troubled banks often attempt to hide their loan losses by passively rescheduling loans in default. This behavior can worsen a crisis; regulators may not detect the problem until it has become serious or widespread. As the notion of too-many-to-fail suggests, the number of banks suffering from financial distress is also important. Although the well-accepted concept of “too-big-to-fail” can explain rescues of large, individual banks observed in different countries, it cannot explain the simultaneous rescue of several banks. In contrast, “too-many-to-fail” captures the idea that multiple bank closures can generate high social costs—arising from reductions in the output of firms deprived of financing, and from the significant resource costs required to impose tough, case-by-case policies on many troubled banks.

The proposition that regulators may have to become soft in order to be tough implies that it can be less costly for regulators to weaken banking regulations ex ante and to apply tough policies ex post to a smaller number of troubled banks (allowing some troubled banks to go undiscovered) than to detect more troubled banks but be forced to rescue them. This suggests that in emerging market economies and in economies in transition, where the risk of systemic banking crises is high, it may be impossible for regulators to implement stringent banking regulations without running the risk of a bailout of the entire banking system. The outcome may be only a gradual strengthening of banking regulation over time, as the risk of a systemic banking crisis subsides.

Janet Mitchell is a professor in the Faculties Universitaires Saint-Louis and ECARE, Free University of Brussels. The paper “Strategic Creditor Passivity, Regulation, and Bank Bailouts” was disseminated as William Davidson Institute Working Paper no. 146.

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Martina Lubyova and Jan C. van Ours, Effects of Active Labor Market Programs on the Transition Rate from Unemployment into Regular Jobs in the Slovak Republic, WP 213, December 1998.


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Starting with this issue, the William Davidson Institute (WDI) will profile the latest findings of its research fellows. The goal is to highlight academic and policy publications appearing in leading journals in order to provide readers with an up-to-date perspective on the main theoretical and empirical issues analyzed by the fellows. Most of the studies have appeared earlier as Davidson Institute Working Papers. The published papers reflect revisions based on referee comments and subsequent theoretical and empirical investigations. Whenever possible, Publication Profiles will review several related papers to provide a comprehensive perspective on the state of knowledge in a given area.

Disorganization Explains Initial Economic Decline


Countries of the former Soviet bloc have been in transition from central economic planning for almost 10 years. The variety of outcomes across many dimensions—from degree of privatization to unemployment levels to speed of economic recovery—is of great interest to economists and policymakers looking to advise these countries early in the transition process.

The measured drop in output from prereform levels was dramatic in all of these countries. The lowest level of decline—on average, about 20 percent—was in the Czech Republic, Hungary, and Poland. By contrast the Baltics, Russia, and Ukraine have each seen output decline by more than 50 percent. Even taking into account problems with data collection and interpretation, there is a clear trend of dramatic decline in GDP in the initial stages of reform for these countries. Strikingly, in almost every case, GDP fell after prices and trade had been liberalized.

Central planning was characterized by a complex set of highly specific relations between firms, meaning that firms typically had one supplier for each input and one buyer for output. In a market economy, relationships like these lead to abuses by one or both parties, which would have adverse effects on overall production. Market economies eliminate such negative effects either by encouraging competition (many buyers and sellers eliminates specificity) or through the evolution of institutional arrangements such as contracts and vertical integration. Under central planning, the main instrument available to prevent the adverse effects of specificity was the coercive power of the central planner.

Transition of these economies has eliminated the central planner, but institutional arrangements common in the West have been slower to arise. As a result, a number of economic relations have broken down. Sectors with the most complex production processes have suffered the most dramatic output losses. Trade between former republics of the Soviet Union has collapsed, and many firms report shortages of inputs despite price liberalization. Blanchard and Kremer argue that this general “disorganization” has played an important role in the former Soviet Union than in Central Europe.

Roland and Verdier emphasize the costs of searching for new trading partners subsequent to the end of central planning and the introduction of price liberalization—and the fall in investment associated with such a search. They show that the output contraction is followed by a post-transition output level that is higher than the pre-transition level. Their analysis also leads them to conclude that Chinese-style gradual liberalization, characterized by a lower level of disorganization than the all-at-once approach, may prevent the output disruption and temporary fall in investment generated by a big bang policy.

Destination: Europe

From the Hungarian Economy
Searching for Optimal Unemployment Policies


As the transition to a market system began in the early 1990s, all Central and East European (CEE) economies, except for the Czech Republic, registered unemployment rates that rose dramatically from zero to double digits and were accompanied by long periods of high unemployment. The Czech Republic was an intriguing outlier, with its unemployment rate hovering in the 3-4 percent range, well below the 6-8 percent OECD average, and with only short periods of high unemployment throughout the early to mid-1990s. The CEE unemployment crisis contributed to a political backlash as voters rapidly ousted the first reform governments. Analysts and policymakers have wondered whether the Czech experience provides any policy lessons that could be useful for other transition economies. The studies profiled in this review have focused on answering the following questions:

Why has the unemployment problem associated with the transition been much less severe in the Czech Republic than in other transition countries?

Comparing the experience of the Czech Republic to the experience of other CEE countries, it is difficult to account for differences in relevant laws, institutions, and definitions of variables. To minimize this difficulty, Ham, Svejnar, and Terrell, (1998, 1999) collected and analyzed parallel microeconomic data sets from a sample of about 6,000 individuals in the Czech and Slovak Republics.

Slovakia is a natural country for comparison with the Czech Republic because the two republics were one country from 1918 until January 1993, except during World War II. They thus shared the same laws and regulations, institutions, currency, and government programs for many years. Despite the common history, their labor markets have performed differently since the Velvet Revolution of November 1989, with the Slovak labor market resembling those of the other CEE economies in terms of unemployment rates and periods of high unemployment.

With the average high unemployment period lasting three to four times longer in Slovakia than in the Czech Republic, the studies show that nearly 50 percent of this difference is explained by differences in labor market demand and demographic conditions in the two republics. For example, the Czech Republic, unlike Slovakia and other CEE economies, was able to provide jobs to low-skilled workers at a rate similar to skilled workers. The remaining difference is accounted for by the behavior of firms, individuals, and institutions in the labor market. For example, in the Czech Republic the private service sector grew faster, foreign investment was higher, and the impact of the decline in military production was less, and enforcement of labor regulations was stricter than in Slovakia. Also, Czech factories were newer and better located than those in Slovakia. There were greater opportunities for Czechs than for Slovaks to work in neighboring western economies.

To what extent is the unemployment compensation system striking the right balance between (a) reducing government intervention and introducing market incentives and (b) providing an adequate social safety net that ensures public support for the transition?

The Ham, Svejnar, and Terrell studies calculate the effect of marginal changes in unemployment compensation on the duration of unemployment, and they estimate the impact of removing unemployment benefits altogether. In both republics unemployment benefits have only a moderate effect on lengthening a high unemployment period. Thus, policymakers in both low and high unemployment transition economies have considerable latitude in providing an adequate social safety net without jeopardizing incentives and efficiency. The studies also find that married women in the Czech Republic are more responsive to changes in benefits and entitlement than single women are—which is the pattern of behavior in market economies—whereas in Slovakia the response patterns of married and single women to these changes are similar.

Terrell and Sorm (1999) focus on the effects of both passive labor market policies, based on unemployment compensation, and active labor market policies—but in the Czech Republic only. The two important policy questions they address are: (1) To what extent did the unemployment benefits deter people from leaving unemployment and increase the duration of the unemployment period? (2) To what extent did the active labor market policies help employ people more rapidly than they would have been employed on their own, without the assistance of the district labor office? More
specifically, to what extent were hard-to-employ people targeted for assistance through active labor market policies, primarily through finding jobs from labor offices, and, to some extent, receiving assistance in the form of job subsidies?

Terrell and Sorm's work complements the studies of Ham, Svejnar, and Terrell by examining the effects of unemployment compensation using the same methodology, applied to an identically drawn sample of individuals. Those individuals, however, became unemployed one year later, when the transition was in a more mature phase and the economy was growing rather than declining. The authors confirm that unemployment compensation allows individuals to search for jobs without substantially prolonging their duration of unemployment. Moreover, they conclude that these benefits do not have a greater impact on the durations of unemployment in periods of economic growth as compared with periods of recession.

Terrell and Sorm find that education is important in the unemployment equation: in general, the less educated the individual, the longer his or her duration of unemployment. While previously unemployed men find it difficult to find a job, previous unemployment did not affect a woman's chances of finding employment.

The paper also examines the differences in duration of men and women's unemployment, and finds women are unemployed an average of 8.6 weeks longer than men. One-third of this difference can be attributed to dissimilarities in the demographic characteristics of men and women, with educational differences seeming most important, and to variations in local labor demand. Two-thirds of the difference in the unemployment rate is due to differences in the behavior of the unemployed individuals, employers, and institutions.

The Terrell and Sorm study is the first to evaluate active labor market policies in terms of their effective targeting and ability to reduce the length of unemployment duration of different groups in the Czech Republic. To address this issue, they estimate and compare the probability that an in a given week an unemployed individual finds a job with the help of the district labor office to the probability that someone finds a job on his or her own. People who find jobs on their own reflect the preferences of the market. To the extent that the characteristics of each group differ, one can learn how the labor office intervenes in the market to help certain groups of unemployed people over others.

The authors find that active labor market policies lower the unemployment duration of the groups that tend to have longer unemployment periods: women, Romanies, the handicapped, the less educated, and those who have been unemployed before. Moreover, the labor offices assist more individuals who receive unemployment benefits than those who do not. This finding is consistent with the hypothesis that the labor offices are motivated to reduce the costs of assistance programs.

Overall, the results of the three studies suggest that by providing support to the unemployed job seekers and assisting them in finding employment, unemployment compensation and active labor market policies such as job brokering programs increase the social acceptability of the transition without creating tremendous inefficiency. Unemployment benefits do not prolong unemployment periods by much, and job brokering programs are focused on assisting the hard-to-employ, and only after they have been unemployed for some time. Nevertheless, higher demand for labor is clearly the most effective way of reducing the duration of unemployment.

From the Hungarian Economy

“I'm not gonna tell you everything because I don't want to upset you.”
Searching for a Common Customs Code in the CIS

by Garry Kemp

Seven years after the creation of the Commonwealth of Independent States (CIS)—comprising the countries of the former Soviet Union minus the three Baltic states—some of its political leaders seem to be agreeing on one focus point: its development into a customs union for the ex-Soviet territory.

Root Causes of Customs Problems in the CIS

Until 1992 a common market existed among the republics of the former Soviet Union. Goods moved freely from one republic to another, although there were limits on what could leave and enter the Soviet Union itself. Following the independence of Latvia, Lithuania, and Estonia, the remaining republics put into place the trappings of sovereignty—including local currencies, central banks, border controls, and national customs authorities. In practice, however, this hindered the economic development of the region. Although most of the CIS customs codes were originally based on 20-year-old Soviet regulations, they have long since diverged, thanks to a stream of executive and legislative orders followed by a second wave of orders detailing how each piece of legislation was to be implemented.

Customs Functions

Answers to the fundamental question of what customs is meant to achieve differ depending on the interest of the CIS member. Russia—which aims to generate up to 45 percent of government revenue through customs—Belarus, and Ukraine have traditionally viewed the customs process first and foremost as a revenue earner rather than as a method for stimulating trade. The Central Asian and Caucasus states have generally been more determined to develop foreign investment by easing customs restrictions.

Some observers claim the Iron Curtain has been replaced by a curtain of red tape. Companies that previously dealt with one set of strict, but relatively clear customs procedures now must deal with at least 13 sets. There is widespread confusion and a lack of clarity about how customs rules should be applied, and interpretations of the rules can vary from one customs point to another, even within the same city!

Unwanted Diversity

This lack of clarity has resulted in customs officials going to extremes to err on the side of caution. Every "i" must be crossed and every "t" dotted. Required documentation can be refused even when minor typographical errors are made. For example, an airway bill can be refused if two digits of a 10-digit number are written incorrectly, even if the bill itself and other documents quote the number correctly.

Sending a product for repair or return under warranty can also be fiendishly complicated. While the practice of an individual temporarily exporting and reimporting a warranty item without being subject to duties is accepted as normal in the West, in the CIS such transactions are subject to extensive registration and licensing, often leading to additional rounds of paperwork and delays every time a piece of machinery needs to be fixed.

Resistance to Creation of a Customs Union

From the point of view of some of the CIS countries, there are as many reasons not to cooperate more closely with their neighbors as there are reasons to cooperate. First, there is the fear of going under during any future Russian economic meltdown, something that encourages each state to look beyond its borders for new trade routes (such as the Silk Road project and the southern pipelines). Second, there is the natural resistance of nationalism and the many unresolved conflicts between CIS countries (such as that between Armenia and Azerbaijan). Consider the difficulties that even the stable, like-minded governments making up the European Union have faced while attempting to create their own common market.

Nevertheless, the CIS countries still have a common language (despite nationalist tendencies, Russian is still the lingua franca of the CIS states), a shared history (including shared problems as a result of trying to adapt to a market system), and economic interdependency. For these reasons most multinationals, including DHL, continue to reflect the CIS in their organizational and commercial structures.

Solutions

DHL’s approach to customs in the CIS is on a country-by-country basis, with common long-term goals but differing issues. The best short-term solution available may be multilateral movement toward simplifying procedures, increasing automation in the customs process,
establishing a consistent interpretation of customs regulations, and continuing to empower the companies that perform clearance. In themselves, these steps would be a huge improvement on the current state of affairs. At a political level, there is now a realization that the mountains of paperwork and bureaucracy in the CIS need to be reduced.

Unified Approach?

In November 1998, Russian Prime Minister Yevgeniy Primakov stated that bringing back a common economic space "is the way towards the economic revival of the CIS countries." Primakov expressed the hope that an initial customs union involving Belarus, Kazakhstan, the Kyrgyz Republic, and Russia could be extended to all 12 countries in the CIS—to facilitate their integration into the world community rather than isolate them from it. CIS Executive Secretary Boris Berezovsky backed up this notion when he said that the CIS should "follow the example of the European Union. The creation of a free trade zone seems the best option, with common customs regulations and a common economic space aimed at facilitating market-based relations."

As the leading air express carrier in all the CIS states, DHL has a keen interest in any steps that would support trade within and with the CIS to the benefit of DHL customers, who are the largest investors in the area. Far from undermining individual sovereignty, a unified CIS approach to trade would serve each member's best interests and open them up to further trade and investment opportunities.

The author is DHL's area director for the CIS. DHL is interested in comments from individuals or companies regarding customs issues in Central and Eastern Europe and the CIS. Please contact either Richard Kanarecky or Dirk Singer at the RED Consultancy, tel. 44-171-465-7700, Email: richardk@redconsultancy.com.

Foreign Trade and FDI in Hungary and Slovenia: Different Paths—Different Outcomes

by Bartlomiej Kaminski

Among the frontrunners seeking membership in the European Union, Hungary and Slovenia are standouts. Democratic Hungary successfully avoided a default on $35 billion in foreign debt, a legacy of the Communist era, and has become one of the most stable and growth-oriented of the transition economies. Slovenia—despite relatively slow economic growth—has maintained its position as the most advanced economy in postsocialist Central and Eastern Europe, measured by both GDP per capita and the quality of its physical infrastructure. Under the "socialist" regimes, each country experimented with economic reforms that were politically feasible: Hungary introduced a two-tiered banking sector and a modern taxation system, and granted relative autonomy to enterprise managers. And Slovenia became the most reformed economy, under Yugoslav market socialism. Each country had a unique opportunity—Hungary in 1989, with the breakup of the Warsaw Pact; Slovenia in 1992, with the dissolution of Yugoslavia—to shift to a democratic political system, a market-oriented economic system, and a sharply altered trade regime. Both countries chose a relatively gradualist path, in the absence of political or economic incentives to introduce shock measures. Despite similarities in their methods, however, Hungary and Slovenia chose different development paths—including their foreign trade regimes. This article analyzes the motives and results of these different approaches.

Quite different initial conditions determined the countries' distinct reform efforts, particularly in determining foreign trade, as well as adopting policies toward foreign investment: Hungary had high external debt, producing a precarious macroeconomic equilibrium; Slovenia, in contrast, was freed of the requirement to subsidize other republics of the former Yugoslavia. The challenge Slovenia faced was inflation and—in becoming an independent state—launching its own currency.

These differences set the stage for a different approach to institutional transition. Hungary came to the conclusion that rescheduling its high external debt would bring more harm than benefit. Consequently, the successive governments were ready to sell flagship companies to strategic, primarily foreign investors, in order to increase budget revenues. They were also willing to open up to foreign investors a large part of the industrial and service sectors, including telecommunications and banking. This resulted in a large influx of foreign direct investment—between 1990 and 1997 Hungary absorbed about one-half of the foreign capital invested in Central Europe. This development also helped to create effective corporate governance at the earlier state-owned enterprises.

In Slovenia, with macroeconomic stability quickly achieved and the economy rebounding, the sense of urgency to implement microeconomic reforms quickly evaporated. The main method of...
privatization was insider (management-workers) buyout, arising out of strong traditions of self-management. But this method carries several risks. Where there is a lack of well-developed product and capital markets, managers are not constrained by competition or through the fluctuation of the stock market, and this can lead to weak corporate governance. There is also a strong incentive to keep outsiders, or foreign investors, out.

The Slovene government has restricted foreign direct investment (FDI) in auditing agencies, investment companies that manage investment funds, and stockbroking agencies. Moreover, a majority of the directors in joint stock companies must be Slovene citizens. As a consequence of these and similar restrictions, Slovenia is attracting far less foreign capital than it should. (Considering Slovenia's superb geographical location, and its high level of industrial development, FDI should be around 3–5 percent of GDP, instead of the present 1.5 percent.)

In Hungary joint ventures have been allowed since 1972, although under the communist regime, foreign equity couldn't exceed 50 percent. Some multinationals established their presence early, even if they did not really invest until around 1990. Subcontracting links

The Slovene Path

In the post-independence period, Slovene economic policy has concentrated more on achieving macroeconomic stability, in terms of external and internal balances, than on institutional reform. Slovenia has run a balanced current account since 1995 under a floating exchange rate regime, while the general government budget has also been more or less balanced for the past few years (a 0.3 percent of GDP surplus in 1995, and a 1.0 percent deficit in 1996 and 1997).

The current account balance has been achieved not only through floating the tolar but also by the introduction of capital account controls. Foreign capital has been discouraged informally from flowing into Slovenia in recent years because of the privatization program's bias in favor of insiders. Foreigners were almost entirely excluded from participating. Slovenia formally introduced capital controls in the aftermath of the Czech currency crisis in the first half of 1997 to prevent appreciation of the tolar, and worsening of the current account in the balance of payment. Borrowers were required to deposit tolar in "custody accounts" in authorized Slovene banks. The inflow of foreign currency dropped significantly in the second half of 1997.

The restrictions were later relaxed somewhat, but the inflow of both foreign direct investment (FDI) and of short-term portfolio investments and credits to Slovenia did not increase significantly. In the first half of 1998, FDI was only $33 million, portfolio investments $190 million, and credits negligible.

This policy has, however, delayed restructuring of the financial and real sectors. The Slovene equity market is small and dominated by privatization coupons or shares. The capitalization of the Ljubljana stock exchange was about 15 percent in terms of Slovenia's GDP in July 1998—approximately $2.5 billion. Foreign participation fell to almost zero in the second quarter. Thus, capital flight during and in the aftermath of the Russian crisis was inconsequential. The stock market index suffered noticeable losses in August and September, about 20 percent, but given the small size of the market this move of domestic investors from equity to cash is of little consequence for the economy as a whole. Bonds do not play a significant role in the financial system. Interest rates are indexed and have been falling in line with the continued trend of declining inflation in Slovenia—infation for 1998 is expected to be 8 percent year-on-year, down from around 10 percent in 1996 and 1997.

The government undertook a costly rehabilitation of the banking sector in the mid-1990s, although there has been little transfer of ownership. Most of the sector remains state-owned—notably the largest bank, Nova Ljubljanska Banka, and the third-largest bank, Nova Kreditna Banka Maribor. The sector's bad loans were transferred to the budget, allowing bank failures to be largely avoided. Hence, very little restructuring has been carried out. Consolidation of the banking sector and privatization of large state banks are expected to proceed very slowly.

There has been little restructuring in the real sector, leaving Slovenia dependent on high levels of exports if it wants to sustain growth. GNP growth has recently accelerated, from 3.1 percent in 1996 and 3.8 percent in 1997 to an annualized rate of 6.5 percent in the first half of 1998. This was mainly the consequence of increased foreign trade in the period, with exports up 8.5 percent and imports up 9.0 percent year-on-year in the first half of 1998, in turn due to higher growth in the EU and the CEFTA states. Thus, if there is a slowdown in Europe, Slovenia's growth rate can also be expected to decline. This vulnerability, together with EU accession requirements, is likely to force Slovenia to relax its capital controls and open up to foreign investment in the medium term.
Hungary’s Conservative Budget

The Hungarian government’s 1999 budget plan is tight, reflecting government concern about a downturn in export demand. Economy Minister Attila Chikan recently noted that the European Commission had reduced its forecast for EU GDP growth in 1999, to 2.4 percent from 2.8 percent, and warned that the 5 percent Hungarian growth target was conditional on EU growth remaining above 2 percent. Growth will be led principally by industry—September figures showed industrial output up some 14 percent year-on-year, despite the impact of the Russian crisis in reducing demand for products in some key industries.

Just in case, the government has created a special contingency fund of around 33 billion forints ($154 million) to cover the shortfall if Hungarian growth in 1999 is only 4 percent. The government is also concerned that the current account deficit may increase as a result of accelerating domestic demand. Its reluctance to cut taxes may be partly attributable to a wish to dampen demand.

The budget deficit target is 4 percent of GDP for 1999, compared with a projected deficit of 4.7 percent for 1998. (The budget deficit is due to fall to 3.5 percent of GDP in 2000 and 3 percent in 2001.) Overall, the government hopes to raise spending by some 2–3 percent in real terms in 1999, compared with 1998. The government has reduced by 1 percent its inflation forecast, to 10–11 percent for 1999. Real wages are expected to rise by around 2 percent. Current indications are that a thorough overhaul of the tax system will be attempted in 1999. However, the reforms being tabled for the 1999 budget are relatively modest.

The government will face growing fiscal pressures from two areas in particular over 1999:

- **Social security.** The pensions and health social security funds—brought under direct government control by the new government—show sizable deficits, estimated at 77 billion forints for 1998 (up from 51 billion in 1997), and expected to increase rapidly to 193 billion forints in 1999. Of the 1999 deficit, 140 billion would likely be financed by the central budget, with the rest coming from asset sales. Expenditure on family welfare benefits will increase to 252 billion forints, an increase of 18 billion on 1998, while the child benefit will become a universal entitlement from January.
- **Agriculture.** The Ministry of Agriculture has asked for substantial subsidy increases for the agricultural sector, to 155 billion forints, from 104 billion in 1998. However, thus far the Finance Ministry has resisted this, promising instead to raise the agriculture budget by 18 percent in recognition of the serious difficulties faced by the sector as a result of the collapse in CIS demand.

with Western firms had been building since 1968, so managers were accustomed to cooperating with foreigners. After the 1989 “revolutions,” the only country that was attractive to international investors was Hungary, which had a good record in its relations with private and multilateral financial institutions. (Poland should have been a competitor, but for several years foreign investors avoided dealings there because of the country’s moratorium on servicing its external debt.) In 1998 firms with foreign capital were responsible for three-quarters of Hungary’s exports and imports.

By the end of 1997, cumulative FDI in Hungary since the start of market transition reached $17 billion, making it the only East European state with per capita FDI above $1,000. As of end-1997, 50 percent of the aggregate equity of Hungarian companies was in foreign ownership, and this proportion has risen since. Banking and processing have the heaviest foreign ownership presence, at more than 50 percent. According to data from the State Privatization Agency, the country’s most active foreign investors are from Germany, followed by the United States, France, and Austria. Hungary is the only country in the region to have attracted significant Japanese investment, which now surpasses $500 million.

Of the 50 largest multinationals, 40 are present in Hungary, providing more than 60 percent of total FDI. Multinationals produce nearly 25 percent of GDP, according to estimates. In the country’s small, open economy, the multinationals have developed an especially important role in the generation of exports. Just four multinationals—IBM, Philips, TDK, and Sony—account for roughly one-fifth of exports.

As part of a drive to encourage investment, the Hungarian parliament has approved tax allowances affecting large investment projects in high-unemployment regions. Companies with capital investment projects worth over 10 billion forints and which started up after December 31, 1996, have been made exempt from corporate taxes for 10 years, if their employee ranks increase by at least 500 over the 10-year period and annual turnover increases by at least 5 percent of invested value compared with the previous year. The exemption will be offered for the last time on the tax year 2011. One should note that these incentives...
Developments in External Sector in Hungary and Slovenia (millions of dollars)

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<td>Exports</td>
<td>9,588</td>
<td>10,187</td>
<td>10,705</td>
<td>8,906</td>
<td>10,701</td>
<td>12,867</td>
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<td>352</td>
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<td>6,853</td>
<td>12,095</td>
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<td>(in months of imports)</td>
<td>1.6</td>
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<td>4.8</td>
<td>6.5</td>
<td>5.7</td>
<td>9.4</td>
<td>7.3</td>
<td>6.5</td>
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<tr>
<td>Real GDP (percent)</td>
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<td>-11.9</td>
<td>-3.1</td>
<td>-0.6</td>
<td>2.9</td>
<td>1.5</td>
<td>1.3</td>
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<tr>
<td>Exports</td>
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<td>6,681</td>
<td>6,083</td>
<td>6,828</td>
<td>8,316</td>
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<td>8,372</td>
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<td>Imports</td>
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<td>Current account balance</td>
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<td>International reserves</td>
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<tr>
<td>(in months of imports)</td>
<td>1.4</td>
<td>1.5</td>
<td>2.5</td>
<td>2.3</td>
<td>2.9</td>
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<tr>
<td>Real GDP (percent)</td>
<td>-5.5</td>
<td>2.8</td>
<td>5.3</td>
<td>4.1</td>
<td>3.1</td>
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**Source:** Author.

have been made available to all investors, foreign and domestic alike.

**Foreign Trade Dissimilarities**

There have also been similarities in the evolution of the two countries’ foreign trade policies. The collapse of the old economic regime put an end to the state’s administrative micromanagement in both countries. Both were driven to liberalize under commitments to the World Trade Organization as well as regional trade agreements. Both countries are signatories to the Pan-European Cumulation Agreement (1997), and around 80 percent of their respective manufacturing imports are duty-free.

Hungary has fallen behind in dismantling vestiges of central planning. Nontariff barriers still abound, among them quantitative restrictions. Foreign investors can be shielded from these barriers, however, if they move to free trade zones, and take advantage of the so-called “duty drawback,” claiming back the duty paid on the import content of the export. (By the end of 1998, this scheme will lose its attraction, as products from free-trade zones will lose their preferential treatment in the Pan-European markets, including EU and EFTA members.) As another vestige of the command economy, Hungary still applies an annual global quota on imported consumer goods (the level has fluctuated between $400 million and $600 million over 1994-98). Around 6 percent of Hungary’s exports are still subject to nonautomatic license requirements.

Both countries, however, have demonstrated that they have internationally competitive industrial capacities; and both countries are shifting from natural resource- and unskilled labor-intensive products to capital- and skilled labor-intensive products. This suggests that they will be able to integrate into the European Union at a higher end of the value added spectrum; in other words, despite gloomy predictions, Hungary will not become a provider of cheap, mass-produced goods.

Yet Hungary’s performance in EU markets excels that of Slovenia. The pace of change has been much faster for Hungary’s exports to the European Union.

**Cumulative FDI Inflows, Per Capita and as a Share of GDP**

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<td>0.00</td>
<td>0.00</td>
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<td>1.66</td>
<td>12.20</td>
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<td>0.00</td>
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<td>3.27</td>
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<td><strong>As share of GDP</strong></td>
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Union, despite its seemingly more protectionist trade policies. Spectacular changes in Hungary's export structure point to a massive emergence of "second generation" firms—primarily local branches of multinationals—demonstrating progress in industrial restructuring. Eighty percent of Hungary's exports are directed toward the European Union. Between 1994 and 1997 the value of its exports to EU countries increased by 132 percent, as rapidly growing export earnings and an influx of foreign capital allowed an increase in imports, thereby providing higher-quality products for both consumption and investment. Hungary registered the highest export growth rates over 1995-97, compared with five other first-wave candidates. During this period the share of manufactured products increased from 71 to 85 percent.

In Slovenia the shift toward a more technology- and skilled labor-intensive export structure is progressing more slowly than expected. This is partly the result of a lack of new industrial capacities and "second generation" firms, and partly because of low FDI flows. The weak incorporation of local firms into global networks of production and marketing, especially in tele-communications and financial services, has slowed corporate restructuring.

In summary, the pattern of integration has defied earlier predictions. Both Hungary and Slovenia have demonstrated that their industrial and service sectors are able to withstand the competitive pressures of the European Union. However, FDI plays a crucial role in restructuring in transition economies; thus, attracting large amounts of foreign capital will help Hungary, with its high-value-added products, integrate into the European Union, while Slovenia's restrictive policies governing FDI can make its integration efforts more difficult, despite initial advantages.

The author is a professor at the University of Maryland, College Park, and consultant at the World Bank.

Milestones of Transition

CIS

Moldova

Central bank's hard currency reserve halved in 1998. The Moldovan National Bank's hard currency reserve shrank to half its previous level during 1998 and is currently $150 million. The central bank ran short of its own net hard currency assets to satisfy state needs, so it had to resort to the IMF. The reserve shall be replenished immediately upon the arrival of $35 million from the International Monetary Fund and then $35 million from the World Bank,” National Bank President Leonid Talmaci said. Since August 17 (the date Russia freed the ruble rate), the bank has spent some $100 million over two months to redeem treasury bonds and underpin the Moldovan lei on the currency market. In early November the bank announced it was ceasing its currency interventions to preserve the country's hard currency reserve. The inflation rate in 1999 is expected to hover around 15 percent. The expected budget deficit in the first half of 1999 should be financed from privatization revenue, according to Talmaci.

Russia

Industrial output dropped 5.5 percent while inflation surged to 84.4 percent, in 1998. Russia's Economics Ministry has reported that the ruble has plummeted by nearly 70 percent since September. Russia has the worst-performing stock market among 32 transition countries monitored daily by the International Finance Corporation. As a result of Russia's crisis and lower world prices for oil (Russia's main source of export income), the country's foreign trade for the period from January to November was down 13.6 percent as compared with the same period in 1998. The Economics Ministry said final reports were likely to put exports for 1998 to countries outside the territory of the former Soviet Union at $57.7 billion, or 17.6 percent less than in 1997. Imports for 1998 are 25 percent down from 1997.

Foreign investment down. Foreign investment in Russia totaled just $1.6 billion in the third quarter of 1998, down from $3.7 billion in the second quarter and $4.0 billion in the first quarter. Investment fell in almost all sectors of the economy. Foreigners took a total of $1.3 billion out of the country in the third quarter, so net foreign investment amounted to less than $300 million. Net foreign investment in the first nine months totaled $3.4 billion. There was a net outflow of foreign capital in the financial services industry ($200 million) and in advertising and auditing ($270 million) in the first nine months.

EU plans new $5 billion aid program. The European Union is putting up $5 billion for a new aid strategy for Russia, aimed principally at subsidizing and encouraging foreign private investment. Tough conditions will require the fulfillment of precise interim performance targets before new money is released. The existing Tacis program, which has spent over $3.3 billion since 1991 as the EU's main aid and technical assistance vehicle, is to be overhauled and renamed. This follows a highly critical internal review that concluded that: "cohent strategies for promoting the two Tacis objectives of market-oriented reforms and the reinforcement of democracy are largely absent." The new scheme proposes to put 25 percent of EU funds into promoting private investment and another 25 percent into incentive schemes to reward the best development projects in each of the former Soviet states. The current approach, under which Tacis has supported 1,011 separate programs, is to be replaced by a priority system of putting more resources into fewer than 100 better controlled projects. The EU will keep working on aid projects to improve the safety of Russian nuclear power plants and to
inculcate banking, accounting, and financial skills.

**Population down further.** Between January and October 1998, Russia's population fell by 311,000, or 0.2 percent, to 146.4 million, figures from the State Statistics Committee revealed. Natural population decline remained the chief reason for the dropping numbers. In 1998 Russia saw 439,400 new migrants, while 174,500 left the country. (The figures for 1997 were 490,200 and 196,600, respectively.) The mortality rate, which rose to 15 per 1,000 in 1995 from 7.4 per 1,000 in 1960, put Russia behind all the countries in Europe, America, and Asia, apart from war-torn Afghanistan and Cambodia, according to a report by the presidential Commission on Women, the Family and Demography. The rise in the mortality rate has been attributed largely to the effects of rampant alcoholism and declining standards of health care.

**Organized crime controls nearly 50 percent of the Russian economy,** Prosecutor General Yury Skuratov, who was cited according to Interfax, said organized crime is blocking the normal operation of banking institutions, making the shadow businessmen rich and creating a federal budget deficit. Prosecutors estimate 50 percent of all commercial banks and 40 percent of state-owned companies are criminally controlled, thus affecting between 40 and 50 percent of Russia's annual gross domestic product. Russia's natural gas, oil, and coal sectors have been particularly hard-hit by organized crime units.

**Salvaging the banking system.** Central Bank of Russia First Deputy Chairman Andrei Kozlov estimates that of the country's roughly 1,500 banks, at least 720 will have to close their doors. Kozlov said rescuing the banking sector will cost 141 billion rubles ($8.3 billion). To date, the central bank has granted stabilization credits of nearly 15 billion rubles ($860 million) and planned to use another 5 billion rubles in 1998. In 1999 the bank plans to provide another 25 billion rubles' worth of stabilization credits.

**Ukraine**

**State debt is accumulating.** Finance Minister Ihor Mityukov reported that state debt totaled $14.9 billion as of October 1, of which external debt had risen $1.4 billion from the start of the year to $10.9 billion. "We have now reached a critical point," he said. The government plans to raise 23.1 billion hryvni ($6.74 billion) in budget revenues in 1999. The national bank's goal in 1999 is to preserve the hryvnya exchange rate at 4 hryvni to $1, bank chairman Viktor Yushchenko said. Economy Minister Vasyl Rohovyy told the parliament that GDP is expected to fall by 1.5 percent in 1998, instead of growing by 0.5 percent, as previously projected. The economy is projected to grow by 1 percent in 1999.

**Central and Eastern Europe**

**Estonia**

**Spending cuts.** The cabinet approved cutting the 1999 budget by 800 million kroons ($62 million), based on projected GDP growth of 4 percent. As a result, local municipalities will receive considerably less money, as will those ministries whose budgets were expected to show the biggest growth in 1999, including the Ministry of Interior. The opposition had rejected the original 18.45 billion kroon budget, which was based on GDP growth of 6 percent, as overly optimistic.

**Poland**

**Administrative restructuring.** Poland redrew its domestic administrative map under a plan that aims to increase government efficiency. The makeover, which went into effect January 1, 1999, replaces the country's communist-era division into 49 regions with 16 larger ones, which designers say are more in line with existing administrative regions in EU countries. The new scheme also brings back 308 county-level units that existed in Poland decades ago. Local units, such as towns and villages, remain largely as they were. The 16 regional governors are appointed by the government, while politicians at lower levels were elected in nationwide local voting last October. Economists say that to make the administrative reforms truly effective, more taxing power will need to be shifted to local governments.

**Inflation down to one digit.** The annual inflation rate from October 1997 to October 1998 dropped to one digit (9.9 percent) for the first time since Poland began reforming its economy. Consumer prices rose by 7.6 percent from January to October 1999, down from 10.8 percent in the same period in 1997. Lower inflation can be attributed to smaller price increases for foodstuffs following the good harvest and surplus agricultural production of 1998.

**Romania**

**Poor performance in 1998.** Alone among the transition economies in Central and Eastern Europe, Romania's economy has by most measures performed worse since a reformist government was elected to replace the former Communists (in Romania's case, in November 1996), according to research scholar Michael Wyzan. Although inflation is down and the exchange rate has been relatively stable in 1998, GDP will decline between 3 and 6 percent for the second consecutive year, and privatization efforts have been largely stalled. After experiencing positive growth from 1993 to 1996, GDP fell by 6.6 percent in 1997. Industrial production was down by 19.1 percent in the first half of 1998, relative to the same period in 1997. Slower growth in imports has been more than offset by a decline in exports.

We appreciate the contributions of FRE correspondent Robert Lyle.
World Bank Approves $400 Million Loan to Russia

The World Bank approved a new $400 million road construction loan for Russia on December 22. With this loan, the Bank’s total commitments (net of cancellations) to Russia—for the 41 projects involved—increased to some $11.3 billion. The latest loan is expected to contribute to major improvements in road financing, particularly through significantly increasing the road user charges paid by heavy trucks; and to improve the condition of selected high-priority roads and bridges in the federal road system, including in Siberia and the Far East, and in the regional road systems of the Krasnoyarsk and Khabarovsk regions. It will also help further develop the private road construction and consulting industries and expand the use of competitive bidding.

The Bank is attempting to find ways to continue to help Russia, despite the financial crisis and the fact that Russia does not yet have a comprehensive recovery strategy, Vice President for Europe and Central Asia Johannes Linn pointed out. The crisis has already taken a heavy toll on the Bank’s current lending projects in Russia—the number of projects with a satisfactory implementation rate dropped from around 80 percent in July to only 54 percent in November, Country Director for Russia Michael Carter noted. Some projects were brought temporarily to a halt because of the financial crisis, which has frozen funds in some banks and in some instances prevented local Russian partners from paying their share of the projects. The $1,850 million in undisbursed drawings from three adjustment loans await compliance with conditions of tranche disbursement and agreement on a broad economic reform plan with the IMF.

In a review of its overall strategy toward Russia, the Bank’s Board of Executive Directors approved an "interim plan" for working with Russia in the midst of the current crisis. The plan will focus on social issues, structuring a strong reform program, and continuing project preparation, pending a decision on future lending that will be made in the context of the new country assistance strategy, scheduled for next June.

IFC Finances Georgian Oil Development

The International Finance Corporation will finance further development of the Ninotsminda oil field in the Republic of Georgia through a $6 million loan to Ninotsminda Oil Company (NOC). The Ninotsminda field, which was first developed in the 1980’s, currently has a 2,000 barrel-per-day capacity and accounts for more than 50 percent of Georgia’s domestic oil output. Production is shared between NOC and Georgian Oil, the state oil company of Georgia. IFC’s loan will allow at least five more wells to be drilled in order to increase production and realize the field’s full potential.

NOC is owned by CanArgo Energy Corporation of Calgary, Canada (with 68.5 percent) and JKK Oil and Gas PLC of London, UK (31.5 percent). The project will help to redress Georgia’s large energy deficit and improve its external trade balance, as well as contributing to the government’s fiscal revenues. Development of the Ninotsminda field will be undertaken by Georgian staff and management, and the project is expected to directly employ more than 100 people.

World Bank–IMF Support for Poorest Countries Neighboring Russia

The International Monetary Fund (IMF) and the World Bank on December 11 hosted a special financing meeting to mobilize additional balance-of-payments support for the poorest countries neighboring Russia: Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova, and Tajikistan—which have been hardest hit by the crisis. The meeting was called to support these countries’ own efforts by raising funds to cover half of the financing gap caused by the Russian crisis. Participants in the meeting pledged nearly $200 million to bolster the countries’ foreign reserves. Moreover, some participants indicated that more may be added in coming months. The meeting, chaired by John Odling-Smee, Director of the European II Department of the IMF, and Johannes Linn, Vice President of the World Bank, included participants from Canada, Japan, Russia, and the United States, several European countries, the European Union, and the Asian Development Bank.

Donors Pledge $2.2 Billion to Vietnam

Foreign donors pledged financial support of $2.2 billion to Vietnam, but offered to provide another $500 million to support the implementation of an accelerated reform program. During their Sixth Consultative Group Meeting in Paris (the annual forum for discussions between the Government of Vietnam and the international donor community) on December 7 and 8, the participants concluded that the aid package should fund the social and financial costs of the reforms, especially state-owned enterprise (SOE) reform, banking reform, including comprehensive restructuring of the four state-owned commercial banks); and trade liberalization.

The donors agreed that Vietnam faces a serious economic situation and strongly supported its plans for reinvigorated
rural development, but noted that increased investments in rural areas will be effective only if they are accompanied by policy and institutional reforms.

**Loan Supports Bulgaria's Social Protection Reform**

The World Bank on November 19 approved an $80 million-equivalent loan (DEM 145.7 million) to Bulgaria in support of the government's social protection reform program, to be used in the following areas:

- To help reform the pension system, encouraging the development of a second and third pillar pension provision to diversify old-age risk beyond the public system.
- To strengthen and consolidate means-tested benefits for the most vulnerable, strengthen the management and quality of social assistance services, and increase community and private participation.

**IMF Lowers Growth Forecasts for Transition Economies**

For the countries in transition to market economies, the International Monetary Fund (IMF) forecasts on average a negative growth rate of nearly 1 percent in 1998, and a nearly 2 percent decline in 1999. The latest IMF analysis was released on December 22 in the Fund's most recent interim reassessment of its World Economic Outlook.

The IMF said that both economic and social conditions in Russia have "deteriorated dramatically" since the August financial crisis. Moscow continues to lack macroeconomic policies that would help restore the confidence of investors and establish the preconditions for sustainable growth; has a large underlying fiscal imbalance; and has current budget plans that simply fail to meet the requirements for turning the situation around. For any hope of success, Russia would have to reestablish stability-oriented economic policies, accompanied by significant banking system restructuring, the normalization of relations with creditors, and a return to the unfinished task of structural reform. Among the steps required would be a fiscal policy that is based on the bulk of government expenditures being financed by tax revenues, without resort to arrears, and whose financing would allow inflation to be reasonably contained, said the IMF.

In Central and Eastern Europe, the Fund report said, Hungary and Poland have weathered the financial market turmoil reasonably well while in the Czech Republic output should recover in 1999. For all the countries of Central and East Europe, excluding Belarus and Ukraine, the Fund is forecasting growth in 1998 of 2.9 percent and a much better 3.2 percent in 1999. Ukraine, in addition to facing reduced trade from Russia and other effects of the country's crisis, is also confronted with the consequences of its persistent budgetary imbalances and inadequate reform efforts. The Baltic countries—Estonia, Latvia, and Lithuania—have been hit by both reduced access to private external financing and direct effects of the Russian crisis, especially in banking and trade

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in the delivery of social assistance pro-
grams and services.

- To reform the health system by im-
proving its fiscal sustainability and by re-
ducing costs of health benefits to
employers.

The loan has a maturity of 20 years, in-
cluding a five-year grace period, and will
be at the standard interest rate for
LIBOR-based, deutsche mark single
currency loans. Since joining the Bank
in 1990, Bulgaria has received commit-
tments of loans totaling more than $1.13
billion for 16 projects.

World Bank's GEP: Global Spillover
of the Russian Crisis

The global economy took a bigger hit
than anyone expected from the finan-
cial crisis that began in Asia in 1997
and spread to Russia in 1998, accord-
ing to the World Bank's annual report
on Global Economic Prospects, which
adds that it is too soon to tell whether a
worldwide recession is in store in 1999.
The Bank lowered its worldwide per
capita growth forecast for 1998 to less
than one-half percent (0.4)—compared
with 3.2 percent in 1997—and projects
that global growth in 1999 will be just
1.9 percent.

The Russian crisis has been a major
part of the downturn in global output and
the report says the potential for spillover
effects within the region of Central and
Eastern Europe and Central Asia re-
mains high in the near term. But in the
entire region, only 4 of the 25 countries
had negative growth rates in 1998—
Czech Republic, Romania, Russia, and
Ukraine. (The IMF added Kazakhstan
to this list of "negative growth coun-
tries," while the World Bank predicted
0.5 percent growth for 1998 in this Cen-
tral Asian country. In general, the Bank
is a bit more optimistic in its forecasts
than the IMF.)

Excluding Central and Eastern Europe
and the Baltics, the countries of the
former Soviet Union would have a nega-
tive 3.7 percent growth rate in 1998,
and an even worse negative 4.3 per-
cent in 1999. The Bank's report says
the 30 percent decline in oil prices and
similar drops in metals and agricultural-
resource prices have pushed Russia's
current account into deficit, with 25 per-
cent of the government's revenues tied
to oil and gas sales. Resource-depen-
dent Azerbaijan, Kazakhstan, and
Uzbekistan are being hurt by this as
well. Terms of trade figures of CIS coun-
tries (this index compares export price
changes to import price changes) de-
teriorated an estimated 13.5 percent
in 1998, or 1.5 percent of total GDP.
Central European countries, in con-
trast, saw a 6 percent gain in terms of
trade in 1998, or 2 percent of GDP. The
main indirect spillover of the Russian
crisis affecting developing and transi-
tion countries around the world is the
reduced availability of private capital
and the increased cost of borrowing.

IMF Could Become World Lender
of Last Resort

IMF First Deputy Managing Director
Stanley Fischer said in early January
that bigger central bank reserves, more
transparent financial systems, and an
enhanced role for the Fund are all pos-
sible responses to the 1998 financial
crises. Countries with large reserves
have, by and large, coped better with the
turmoil than those with smaller ones, and
this is likely to prompt countries to re-
think their reserve policy. But efforts by
emerging market economies to create
current account surpluses to build up re-
erves could have a deflationary impact
on the world economy.

The IMF could build on its latest expe-
riences to become an international lender
of last resort—sort of a national central
bank that can provide unlimited funds to
a bank that has short-term problems and
can provide collateral. Interest rates on
emergency loans would be determined
by a government's economic policies
and financial management, with lower
charges for those adhering to standards
that are being drawn up by the major in-
dustrialized nations. Governments that
failed to meet the new code of good eco-
nomic conduct or that delayed approach-
ing the IMF until crisis was inevitable
would likely be penalized with higher in-
terest rates and demands for sweeping
policy reforms.

World Bank Fights Tobacco
Epidemic

If present smoking patterns persist, at least
100 million of the 340 million Chinese males
below age 29 will eventually be killed by

From the World Press Review
tobacco, warned the *British Medical Journal* on November 20, 1998. The journal published the results of the world's largest-ever study of tobacco-related deaths and health hazards. Partly financed by a World Bank loan to China, the study involved 1.25 million Chinese and concluded that in the mid-1990s smoking was already responsible for about 12 percent, or 0.7 million, of all adult male deaths in China, plus about 3 percent, or 100,000, of all adult female deaths.

Based on present smoking patterns, the study predicts annual tobacco deaths will reach 1 million just after 2010, 2 million by about 2025, and 3 million, almost all male, by 2050, as today's young adults reach old age. Two out of three Chinese males now become smokers before age 25. Few give up smoking, and about half of those who persist will be killed by tobacco in middle or old age. China has about one in four of all smokers in the world. One in two persistent cigarette smokers—no matter where they live—is eventually killed by tobacco.

Since 1991 the World Bank's formal policy is to not lend for tobacco production, processing, or marketing. The Bank encourages governments to control tobacco and to reduce or minimize the tobacco epidemic. In its 1997 Health Sector Strategy Paper, the Bank strongly recommended that governments:

- Significantly increase tobacco taxes, and thus prices.
- Implement complete bans on tobacco advertising and promotion of tobacco products.
- Disseminate easily understood information on health risks.
- Research the causes, consequences, and costs of tobacco use.
- Increase funding and expertise for tobacco control units.

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**Conference Diary**

**Eurasia Forum**  
March 8 (New York) and 9 (Washington, D.C.), United States  
Organizer: Eurasia Group.  
Topics: Economic Stability in Russia and the CIS (New York), by Boris Berezovsky, Executive Secretary of the CIS; and Russian Foreign Policy and the CIS (Washington, D.C.).  
Information: Eurasia Group, 1133 Broadway, Suite 1600, New York, NY 10010, United States, tel. 212-366-9560, fax 212-366-9699, Email: kapoor@eurasia group.net.

**Cultural Standards in Business and Society in the European Union: Methods and Methodology in Intercultural Research**  
March 10-13, 1999, Gloggnitz, Austria  
Organizer: Institute for the Danube Region and Central Europe, with support from the European Commission.  
Languages: English and German.  
Information: Applications as discussants (informal letter; CV indicating nationality, age, and gender) and applications as speakers (abstracts of about 500 words, scientific CV) should be sent to: Sylvia Meierwewert, Forschungsinstitut fuer Europafraegen (Research Institute for European Affairs), Wirtschaftsuniversitaet Wien, Althanstrasse 39-45, A-1090 Wien, tel. 43-31336-5084, fax 43-1-31336-752, Email: Meierewe@fgr. wu-wien.ac.at. Applications should be received by January 18, 1999.

**Enlarging the European Union to Encompass Central and Eastern Europe**  
March 16, 1999, Kiel, Germany  
Organizer: Ostsee Akademie.  
Language: German.  
Information: Ostsee-Akademie, Trave- muende, Europaweg 3, D-23570 Luebeck, tel. 49-4502-803-203/205, fax 49-4502-803-200, Email: ostseeaka demie@t-online.de, Internet: http://www. balticnet.de/Ostsee-Akademie/Ostsee eakademie-Info.html.

**Unions and Industrial Relations in the Transformation Countries**  
Date changed: formerly November 1998, now March 14-17, 1999, Berlin, Germany  
Languages: English, German, and Russian.  
Call for papers: The Otto Brenner Foundation invites researchers to propose topics for lectures. Submit CV with list of relevant publications to the address below. The costs of participation and travel will be covered for those applicants accepted.  
Information: Michael Guggemos, or Dr. Wim van Meurs, Otto-Brenner-Stiftung, Buero Berlin, Alfte Jakobstrasse 149, D-10969 Berlin, tel. 49-30-834-8688, fax 49-30-25396011, Email: meurs@zedat. fu-berlin.de.

**The European Union Enlargement to the East, But at What Speed?**  
March 22-23, 1999, Paris, France  
Organizers: GASI (University Marne la Vallee) and ROSES (University Paris 1, Panthéon Sorbonne).  
Topics: EU enlargement in process, East-West economic convergence in Europe; costs and benefits of EU accession for both associated countries and EU members; microeconomics of EU enlargement, including competition, investment, and enterprise adjustment.  
Organizer: Sts. Cyril and Methodius University, Faculty of Economics.

International Conference: Recent Developments and Problems in the Transition Economies
March 25-27, 1999, Skopje, Macedonia

Eighth Annual Bank Conference on Development Economics (ABCDE)—1999
April 28-30, 1999, Washington, D.C.

Welcoming address by James D. Wolfensohn, President, the World Bank; keynote addresses by Kenneth Arrow, Stanford University, and Joseph E. Stiglitz, Senior Vice President Development Economics and Chief Economist, World Bank.

Sessions include: Economic Architecture (Arminio Fraga/Dani Rodrik; Amar Bhattacharya/Joseph E. Stiglitz; Erik Berglof; and Ann Florini); Social Issues (François J. Bourguignon; Glenn C. Loury; Abhijit Banerjee; and Ravi Kanbur/Nora Lustig); Economics of Transition—Ten Years After (Charles Wyplosz; Nicholas Stern; Yingyi Qian; and Anders Aslund). Workshop sessions cover Health; Social Insurance; Decentralization and Environment; Macro Issues; Financial Market; Trade Policy; and Aid Conditionality. Participation for nonstaff by invitation.

Information: Boris Pleskovic or Gregory Ingram, Research Advisory Staff, World Bank, 1818 H. Street, Room MC4-391, Washington D.C. 20433, United States, tel. 202-473-1062, fax 202-522-0304, Email: bpleskovic@worldbank.org.

Enterprise in Transition
May 27-29, 1999, Šibenik, Croatia

Organizer: University of Split.


Information: Faculty of Economics, Radovana 13, HR21000 Split, Croatia, tel. 385-21-362-465, fax 385-21-366-026, Email: eitconf@efst.hr, Internet: http://www.efst.hr/eitconf/.

Germany and the Baltic Countries in the New Europe: Experiences of One Decade of the New “Neighborhood”
May 28-30, 1999, Kiel, Germany

Organizer: Ostsee Akademie.

Language: German.

Information: Ostsee-Akademie, Travemuende, Europaweg 3, D-23570 Luebeck, tel. 49-4502-803-203/205, fax 49-4502-803-200, Email: ostseeakademie@t-online.de, Internet: http://www.balticnet.de/Ostsee-Akademie/Ostseeakademie-Info.html.

First ABCDE—Europe, 1999
June 21-23, 1999, Paris, France

Keynote addresses by Lionel Jospin, Prime Minister, France; James D. Wolfensohn, President, the World Bank; Joseph E. Stiglitz and Jean-François Rischar, the World Bank. Sessions include: The New Comparative Economic Systems (Roundtable: Mustapha Nabil, Oliver Hart, Jean Tirole, Katharina Pistor); Transition—First Ten Years (John Fleming); Market Organization (Roundtable: Ischer Aahuwalia, Masahiko Aoki, Assar Lindbeck); Poverty and Inclusion (François Bourguignon and Anthony Atkinson); Global Externalities (Domenico Sinscalco); and Closing: Dominique Strauss-Kahn and Oskar Lafontaine.


Fifth Annual CREEB Conference: The Impact of Transformation on Individuals, Organizations, Society
June 22-23, 1999, Chalfont St. Giles, England

Organizers: CREEB, Buckinghamshire Business School.

Information: Vincent Edwards, CREEB, Bucks College, Newland Park, Chalfont St. Giles, HP8 4AD, United Kingdom, tel. 44-1494-603159, fax 44-1494-874230, Email: creeb@buckscoll.ac.uk.

PHARE ACE Competition and Investment Summer Seminar
August 27–September 5, 1999, Vysoké Tatry-Podbanské, Slovak Republic

Organizer: PHARE ACE, and coordinated by the Center for Economic Development, Slovakia.

Topics: EU enlargement, Economic Competition, Foreign Investment.

Information: Mr. Luboš Vagaš, Center for Economic Development, Bajkalská 25, 827 18 Bratislava, Slovakia, tel. 421-7-5341 7026, fax 421-7-5823 3487, Email: lubovs@phr.sk.

The Baltics in Research and Teaching in Germany, Europe and North America
September 19-22, 1999, Kiel, Germany

Organizer: Ostsee Akademie.

Language: German.

Information: Ostsee-Akademie, Travemuende, Europaweg 3, D-23570 Luebeck, tel. 49-4502-803-203/205, fax 49-4502-803-200, Email: ostseeakademie@t-online.de, Internet: http://www.balticnet.de/Ostsee-Akademie/Ostseeakademie-Info.html.

We appreciate the contributions of the Cooperation Bureau for Economic Research on Eastern Europe, Koenigin-Luise-Str. 5, D14195, Berlin, Germany, tel. 4930-8977708-68, fax 4930-897789-99, Email: tribakova@diwberlin.de or dbowen@diw-berlin.de.
New Books and Working Papers

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

World Bank Publications


Working Papers


Empirical analysis confirms that trade openness has a strong positive impact on economic growth, leading to accelerated accumulation of physical capital, enhanced technological transmissions, and improvements in the quality of macroeconomic policy. The author uses data from a panel of 57 countries from 1970-89.

To order: Sarah Crow, Room MC4-706, tel. 202-473-0763, fax 202-522-2578, Email: scrow@worldbank.org.


Some major lessons of experience about fiscal reform in developing countries:
• Monetary policy is best entrusted to an independent central bank with a mandate for price stability.
• Fiscal rules accompanied by “gatekeeper” intergovernmental councils or committees provide a useful framework for fiscal discipline and coordination of fiscal policy.
• The integrity and independence of the financial sector contribute to fiscal prudence in the public sector.
• Societal norms and consensus about the roles of various levels of government and limits to their authority are vital to the success of decentralized decision-making.
• Tax decentralization is a prerequisite for subnational access to credit markets.
• An internal common market is best preserved by constitutional guarantees.
• Intergovernmental transfers in developing countries undermine fiscal discipline and accountability, and transfer dependencies cause a slow economic strangulation of fiscally disadvantaged regions.
• Periodic review of jurisdictional assignments is essential to realign responsibilities in accordance with changing economic and political realities.
• Decentralized fiscal systems offer more potential for improved macroeconomic governance than do centralized fiscal systems.

To order: Silvana Valle, Room G6-079, tel. 202-458-4493, fax 202-522-3124, Email: svalle@worldbank.org.


To order: PREM Advisory Service, Room MC4-501, tel. 202-458-7736, fax 202-522-1135, Email: premadvisory@worldbank.org.


Much attention has been paid to the relative vulnerability of two well-defined household groups during the transition. Some observers argue that old-age pensioner households have been relatively protected because of a less steep decline in real pensions compared with wages in most transition economies. By contrast, households with young children are believed to have experienced a substantial decline in living standards under reform and show strikingly higher rates of measured poverty than pensioner households.

But others argue that the elderly have suffered more than the young during the transition. Can these conflicting viewpoints about the relative poverty of old and young households be arbitrated? The authors show that strong—though implicit—assumptions underpin certain poverty comparisons. Notably, using a per capita measure of individual welfare assumes that there are no economies of scale in household consumption, in the sense that the per capita cost of reaching a specific level of welfare does not fall as household size increases. Relaxing that assumption could affect comparisons, showing higher poverty rates among the elderly because their households tend to be smaller than the households containing children.

Even the nature of transition has implications for economies of scale. The relative cost of housing and other goods and services with at least some public good characteristics has risen rapidly. These
relative price shifts hit small households particularly hard because a greater share of their expenditures goes to public and quasi-public goods. But, transition economies have also experienced big increases in the relative prices of goods and services consumed largely by children, such as kindergarten and other education services. These increases thus affect younger households more.

Since there is no accepted way to establish the true extent of economies of scale in a given country, the question cannot be answered exactly. But clearly a small departure from a per capita measure may be enough in some cases to overturn the conventional relative ranking of poverty headcounts; poverty among the elderly may then turn out to be worse than among children.

To order: Patricia Sader, Room MC3-632, tel. 202-473-3902, fax 202-522-1153, Email: psader@worldbank.org.

Other World Bank Publications


Global Commodity Markets, a quarterly.

Beginning in January 1999, Global Commodity Markets will provide readers with greatly enhanced and more timely information on 46 primary commodities, together with analytical special features, regional price indices, information on transportation costs, and a macroeconomic overview. Global Commodity Markets will be published four times a year (January, April, July, and October). Each issue will be available in print and electronic form.

Over the past three years the World Bank has lent approximately $550 million for textbook components within education projects. This volume is based on the proceedings of a seminar titled "Understanding the Educational Book Industry," organized by the World Bank in 1997 in Washington, D.C. It deals with such issues as policies for the provision of educational materials; growth of the publishing industry in developing countries; procurement, protection, and copyright; and longer-term solutions.


The International Finance Corporation (IFC), the private sector arm of the World Bank Group, represents the world’s largest multilateral source of debt and equity financing of private sector projects in developing countries. IFC recognizes that the private sector operates under certain constraints, which at times make public consultation and disclosure particularly sensitive and complex. The manual is based on practical experience from current IFC activities and from other examples of international good practice for public involvement and consultation in private sector projects. It is tailored to assist companies working in developing and emerging economies.


The application of the guidelines set out in this book can minimize the use of resources as well as reduce the quantity of wastes requiring treatment and disposal. The guidelines are designed to protect human health, reduce discharge of pollutants into the environment, use commercially proven and cost-effective technologies, follow regulatory trends, and promote good industrial practices. These guidelines represent good environmental management practices, which can be achieved and maintained with the levels of skills and resources typically available in countries in which the World Bank operates.


Following the heady days when communist regimes in Central and Eastern Europe (CEE) were crumbling one after another, international support was mobilized to help guide the region’s journey toward the free market. As experience with the economic reform agenda began to accumulate, the centrality of the state’s role in helping to formulate and implement reform grew increasingly evident. This publication aims to present an accurate, empirical picture of recent trends in CEE administration. It focuses on the three priority items on CEE countries’ administrative agendas: restructuring the machinery of government, reforming government pay and employment practice, and developing a politically neutral, professionalized civil service.


Microfinance is not simply banking; it is a development tool. It has been estimated that there are 500 million economically active poor people in the world operating microenterprises and small businesses. Most of these people do not have access to adequate financial services. The purpose of this handbook is to bring together in a single source guiding principles and tools that will promote sustainable microfinance and create visible institutions. The handbook takes a global perspective, drawing on lessons learned from the experiences of microfinance practitioners, donors, and others throughout the world.


IMF Publications


High capital mobility could cause instability in current accounts. Therefore, macroeconomic policy, if it wants to restore external balance, must deal directly with capital inflows. Nominal exchange rates should be made sufficiently flexible to avoid inconsistencies between short-run and long-run real exchange rates; credit tightening should be complemented by fiscal restraint to reduce interest rate differentials; and surveillance of the financial
system should be strengthened to prevent banks from excessive risk-taking.


*Bundesinstitut für Ostwissenschaftliche und Internationale Studien* Publications


*Asian Development Bank Publications*

To order: Asian Development Bank, Information Office, P.O. Box 789, 0980 Manila, Philippines, fax 632-636-2648, Email: adbpub@mail.asiandevbank.org.


Children in Central Asia are currently experiencing an enormous deterioration in what were once constants in their everyday lives. Transition deprives them of a comprehensive social safety net, free education, nourishment programs, cultural enrichment activities, socialized health care, and guaranteed employment upon reaching young adulthood. Before transition, child development indicators in Kazakhstan and Kyrgyzstan were comparatively high in relation to other countries. Some problems existed, especially pertaining to environmental degradation and its direct effect on children's health; but over the past five years, the difficult processes of creating a market have opened an enormous societal gap into which children have been the first to fall. In spite of the high regard for children in the Central Asian societies, the transition has had devastating effects on many families due to widespread unemployment, an eroding education system, debilitating communicable diseases, collapsing infrastructure, and general impoverishment.


*Center for Social and Economic Research (CASE-CEU) Publications*

To order: CASE-CEU, Bagatela 14, 00-585 Warsaw, Poland, tel. 4822-628-0912, fax 4822-628-6581, Email: case@case.com.pl.


In the countries of Central Europe and the former Soviet Union, the quantity and quality of human capital is similar to what the successful emerging economies of East Asia, Western Europe, and Latin America have or had—at similar levels of GDP per capita. International statistics suggest that the growth rates of such economies can be high, provided the macroeconomic environment is stable and the microeconomic environment is liberal and competitive. In the decades since the 1950s, the bulk of Latin American countries have, for the most part, failed to create such an environment. The CE and FSU countries thus know which model they should not follow. On the other hand, the East Asia model relies on a specific culture that limits social transfers to very low levels, and therefore, also limits the tax burden. This has helped to vigorously lift national savings. But that model may prove difficult to adopt by countries that developed and for several generations operated according to the culture of a large welfare state.


CASE Studies and Analyses Publications


CEES Publications

To order: Centre for European Economic Studies, Department of Economics, University of Leicester, University Road, Leicester LE1 7RH, United Kingdom, tel. 44(0)116-252-2757, fax 44(0)116-252-2908, Internet: http://www.le.ac.uk/economics/research/cees.html.


CEPR Publications

To order: Centre for Economic Policy Research, 90-98 Goswell Road, London EC1V 7DB, United Kingdom, tel. 44-171-878-2900, fax 44-171-878-2999, Email: cepr@cepr.org.


Having pegged its exchange rate since the outset of reform in 1991, the Czechs were finally forced to abandon the peg in May 1997. What lessons does this episode contain for the design of macroeconomic policy? One interpretation is that the koruna was the innocent victim of turmoil in Asia. This neglects the deterioration of competitiveness prior to the crisis. This crisis provoked a much-needed adjustment in fiscal policy, which altered the monetary-fiscal mix and consequent equilibrium exchange rate. Sterilization during 1994–96 unhelpfully delayed adjustment. Earlier abandonment of the parity would have helped only if it had also induced the required fiscal adjustment.


European Economic Perspectives [Special Issue]


EBRD Publications


Recapitalization should be made explicitly conditional on liquidations of
nonperforming loans. Ideally, recapitalization should not take the form of purchases of preferred stock or subordinated bonds. Of course, it may not be practical or feasible to set up such a conditional scheme on short notice following the outbreak of a banking crisis. This is why the authors advocate the institution of bankruptcy procedures for banks in anticipation of future banking crises.

Greenwood Publishing Group Publications


Wirtschaft im Wandel Publications

To order: Institut fur Wirtschaftsforschung Halle, Deitlischer Strasse 118, 06116 Halle, tel. 0345-775-3701, fax 0345-775-3820, Internet: http://www.iwh.uni-halle.de.


Other Publications

To order: Katy Wight, Edward Elgar Publishing Inc., 6 Market Street, Northampton, Massachusetts 01060, United States, tel. 413-584-5551, fax 413-584-9933, Email: kwight@e-elgar.co.uk, Internet: http://www.e-elgar.co.uk.


To order: Michelle Gahan, 179 Queen Victoria Street, London EC4V 4DD, United Kingdom, tel. 44171-248-0458, fax 44171-248-0467, Email: busmon@dial.pipex.com.

To order: Grove’s Dictionaries Inc., 345 Park Avenue South, 10th Floor, New York, New York 10010, United States, tel. 212-689-9200, fax 212-689-9711, Email: grove@grovereference.com.

To order: European Center for Peace and Development (ECPD) of the United Nations University of Peace, 11000 Belgrade, Terazije 41, tel. 38111-3246-041, fax 38111-3240-673.

Katarina Ott, Tax Administration Reform in Transition: The Case of Croatia, Occasional Paper Series no. 5, Institute of Public Finance, Belgrade, Terazije 41, tel. 385-1-481-9363, fax 385-1-481-9365, Email: used@iif.hr.

To order: Poverty Research Unit, School of African and Asian Studies, University of Sussex, Falmer, Brighton BN1 9QN, United Kingdom, tel. 44-1273-678-739, fax 44-1273-623-572, Email: PRU@sussex.ac.uk.

Special Publications


To order: Sodertorns Hogskola, Box 4101, S-141 04 Gyddubge, Sweden, tel. 468-5858-8059, fax 468-5858-8080, Email: Victor.Pestoff@sh.se.
Bibliography of Selected Articles

Postsocialist Economies


Asia


Central and Eastern Europe


CIS


As our readers will notice we have changed our partners in Kyiv, Ukraine. As of August 1998 the Russian version of the Transition Newsletter is being printed and distributed by the International Center for Policy Studies, a newly established, dynamic and competent think-tank under the directorship of Vira Nanivska. We would like to express our gratitude to the International Center for Privatization, Investment and Management, our partner for the past two years. Special thanks to President Henryk Stermiczuk and Director Volodymyr Zabolotny for their groundwork in establishing Transformatziya and making it a permanent feature in the CIS and Baltic countries. For a free subscription to the Russian language version of Transition, write to:

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We are pleased to announce that starting with the newsletter’s first issue in 1999 we will be able to provide an electronic version to those who wish to receive it by Email.

Please send your Email address to:

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We appreciate the continuing support of:

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