Lending to Russia: A New Challenge to the World Bank
Interview with Managing Director Earnest Stern

History's bitter irony is that the Soviet Union did not exist long enough to be able to join the very organizations it helped to create. Initially a major player in establishing the World Bank and the International Monetary Fund at Bretton Woods (1944), Stalin abruptly changed his mind and declined to ratify the Articles of Agreement. He and successor Soviet leaders consequently labeled the Bretton Woods institutions as tools of Western imperialism. It was Mikhail Gorbachev who revised this initial policy and finally forwarded the Soviet application on July 15, 1991. But it was too late. While the Soviet request was being considered in Washington, the applicant ceased to exist—the Soviet Union disintegrated in December 1991.

The three Baltic countries and twelve other successor states of the former Soviet Union joined the World Bank by mid-1993. Having added other new member nations from Central and Eastern Europe, the World Bank has truly become a "bank to the world," a genuinely global institution. Can the World Bank take advantage of this historic opportunity and help mobilize adequate resources—both human capital and investment—in order to accelerate the transition process of the postsocialist economies? What are the lessons of experiences so far? Transition editor Richard Hirschler interviewed Managing Director Ernest Stern, whose responsibilities include overseeing the Bank's work in the countries of the former Soviet Union.

Q. Can the World Bank rely on its existing lending instruments to assist Russia and the other states of the former Soviet Union? The Bank, which had traditionally provided project loans, introduced structural and sectoral adjustment loans in the 1980s to help countries deal with the debt crisis and major changes in the international economy. By promoting far-reaching structural reforms in developing countries, the Bank shifted

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emphasis from specific projects to macroeconomic and sectoral issues. You were a leader in that shift. Are similar changes in the Bank's lending operations required now?

A. In the early 1980s—after the oil price increase, the change to deflationary policies in the OECD countries, and the onset of the international debt crisis—many of our borrowers needed support. It became increasingly clear that the policy framework in these countries was not sustainable without unrealistic assumptions of ever-increasing flows of external capital. The World Bank's response was to help identify the major structural problems, develop reform programs, and provide quick-disbursing funds to finance implementation. The purpose of all these reform programs was to increase the incentives for efficiency and productivity, so that countries would be less dependent on external capital and able to compete at home and internationally. Although the World Bank had been doing regular macroeconomic reports, there had been little linkage between the economic analysis and the lending program. Because we were project-based, we tended not to take adequate account of the macro or sectoral policy framework, even though we knew that projects were not likely to be effective in poorly performing countries. The big change for the Bank was to become engaged in the discussions of the policy and structural changes required in countries and to link these directly to financing of reform programs. And, I should add, to monitoring of the policy and institutional changes.

We now have a range of lending instruments, and the required technical skills, to help countries in transition to market economies. We can provide loans for a wide range of development activities, ranging from infrastructure to health services, from manufacturing to educational systems. The present spectrum of lending instruments—from investment to adjustment loans, plus our guarantee capacity—is adequate. But we will need to continue to be creative in blending these instruments. And, of course, our lending to each country must be tailored to its specific reform program.

Q. If the necessary lending instruments are available, what specific issues have to be considered in lending programs for the countries of the former Soviet Union?

A. There are several issues:
- The political systems are not really in place to develop or articulate a national consensus on the desired economic strategy.
- These countries had a highly planned, centralized approach to managing their economies; so the institutions necessary for the proper functioning of a market system do not exist. It will take time to build those institutions. With the disintegration of the Soviet Union and the emergence of national boundaries, trade between the new countries has collapsed, real demand has dropped, and the financial system to facilitate transactions is weak.
- Most of these countries have a highly educated labor force—intellectually on par with the OECD countries in many areas—but they suffer from serious deficiency in both management and organizational ability.

Q. You had the chance to meet Victor Chernomyrdin, the Russian Prime Minister, early in September. Since your meeting, how do you see the situation in Russia?

A. I met with the Prime Minister for only half an hour, so I do not think we should attribute our understanding of the Russian economy to that meeting. As you know, we have a large field office in Moscow, a constant flow of missions, and an intensive dialogue with our Russian colleagues. In Russia, there is high-level conflict over the constitutional form of the government. This hinders decisionmaking, both domestically and for external investors. Views also differ, even between reformers, on the type of reform to implement, how fast to go, the sequencing, what to do about large-scale enterprises, about land ownership, and the like. That has meant that initial rapid changes—price liberalization, issuing privatization vouchers, introducing an auction system for foreign exchange—have not been followed up with the same attention to the institutional infrastructure. Reform of the legal framework, the regulatory agencies, the capital markets, and banking structure are of fundamental importance. The judiciary needs to be strengthened, since it must now deal with an array of commercial issues it has not had to deal with before. Organizations to regulate markets and financial institutions are needed as well.

Q. During the April meeting in Tokyo, the G-7 said that they welcomed the IBRD's willingness to provide to Russia, over the coming fifteen months, up to $4 billion of new commitments in the form of loans to support investment, the strengthening of institutions, and reform in several key sectors, such as housing, energy, and agriculture. Now, almost six months later, it seems to be a long shot.

A. It is too early to tell. A number of loans are in the design stage: a second oil loan, a second rehabilitation loan. Other loans in the pipeline would support the banking system, help implement the privatization effort, improve the social safety net, and so forth. But the process of working out all the components of the loans takes a long time in Russia. So the pace certainly has been slower than we, or anyone else, anticipated. Whether that $4 billion loan commitment will be approved in fiscal 1994–95 depends
on whether the preparation process can be accelerated. Although loan preparation has not slowed down, the pace with which loans actually become available also is slower than anticipated. For example, in December 1992 the Board of Directors approved a loan to support privatization in Russia. That loan is still not effective. It took a long time to work out the details of the first $610 million oil loan to upgrade oil wells in Western Siberia. It was approved by the Board of Directors in June, although we had initially hoped to do it a year earlier. It, too, was still not effective by September 15.

Q. If the disbursement process slows down, reformers in the post-socialist countries are going to lose political battles to their opponents. The reformers need proof that the international financial institutions are on their side. But the Bank does not want to pour money into a bottomless barrel. How can you solve that dilemma?

A. Economic transformation and reform certainly has its political dimension: reformers have to survive. People have shown themselves willing to bear hardships during the transformation process. But they also want to see concrete signs of change and improvements in such basics as essential consumer goods, food, shelter, and jobs. And they need some evidence that their future will be better than the present—or the past. The World Bank is conscious that governments are under pressure to respond expeditiously to the expectations of people. Our objective is to help them do that. In many of these countries, we have started with a Rehabilitation Loan, which supports implementation of reform measures and helps provide urgently needed imports of production inputs, as well as consumer goods. We have supported the stabilization programs that are fundamental to resumption of growth. We are working to improve the social safety nets so that they can provide effective assistance to people, as the responsibility for social services shifts from public enterprises to municipalities, provinces, or the central government.

And, of course, we are financing projects in the productive sectors—from agriculture to oil and gas. So, I do not believe the reformers need be concerned about lack of support from us. The record is pretty clear. Sound reform programs, which are implemented effectively, have been able to attract adequate external support.

Q. What do you think of Mr. George Soros's idea to take advantage of the low exchange rate of the ruble and, for a relatively small amount of dollars and German marks, raise enough rubles to pay social welfare to Russia's needy?

A. I think Mr. Soros knows better than almost anybody, that if you start buying large amounts of rubles with foreign exchange, the rate will not stay low for very long. I think this suggestion falls in the category of providing support to the reformers, and that is important. And the social welfare requirements in Russia will be substantial. But, of course, there is no reason why a country like Russia could not manage its own social security system. However, there is a real problem caused by the transition. Many social responsibilities have been met by the public enterprises. And as those enterprises shrink or are privatized, the public social security system is exposed to a tremendous burden, which it was not designed to bear. Data shows that an increasing percentage of the Russian population live in poverty, with poor nutrition and inadequate health services. In response, the World Bank is preparing a social safety net loan, which would cover a range of reforms, including pensions and health benefits. One of the first loans we made was a $70 million loan to strengthen employment services and social protection.

Q. Do you think that organizational changes will be necessary within the World Bank, if lending operations continue to increase to countries of the former Soviet Union?

A. The organizational structure has already changed. Certainly, when you have a sudden infusion of new members, with plans for substantial lending programs, the responsible departments need to grow in terms of resources and staff. We have increased available resources considerably in the last two fiscal years, and the structure of the Region has changed as the work has expanded.

Q. Will field offices in Russia, but also in other countries of the former Soviet Union, get further allocations of staff and resources?

A. As our lending activity and dialogue with Russia expands, the Moscow Office also is likely to grow. As we shift from the issue of the macroeconomic policy framework to sectors and specific investment projects, the staff required locally also will change as the office's responsibilities increase. Similarly, in the other countries, the size and responsibilities of the field offices will be driven by the work program.

Tough Start in Fiscal 1993

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<thead>
<tr>
<th>Country/loans</th>
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<td>Russia</td>
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<td>Belarus a</td>
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<td>Latvia</td>
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<td>Lithuania</td>
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<td>Moldova</td>
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<td>Ukraine</td>
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<td>Total</td>
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Q. Some critics claim that the Bank, perhaps inadvertently, tries to implement a grand design for a market economy in the transition economies, regardless of their unique social and political circumstances. Do you agree?

A. No, there is no grand design. There are some basic principles, but the specifics of their application depend on the conditions in each country. Of course, we have a problem at the Bank, for the simple reason that these countries are very new to us. It is a learning process, for us and for our members as well. I think we have made good progress in understanding their economies and social structures, but there still is much to be learned. There also is a problem of scale. The size of any operation in a country such as Russia or Ukraine is likely to be large relative to the average size of our loans. But operations in these countries should be compared to those in other large countries such as India and China, where the size of the loans is also well above the average. Regardless of the size of a loan, the lending program must be worked out in detail with each borrower to support its priority areas for reform. And, you will find that the approach to specific issues varies from country to country, as it should.

Russia’s Withdrawal Syndromes in Currency Reform

The Russian Central Bank’s end-July surprise, ordering the withdrawal of all pre-1993 banknotes, has been in many ways comparable to former monetary reforms in the postwar Soviet Union:

- In 1947 all banknotes that had been in circulation before and during World War II were withdrawn. Holders of cash and deposits were allowed to swap only a small portion of their assets for the new ruble notes.
- In 1961 ruble notes were reformed—one zero was cut from the nominal value—to simplify currency circulation. During a transition period of several months both the old and the new banknotes were in circulation. Consumers were skimped nevertheless through the rounding of prices.
- In 1991, under the “Pavlov reform” (named after the former Soviet Prime Minister who six months later participated in the ill-fated coup), all 50- and 100-ruble notes were withdrawn from circulation. (A total of 51.5 billion rubles were replaced, that is, 39 percent of all banknotes held by the public.) As a rule, people were given three days to swap their money.

The above measures were characterized as reforms that were necessary to streamline prevailing monetary policy, and to “counter the flourishing tzaars of the criminal world, as well as defeat counterfeiting” (changes raised in 1947); or, in Pavlov’s words, “to invalidate the piles of bills accumulated in the foreign banks for subversive purposes.” The authorities, meanwhile, wanted to regain control over the citizens’ cash flows, and to accomplish this, confiscation has been the name of the game. (Enterprise deposits, held in a few state-owned banks, were already under rigid control.) The authorities also wanted to penalize the informal sector, which used cash in most transactions. Currency reform was considered a handy tool to disrupt that sector’s operations.

The reform of 1993 also had its confiscatory elements when the Central Bank suddenly announced that all pre-1993 banknotes were to be withdrawn from circulation. Russian citizens were permitted to exchange up to 35,000 rubles for new bills, were given only two weeks to do it (by August 7), and were required to deposit their excess cash in accounts at Russian Savings Bank at low interest rates. (The frozen savings deposits were expected to lose much of their purchasing power because of the 20 percent monthly inflation rate.)

In response to public outcry and the critical reaction of the international finance community, President Yeltsin intervened and softened the original terms; the replacement ceiling was increased to 100,000 rubles, and the bill exchange deadline was extended until end-August. Nonetheless, the basic features of the original reform remained unchanged. As of August 3

Currencies in the former Soviet Republics, July 1993

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<tr>
<th>Country</th>
<th>Currency</th>
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<tr>
<td>Armenia</td>
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<td>Azerbaijan</td>
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<td>Kazakhstan</td>
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<td>Moldova</td>
<td>Russian ruble and Moldovan coupon</td>
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<td>July-August 1993</td>
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<td>Turkmenistan</td>
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<td>Uzbekistan</td>
<td>Russian ruble and Uzbek coupon</td>
<td>(plans to introduce sum by end of 1993)</td>
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Source: Russian business weekly, Kommersant.
about half the old bills had been traded in for new banknotes, and the rest were deposited in savings accounts. (According to Russia’s Central Bank, of the 6,000 billion rubles in circulation at end-July, only 1,000 billion rubles were in old notes or about 17 percent of the total.) Indirectly this reform has also penalized the burgeoning, still cash-sensitive private sector. Charges of counterfeiting were also raised.

Cash and short-term commercial deposits at Russia’s Central Bank (M0) constitute only a relatively small part of the narrowly defined money supply (M1, which equals M0 plus the demand deposits of the population in commercial banks). By May 1993, M0 made up only 25.3 percent of M1, only slightly increased since March. The swap could hardly contribute to a more equitable redistribution of wealth; the lessons of consequent ruble reforms demonstrate that the victims of these measures are usually the average-income households, while the nouveaux riches are able to hedge against such surprise measures.

What, then, was the primary goal of the 1993 ruble swap? Apparently it was to take another step in isolating Russia’s monetary policy from that of other states of the former Soviet Union (FSU), reduce inflationary pressures, and deliver a further blow to the cumbersome mechanism of the ruble zone. The ruble zone—with its lack of common monetary, fiscal, and trade policies—had caused strong inflationary pressure in Russia and in other countries of the Commonwealth of Independent States (CIS).

In 1992 states of the FSU agreed to open correspondent accounts in the Russian Central Bank to monitor noncash ruble transactions. This time the cash circulation of rubles been dealt with.

In late August representatives from Armenia, Kazakhstan, Russia, and Uzbekistan, signed an agreement to create a new type of ruble zone. The agreement seems to envision a gradual transition to unified monetary, fiscal, and trade policies. Belorus and Tajikistan are other possible candidates for the new ruble zone. The document comes on the heels of a declaration of intent to form an economic union between Kazakhstan, Russia, and Uzbekistan, signed earlier this month. Some of the countries, however, have had second thoughts about introducing their own currencies as an alternative to entering the new ruble zone. Kazakhstan has restricted currency transactions with the rest of the CIS, and announced plans to introduce its own currency, the tenge, by the end of 1993. In Belarus the Central Bank favors the creation of a new currency, while the government wants to join the economic union.

Quasi-dismantling of the ruble zone has created an opportunity for Russia to introduce mutual discipline into its monetary and trade relations with partners in the CIS. However, it could also complicate policy coordination and settlement of debates among CIS partners that have their own currencies. And it will require coordination of economic policy. Thus, currency reform in Russia, although it stimulates centrifugal forces in the ruble zone, has not been able to address the fundamental issue of working out new mechanisms for mutual economic relations in the CIS.

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From the Russian business weekly, Commercsant.
Environmental Cleanup in Eastern Europe: A Down-to-Earth Assessment

In 1991 European environment ministers met at Dobris Castle near Prague to discuss steps toward equalizing environmental conditions in the East and West. Two years later, in late April 1993, they met again in Lucerne, Switzerland to endorse a comprehensive action program that spells out how such a process could occur.

The great achievement during those two years was not the preparation of the action program. Rather, it was the shift in understanding—the building of a consensus—of how it might be possible to achieve the greatest possible environmental improvement with the resources available. It was also a recognition that improvements in the environment are rooted in economic and social change, not in isolated investments.

Attendance at the Lucerne conference reflected the new paradigm; not only were environment ministers from fifty countries represented, but many senior finance, economic, and sectoral ministry officials also attended, especially from the nineteen Eastern European countries covered by the action program.

Rethinking Ambitions

At the 1992 Earth Summit in Rio de Janeiro, the world was presented with a bill for environmental cleanup and improvement amounting to some $125 billion a year. In contrast, the program endorsed at the Lucerne conference did not present bills that might never be squared. Instead of offering a detailed blueprint for what must be done, it spells out—using practical examples—how economic and sectoral policies and investments can best contribute to environmental improvement.

The report offers criteria for choosing priorities and draws attention to the need to think carefully about problems and solutions. Experience in the wealthiest OECD countries suggests that solutions often do not address the real problems. What should be the measure of success: the amount of investment in air or water pollution control, or a cleaner environment?

The program was prepared by the World Bank, with the OECD as part of a task force chaired by the EC Commission. The 350-page conference document is currently being edited and revised and is to be formally published toward the end of the year, along with a series of comprehensive technical reports on issues such as liability, health, and sectoral and local expenditure priorities that relate to the environment.

In the meantime, a task force has started preparations for the next ministerial conference, which is to take place toward the end of 1995 in Sofia, Bulgaria. Participants are eager to coordinate their activities, and to discuss ways of developing innovative project ideas. At the Lucerne conference, some eight donors and the EC Commission pledged $30 to $50 million in grant funds over the next two years to support better project identification and preparation, as well as numerous small, tangible investments that would generate immediate environmental benefits.

Studies Built on Sand?

Many in Eastern Europe complain that the opening to the West has produced nothing but papers: options studies, prefeasibility studies, feasibility studies, risk analyses, and so on. Add to that a flood of Western consultants offering Western-style advice that is mostly irrelevant in the turbulent social, political, and economic situation in most Eastern countries, and the outlook seems bleak. In the area of environment—as in many other areas—relatively little money and skills have actually found their way to where they are needed most.

"Could it be," as Vice President Thalwitz of the World Bank explained at the Lucerne ministerial conference, "that the studies didn't ask the right question—that they proposed expensive solutions to meet the highest standards, that the money for this was not available, and that studies become the sand into which to bury our heads?"

The Real Things

The program presented at Lucerne argues that new questions need to be asked: What are the environmental problems that need to be addressed first? And how much improvement can be achieved in view of available means and differing costs? Taking a systems approach and applying economic incentives—as has been the practice in the power and transport sectors—will go a long way toward finding efficient solutions to real problems.

First, investments should not be made where economic or environmental policies are likely to achieve the same result at lower economic cost. Economic policies—above all the removal of subsidies that encourage the excessive use of fossil fuels and water in industry, agriculture, and households—that offer the most efficient mechanism for addressing environmental problems. Many Eastern European countries have already made strides in raising energy prices. There is no question that making further adjustments will be difficult. Rather than give up, however, progress should be sustained, if necessary, with transitional assistance to vulnerable enterprises and households that bear the brunt of adjustment.
Some old and highly polluting plants will be allowed to continue operating because introduction of new, cleaner technologies cannot be economically justified—or because of the risk of unemployment and other social costs of closure. Environmental investments may therefore be necessary to mitigate conflict between economic, social, and environmental considerations, or to speed up the response to economic or environmental policies.

Evidence suggests that improving the environmental performance of old plants will contribute most to achieving a continuous decline in total emissions in the next five to seven years. It is possible, however, to insist that such plants improve their environmental performance without committing significant amount of investment.

**Small is Beautiful**

Small environmental investments, those that cost well under $1 million, can often achieve much greater environmental benefits—for each additional dollar spent—than large investments. Expenditures on good industrial housekeeping and minor plant improvements that reduce spills, leaks, and material use are justified on economic and even narrow financial grounds, but also have major environmental benefits.

For such investments to be undertaken, however, material and energy prices must be high enough to provide an incentive, foreign exchange must be readily available to enterprises, and the traditional central planning behavior must be overcome. On the donor side, banks must find innovative ways of supporting projects that consist of small but efficient investments.

**Learning by Doing**

If in some cases there is a need for larger projects, those investments should be split into several steps that can be phased in over a period reflecting financial and other resource constraints. Limited initial investment can bring significant environmental benefits, and plans can be made to increase investment when it is justified economically. An important aspect of these staggered investments is that they must be evaluated in a framework that looks at the large picture—that is, that assesses the most efficient way to achieve environmental improvement in a river basin as a whole rather than focusing on each investment in isolation from other potential measures.

All these ideas have important implications for the way bilateral and multilateral institutions do business in Eastern Europe. Eastern Europeans may have to learn about Western-style economic management, but Western institutions also need to learn how to offer advice and assistance that meets the needs of their clients. In the end, most of the money spent on environmental investments comes from the Eastern European countries themselves.

**Richard Ackermann**

*Environment Division The World Bank*

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**How to Think Big and Still Spend Less**

**Polish air cleanup:** To achieve the improvements in air pollution emissions currently mandated by Polish law, and to match the equivalent of EC standards for vehicle emissions over the next twenty-five years, would cost an estimated $1.45 billion annually. A World Bank study calculates that an approach involving emissions taxes would reduce the costs of achieving the same target to $650 million a year. The potential savings for air pollution control alone—$800 million a year—is more than twice as much as Poland’s projected power sector development program (10,000 megawatt power capacity over twenty years).

**Hungarian water treatment:** Szeged, a town of 180,000, currently has no municipal wastewater treatment system. Plans call for a technologically advanced treatment plant, with a total investment cost of $80 million. However, local and regional water quality improvements would be small because of the nature of the receiving water. While it might be politically difficult to justify no investment, it is possible to design a sequence of actions over the next ten to fifteen years that imply capital cost savings of at least $40 million, or almost double this amount in net present value terms.

**The legacy of central planning:** Abandoning central planning has proven easier than learning to identify, prepare, appraise, and implement policies in a decentralized manner. For many officials in Central and Eastern Europe (CEE), the routine of centrally controlled resource allocation is so entrenched that ministries often continue to design investment programs in the hope of obtaining financial support from the West. In some cases, Western donors have tended to reinforce old habits, especially in their support for environmental projects.

Donors do not grasp how the habit of central planning continues to influence behavior today. And CEE authorities have difficulty comprehending arcane aspects of financing and procurement common in the West. Decisions on resource allocation tended to be subjective and politically motivated, and took little notice of efficiency and performance quality. Because of a soft budget approach and the scarcity of equipment, materials, the investment pattern was characterized by:

- Easy access to finance.
- Rapid project design (with few studies, typically amounting to less than 5 percent of project costs).
- Slow implementation.

Implementation delays often led to incomplete projects being prematurely put into operation. Subsequent deficiencies in operation and maintenance resulted in proposals for new investments to solve accumulated problems. Often it was easier to launch a new investment cycle than to improve the performance of what already existed.
Targeting Economic Growth while Fighting Inflation
Interview with Victor Orban

The approaching parliamentary elections in Hungary, planned for next May, already influence economic policymakers. While recognizing the strenuous efforts of the Hungarian government to stabilize the economy and eliminate the huge fiscal deficit, we believe that our readers are entitled to learn more about the economic strategy of the FIDESZ— the Alliance of Young Democrats (AYD)—who currently lead in the opinion polls in Hungary. Victor Orban, president of the AYD recently outlined a draft program to Transition editor Richard Hirschler.

Q. What is the centerpiece of the AYD economic program?

A. We would like to see economic growth return to Hungary. In 1990, after forty years of a one-party system, the first democratically elected government took over. It seemed unlikely that three years later the Hungarian economy would still be going downhill, and that the slump would embrace all sectors of the economy. Concern about the economic performance is shared by all responsible political forces, including the government. Most agree that Hungary desperately needs economic recovery. The debate is more about the best methods to break the mold—and jump-start the economy.

Economic growth must have underlying financial stability. In the past three years the Hungarian economy was hampered by fiscal disequilibrium—a drastic rise in the budget deficit. This might have been worth the price, had it been a temporary sacrifice to achieve policy targets of transition—say, the channeling of public resources to the country’s ailing and underdeveloped infrastructure; or it might have been worth it to consolidate the financial sector. But while the budget deficit has grown tremendously, the former budget structure has remained basically unchanged. Economic recovery will be impossible without a complete overhaul of fiscal policy and reduction of the budget deficit.

Ambiguity in ownership issues must be eliminated, and transparent and stable property rights ensured. At present many of the state sector’s assets are losing value. This is one reason that, paradoxically, the private sector’s contribution to the growth domestic product (GDP) has increased relative to the public sector’s. The AYD will reduce the number of state enterprises that are to remain in the public sector, and increase the number to be privatized through a well-defined institutional mechanism. Our suggestion is to merge the State Assets Holding Company, which supervises state companies, into the State Property Agency, which manages the privatization process.

Economic policy must have clear direction. An economic super-minister heading a separate ministry could be in charge of all major economic policy decisions. Whether this Economy czar should be the Minister of Finance, or whether an economic super-ministry could function side-by-side with the budget office, is still under discussion. In any case, a well-defined hierarchical order in public management would help economic policymakers share responsibilities. The restructuring could be part of a wide range of public administrative reform, our way of reinventing government.

Inflation must be checked—a major task for 1994. We want to avoid any delay in fiscal reform, otherwise the budget deficit could generate another wave of accelerating inflation. There is no doubt that without fiscal and monetary discipline, inflation flares up, and fiscal equilibrium deteriorates.

Q. How can you target economic growth while checking inflation, which is already a major principal dilemma for the present government?

A. First, we assume a major increase in foreign direct investment (FDI) in Hungary, acknowledging that additional foreign resources will be necessary to stimulate growth in the economy. Increases in FDI can be assumed if the privatization process speeds up, and foreign investors sense that long-term economic programs are being implemented systematically, in a stable political environment. Specifically, development projects in infrastructure—roads, telecommunications—could be attractive to investors. In my view, no matter which government is at the helm in Hungary in 1994, it will have to spend substantial public resources on investment.

Lessons of foreign experience could be useful. For example, in Spain the government participated in several major investments with foreign companies and, after an initial phase of operation, sold off its stake. Germany’s Treuhand also had interesting experiences with privatization: they handed over state enterprises free of charge to private investors, who guaranteed investment and the preservation, if not the creation, of jobs. Ex-
Transitional methods will have to be tried, but this will require stable, long-term economic policy and a senior management that does not have to worry about abrupt changes, uncoordinated actions, and overlapping responsibilities.

Q. Although you seem to recognize the important role of the state in shaping the Hungarian economy over the next four years, your party, which has been labeled as liberal in the European sense, has always been sceptical about government efficiency. . . .

A. In reassessing our approach, we have had to admit that in Hungary's present circumstances even profitable businesses need government support to increase their market share abroad. Markets in the countries of the former Soviet Union, for example, are of major importance to Hungary, and interested private companies should be given support to help them regain their once-strong positions there. We also propose a reorientation of Hungary's diplomatic representations abroad; they should be more business-oriented, with greater focus on promoting Hungarian trade and economic interests. Less emphasis might have to be placed on fulfilling a cultural mission, even though this is important—painful choices are imperative in the present situation.

Q. Increasing the government's role will require additional financial resources. On the revenue side the AYD has already pledged not to increase taxes or social contributions. On the expenditure side there are increasing financial obligations that have arisen from the increase in government debt, deteriorating social conditions that must be addressed, the need to support major investment with public money, and so on. Could the economic maneuvering space become so narrow that economic policy will be predetermined, no matter who is managing it?

A. Three years ago Hungary's foreign debt reached such a high level that any additional borrowing would have involved substantial risk. The government—after weathering the foreign debt crisis—issued bonds on the domestic market, which were purchased by the state-owned commercial banks. Through issuing securities, banks and other financial institutions mobilized private savings, which indirectly also financed the fiscal disequilibrium. If only those funds had been used to implement long-overdue reforms. . . . Instead they maintained the inefficient, un-targeted social safety net of the previous regime.

Issuing more and more government bonds will crowd out private investors, and treasury interest rates are bound to increase. Besides, the government’s yearly interest payment obligation is increasing each year. True, the economic maneuvering space of the next government will be much narrower, due to the domestic indebtedness.

In our program we foresee a reorientation of social expenditures; social support should be curtailed for those on welfare without making any efforts to break from their situation, and even should be eliminated for those who belong to high income categories, but through the family allowance, child care aid, and so forth, obtain additional income from the budget. On the other hand we should support those who make extra efforts to get rid of social welfare, through contributing more to training and retraining. We also need to increase expenditures on education and vocational training. Reform of the social system will not be popular, although we have no other options, but to rationalize budget expenditures.

Q. How can you convince voters that an austerity program will serve their best interest?

A. We have to demonstrate that we mean business; that the public administration have to be lean, have to cut back expenditures, have to get rid of all kind of waste. Also, we plan to negotiate with representatives of the employers and employees on a social pact, a Hungarian “Moncloa Pact.” A wide-ranged national consensus is a major precondition for launching an economic recovery program in Hungary in 1994, which in turn would lift Hungary out of the present economic abyss.
Price liberalization is a cornerstone of reform programs in the transition economies of Eastern Europe, where since 1989 70 to 90 percent of prices had been liberalized. Unfortunately, inflation is eating up the purchasing power of wages in these countries.

Although declines in purchasing power have proved to be a common—and, one hopes, temporary phenomenon—wage earners have felt the pinch to varying degrees depending on the country in which they work and spend.

The required work hours to purchase the same goods and services differ widely in the countries of the region, the FSU included (see table). These differences are explained in part by variations in the development of inflation.

Ukraine, for example, boasts an impressive annual inflation rate of 4,000 percent. Russia trails not far behind, with more than 2,000 percent inflation. And Romania is is no slouch either, with three-digit inflation “performance.” Inflation in Bulgaria, Hungary, and Poland was also strong in 1991 and in 1992, but has lost steam in recent months.

Inflation develops differently in post-socialist economies, depending on the country’s speed in overcoming supply shortages and in dismantling state subsidies; the extent of import liberalization; the sophistication of wholesale trade; the progress of retail trade privatization; and so on.

Another reason for the disparities in purchasing power among the post-socialist economies is the difference in wage development. Much has depended on the bargaining power of the unions, the political and economic standing of the governments, and their capacity or willingness to compensate the public for price increases.

For example, average gross industrial monthly wages range from $286 in Hungary, to $80 in Romania, and $8 in Ukraine.

National wage levels differ not only in nominal value, but also in purchasing power, expressed in work hours. While a Russian has to work an hour for a liter of milk, his Polish counterpart works only fifteen minutes for the same purchase. In Prague a roll from the bakery costs two minutes of labor, in Bucharest twelve minutes.

An average wage earner in Warsaw has to work a week to buy a domesticaly made suit, while his colleague in Kiev, Ukraine works two months to buy the same outfit. A kilo (about two pounds) of ground beef requires thirty hours of work in Moscow, sixteen hours in Sofia, and just two hours in Warsaw.

The Hungarian wage earner can buy a package of Marlboro cigarettes in exchange for forty-five minutes of work, while in Slovakia, Bratislava even domestic cigarettes are more expensive when measured in working minutes.

Excerpts from a recent article, “Prices and Wages in Eastern Europe,” published in the Hungarian economic magazine, World Economy Weekly (HVG).

Comparing East European Purchasing Power

<table>
<thead>
<tr>
<th>Product</th>
<th>Bulgaria</th>
<th>Czech Republic</th>
<th>Poland</th>
<th>Hungary</th>
<th>Russia</th>
<th>Romania</th>
<th>Slovakia</th>
<th>Ukraine</th>
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<tbody>
<tr>
<td>Milk (1 liter)</td>
<td>0.44</td>
<td>0.18</td>
<td>0.17</td>
<td>0.14</td>
<td>1.03</td>
<td>0.19</td>
<td>0.27</td>
<td>0.17</td>
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<tr>
<td>Rolls (1 piece)</td>
<td>0.06</td>
<td>0.02</td>
<td>0.02</td>
<td>0.02</td>
<td>0.05</td>
<td>0.13</td>
<td>0.02</td>
<td>0.03</td>
</tr>
<tr>
<td>Bread (1 kilo)</td>
<td>0.27</td>
<td>0.24</td>
<td>0.17</td>
<td>0.21</td>
<td>0.24</td>
<td>0.40</td>
<td>0.36</td>
<td>0.31</td>
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<tr>
<td>Potatoes (1 kilo)</td>
<td>0.57</td>
<td>0.12</td>
<td>0.09</td>
<td>0.09</td>
<td>0.39</td>
<td>0.38</td>
<td>0.15</td>
<td>1.02</td>
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<tr>
<td>Table wine (1 liter)</td>
<td>1.06</td>
<td>1.10</td>
<td>2.04</td>
<td>0.30</td>
<td>1.22</td>
<td>1.17</td>
<td>1.19</td>
<td>8.14</td>
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<td>Butter (1/4 liter)</td>
<td>1.37</td>
<td>0.44</td>
<td>0.22</td>
<td>0.30</td>
<td>2.03</td>
<td>1.13</td>
<td>0.43</td>
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<td>Coffee Beans</td>
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<td>1.30</td>
<td>0.42</td>
<td>1.06</td>
<td>3.45</td>
<td>2.35</td>
<td>1.09</td>
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<td>Beef round (1 kilo)</td>
<td>5.54</td>
<td>2.40</td>
<td>2.17</td>
<td>2.82</td>
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<tr>
<td>Pork tenderloin (1 kilo)</td>
<td>5.01</td>
<td>2.20</td>
<td>2.29</td>
<td>2.20</td>
<td>29.21</td>
<td>9.13</td>
<td>3.07</td>
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<td>Wienerschnitzel (inexpensive restaurant)</td>
<td>3.50</td>
<td>1.20</td>
<td>2.54</td>
<td>1.23</td>
<td>16.13</td>
<td>2.57</td>
<td>2.22</td>
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<td>Marlboro (1 box)</td>
<td>1.50</td>
<td>1.16</td>
<td>0.37</td>
<td>0.48</td>
<td>4.26</td>
<td>3.19</td>
<td>1.12</td>
<td>16.01</td>
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<tr>
<td>Cigarettes (domestic)</td>
<td>0.24</td>
<td>0.30</td>
<td>0.15</td>
<td>0.23</td>
<td>0.44</td>
<td>0.15</td>
<td>0.52</td>
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<td>Women’s dress</td>
<td>85.40</td>
<td>36.40</td>
<td>29.10</td>
<td>45.20</td>
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<td>44.06</td>
<td>47.28</td>
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<td>Men’s suit (domestic)</td>
<td>103.14</td>
<td>60.95</td>
<td>49.44</td>
<td>66.30</td>
<td>275.02</td>
<td>73.35</td>
<td>67.31</td>
<td>361.48</td>
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<tr>
<td>Men’s shoes (domestic)</td>
<td>64.09</td>
<td>25.40</td>
<td>15.34</td>
<td>21.40</td>
<td>64.43</td>
<td>25.45</td>
<td>26.15</td>
<td>120.12</td>
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<td>Electric power (1 kilo/hr)</td>
<td>0.03</td>
<td>0.04</td>
<td>0.02</td>
<td>0.02</td>
<td>0.01</td>
<td>0.06</td>
<td>0.02</td>
<td>0.01</td>
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<tr>
<td>Gas (1 cubic meter)</td>
<td>-</td>
<td>0.06</td>
<td>0.06</td>
<td>0.04</td>
<td>0.09</td>
<td>0.05</td>
<td>0.06</td>
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<tr>
<td>Coal (100 kilos)</td>
<td>4.18</td>
<td>2.40</td>
<td>5.01</td>
<td>3.41</td>
<td>4.53</td>
<td>5.13</td>
<td>4.22</td>
<td>12.06</td>
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<tr>
<td>Brick (1 unit)</td>
<td>0.04</td>
<td>0.12</td>
<td>0.05</td>
<td>0.06</td>
<td>0.13</td>
<td>0.15</td>
<td>0.13</td>
<td>0.29</td>
</tr>
<tr>
<td>Cement (100 kilos)</td>
<td>7.22</td>
<td>4.20</td>
<td>2.53</td>
<td>4.32</td>
<td>6.48</td>
<td>14.43</td>
<td>6.38</td>
<td>36.37</td>
</tr>
<tr>
<td>Gas (87 octane)</td>
<td>1.23</td>
<td>0.37</td>
<td>0.21</td>
<td>0.29</td>
<td>0.19</td>
<td>0.42</td>
<td>0.40</td>
<td>3.03</td>
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<tr>
<td>Stamps inland</td>
<td>0.04</td>
<td>0.06</td>
<td>0.06</td>
<td>0.07</td>
<td>0.03</td>
<td>0.04</td>
<td>0.06</td>
<td>0.02</td>
</tr>
<tr>
<td>Dry cleaning</td>
<td>2.13</td>
<td>1.40</td>
<td>2.56</td>
<td>2.04</td>
<td>4.51</td>
<td>1.50</td>
<td>1.03</td>
<td>4.48</td>
</tr>
<tr>
<td>Railway fare (2nd class 100 kilometers)</td>
<td>1.51</td>
<td>1.20</td>
<td>1.03</td>
<td>1.56</td>
<td>1.40</td>
<td>1.15</td>
<td>1.27</td>
<td>6.01</td>
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<tr>
<td>Gas and water repair (1 hr/rate)</td>
<td>1.28</td>
<td>2.05</td>
<td>3.19</td>
<td>2.01</td>
<td>n.a.</td>
<td>0.50</td>
<td>1.38</td>
<td>4.48</td>
</tr>
</tbody>
</table>

Note: Based on national statistics on retail prices and pretax hourly wages in U.S. dollars, May 1993.

Source: World Economy Weekly (HVG).
Mongolia Leaves Systemic Shocks Behind?

Mongolia, because of its nearly total dependence on the former Soviet Union (FSU), suffered a series of external shocks in 1990 and 1991. From 1990 to 1993 imports dropped by about 75 percent, and exports by 40 percent. Reasons for the dramatic fall in foreign trade include:

- Financial aid from the FSU dried up in 1991. (It had made up 30 percent of Mongolia's gross domestic product during the 1980s.)
- Mongolia's terms of trade have declined by more than 10 percent over the past three years. (Prices for both copper and cashmere—major foreign currency earners for the country—dropped on the world market.)
- Trade flows have been dramatically reversed. In 1990 Mongolia's imports from other CMEA countries made up 91 percent of its total; by 1992 the rate for the ex-CMEA partners had dropped to 54 percent of total imports.

Has Inflation Peaked?

The inflation rate between January and June 1993 reached 109 percent, equivalent to an annual rate of 330 percent. That high inflation rate is the result of the following factors:

- As in other command economies, there was no official inflation in Mongolia before 1990. Monetary overhang was at a high level. [Broad money supply (M2) accounted for 54 percent of GDP in 1990, equivalent to an income velocity of 1.9.] In 1992, as prices and trade were liberalized, and goods and services became available, money supply (M2) dropped to 25 percent of GDP. By this time the monetary overhang had disappeared. During the first quarter of 1993, M2 increased by 78 percent on an annual basis. If an adjustment is made to take account of valuation gains in foreign currency deposits, the annual increase in M2 is 50 percent. (Since foreign currency deposits constitute an important component of M2—currently, about 20 percent of the total—any large devaluation has a concomitant impact on monetary expansion.)
- The devaluation of the tugrik, which has brought the exchange rate to realistic levels has also played an important role in price adjustments. Mongolia's economy is relatively open—imports and exports combined accounted for 58 percent of GDP in 1992. The official exchange rate of the tugrik has been changed from 5.33 per U.S. dollar in 1990, to 150 early this year. Subsequently a free, unified foreign exchange market was introduced in May 1993. Since then, the exchange rate has been stable at about 400 tugrik to the dollar.

Since the exchange rate has been unified and most prices liberalized, perseverance in strict monetary policies is the key to bringing down inflation. Given the political commitment to the stabilization and reform program observed since October 1992, the inflation target of 50 percent for 1994 should be attainable. A major concern, however, is the continued practice of direct allocation of credit. The fiscal deficit reached 10 percent of GDP last year, and is running higher this year, financed mostly by external sources. Lending to the private sector increased spectacularly in recent years—its share in total lending has grown from 7.3 percent in 1990 to more than 45 percent at present. Credits to the private sector are important in mitigating the recessionary impact and securing a quick supply response.

The Ochirbat Story

In the June 1993 presidential election in Mongolia the majority parliamentary party—the former communist Mongolian People's Revolutionary Party (MPRP)—conceded defeat to the incumbent, Punsalmaagiyn Ochirbat. Ochirbat retained office with a decisive victory. Although the president does not play a major role in policy making, his victory was interpreted as a favorable development for economic reforms and a sign of the new democracy working.

When the lama king died in 1924, the Republic of Mongolia became the Soviet Union's first "ally," unrecognized by any other state until it was admitted into the United Nations in 1955. Economically dominated by the Soviet Union, which treated it as a sixteenth republic, Mongolia was governed domestically by the monopolistic and repressive MPRP. As the Soviet Union collapsed, Mongolia quickly, and peacefully, moved to independence in 1990. By the end of 1992 all former Soviet troops had been withdrawn and, in January 1993, Ochirbat signed a treaty of friendship and cooperation with President Boris Yeltsin.

After the collapse of communism, the MPRP dropped some of its old leaders, declared itself democratic, and initiated multiparty elections. This political reversal proved a success and the MPRP won overwhelming majorities in the country's first open parliamentary elections in July 1990 and June 1992.

However, the reform process has encountered obstacles. The old nomenclature in the MPRP has sought to make use of its party's parliamentary majority (70 of 76 seats) to reverse economic reform. In April the MPRP refused to nominate Ochirbat as its presidential candidate. Instead it chose Lodongyn Tudev, the old-guard editor of the party newspaper. However, the unified opposition made Ochirbat their candidate. With a 90 percent turnout, Ochirbat won 58 percent of the vote in the June election.

Ochirbat's victory encouraged the reformist members of the MPRP and the society in general to reinvigorate the reform process. With a GDP decline forecast at around 2 percent for 1993, the worst of the recession induced by trade collapse may be over.

(Based on Oxford Analytica Ltd., Oxford reports)
Government Withdrawal

Using a voucher system (see "Voucher Scheme in Mongolia," Transition, July-August 1991, p. 6), the government has privatized practically all small enterprises and more than 400 medium- and large-scale enterprises. (Privatization vouchers with a value of 10,000 tugriks were issued for each citizen.) In addition, over the past four years the number of registered private enterprises has increased to 9,000. And almost all livestock (some 26 million) is now privately owned, compared with 30 percent in 1989. The government plans to complete the privatization program by the end of 1993.

Cash sale of telecommunications services and gas stations has been offered to mobilize domestic and external resources. The private sector's contribution to GDP has reached an estimated 30 to 40 percent. The recently enacted Foreign Investment Law should give a boost to capital inflow, lift major restrictions, and authorize free transfer of profits out of the country.

The government's control over recently privatized enterprises is still strong. This includes leverage over management, as well as the allocation of domestic credit. On the other hand, the size of the government (central administration and local governments) has been sharply reduced. Government expenditures—fell from 52 percent of GDP in 1991 to 22 percent in 1992—mostly as a result of cuts in subsidies to enterprises.

The relative size of government procurement is also getting smaller. In 1991 the government procured 35 percent of all live animals sold in the market; in 1992 the figure diminished to 24 percent. Procurement of sheep wool declined from 106.9 percent in 1991 (indicating the purchases of inventories) to less than 60 percent a year later.

In addition, import licensing and export taxes have been eliminated, and private enterprises can now retain their export earnings. Import duties have declined to a uniform 15 percent. A new profit-based tax on companies and individuals has been enacted. And a 10 percent sales tax on imports and domestic production has been introduced to replace the surcharge on imports introduced in 1991.

Mongolia's economic decline continued in 1992, but at a slower rate. Output cuts were particularly steep in the construction and transport sectors and in agricultural and livestock production. And industrial production plummeted, feeling the heat of the turmoil in the former Soviet Union. Services, on the other hand, began to recover in 1992. Overall economic performance seems to be improving in 1993. Preliminary data suggest that the volume of exports (excluding flourspar and raw cashmere) increased by 21 percent in the first half of 1993 over the same period in 1992. Exports to Russia accounted for 37 percent of total sales, down from 57 percent in 1992, providing a sign that trade diversification continues.

Continuing Challenges

Pressing tasks lie ahead for Mongolia:

* The quality of public expenditures must be improved. Large subsidies to the social security system (4.6 percent of GDP in 1992) could be eliminated through the introduction of workers' contributions and through the reduction of early retirement benefits. Defense expenditures, which declined from 6 percent of GDP in 1988 to 1.8 percent in 1992, will be cut again. A recent increase in crime, however, might require more spending on public order and safety (which accounted for 1.3 percent of GDP in 1992). A well-prepared public investment program is a key developmental requirement.

* The brain drain of skilled personnel from public administration must be stemmed. Many government employees leave their government jobs and find higher salaries and better opportunities in the private sector. Initial steps could include identification of key public sector positions. About 3,000 to 5,000 staff in such positions.

Assistance Flows to Mongolia

The World Bank, in cooperation with Japan, has cochaired three meetings of Mongolia's donor countries. At their recent meeting in Tokyo, the donors pledged more than $150 million to Mongolia. Inflows of international grants and loans accounted for $179 million in 1991 and $153 million in 1992. In late 1991 Mongolia signed a one-year stand-by arrangement with the IMF, but the program failed in 1992. Subsequently, in June 1993, a policy framework was agreed on with the IMF and the World Bank. The same month, the IMF approved a $57 million loan to Mongolia under the ESAF (Enhanced Structural Adjustment Facility) to support the government's economic program for 1993-96. IDA approved in late 1991 a $30 million credit to finance critical imports for energy, mining, transport, agriculture, and other key sectors. (This is now almost fully disbursed.) Another $5 million from IDA finances technical assistance to complete sectoral studies on mining, transport, and agriculture and to provide training for local staff.

Several IDA projects are in the pipeline for approval over the next two years. A $20 million credit is prepared to finance critical imports for the mining and transport sectors. Another $20 million is being designed to address urgent needs of the railways, urban transport, and roads. An agricultural credit would help the expansion of crop production, and a Structural Adjustment Credit would provide import support to the private sector and to a petroleum exploration and promotion project. IFC staff has visited the country on several occasions. It is currently reviewing IFC involvement in a hotel construction project.

July-August 1993
positions might be provided with special remuneration. This exercise could be part of establishing transparent criteria for merit increases, gradually monetizing nonmonetary payments, and reviewing job responsibility for all staff.

- **Socially vulnerable groups must be protected.** About 16 percent of Mongolia's population of roughly 2 million live below the poverty line (347,000 persons in 69,000 households). Since the labor force grows about 3.4 percent annually, unemployment is likely to increase until a full recovery is attained (that is, a yearly growth rate of 5 to 6 percent). About 70 percent of the registered unemployed are unskilled. (Over the past six months alone the number of unemployed increased from 54,000 to 60,000). At present, unemployment benefits are granted for only five months after layoff. Those with no job record are ineligible for unemployment benefits.

- **External resources must be mobilized.** This will be, for the foreseeable future, a crucial requirement for the country. A current balance of payment deficit of about 15 to 17 percent of GDP is projected for the medium term.

This assumes annual net capital inflows in the range of $150 million to $200 million, or about $80 per capita. It will not be easy to sustain such a high level of capital inflows from multilateral and bilateral donors alone. Therefore, in the longer term, assuring sizable amounts of foreign direct investment will be crucial to maintaining a viable balance of payments position.

Carlos Elbirt
East Asia and Pacific, Country Department II
Country Operation Division

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**Behavior of Polish State Enterprises: Reflections on a Path-breaking Study**

**The Common Wisdom**

Many economists distrust enterprises owned by postsocialist states. They theorize that:

- **State enterprises, when given autonomy, are unable to generate normal supply responses to policies and market signals.** Managers, like other members of the corrupt former nomenklatura, have no incentives. Often they are unqualified entrepreneurs. In most cases, they simply continue to perform as pawns of the government.

- **Soft budget constraints of state enterprises cannot be changed.** Governments are too addicted to the practice of direct subsidies (including discretionary tax relief), and state enterprises can always count on the indiscriminate lending of state-owned banks, as well as the voluntary or involuntary provision of interfirm credits (arrears).

- **State enterprises are incapable of adapting to competitive markets— particularly adjusting employment to output, and product type and quality to demand.**

- **State enterprises make little distinction in their remuneration policies between differences in employee skills and performance, and therefore cannot operate efficiently.**

- **State enterprises' assets deteriorate quickly because of managerial incompetence, outright asset-stripping, and decapitalization both by employees and managers.**

- **Without privatization the socialist economies cannot be transformed.** Therefore, privatization of state-owned enterprises, together with macrostabilization and decontrol of prices and trade, should receive the highest priority, and be pursued as quickly as possible, regardless of economic and social costs. As an intermediate step, state enterprises should be commercialized—they should be transformed into joint-stock companies, be 100 percent state-owned, and have their management placed under the control of a supervisory board that provides commercial skill and accountability.

**New Study's Challenge**

Brian Pinto, Marek Belka, and Stefan Krajewski, in their recent study, "Transforming State Enterprises: Evidence on Adjustment by Manufacturing Firms" (Brookings Papers on Economic Activity, 1:1993, p. 213–70), challenge the above hypotheses. Their study is based on interviews with managers from sixty-four state enterprises representing five manufacturing industries: metallurgy, electromachinery, chemicals, light manufacturing (textiles, leather), and food processing. Their average size is almost identical to that of the 500 largest state-owned enterprises.

The first interviews were done in mid-1990, then repeated in mid-1992. Quantitative data for the same firms and for the same period were collected through questionnaires. The study thus covers the turbulent period from the introduction of the Balcerowicz program on January 1, 1990 to a point at which a considerable degree of marketization had been achieved. By mid-1992 thirty-seven firms were still state-owned, three had been privatized, and the remaining twenty-four were converted into commercialized firms, controlled by the Ministry of Privatization and governed by a board whose majority was appointed by the ministry.

The study ranks the firms into three groups, corresponding to their performance: thirty-one firms are classified as "AAA" (if they achieved after-tax profits), eight firms as "AA" (pretax profits, and after-tax losses), and twenty-five as "A" (pretax loss-makers) (see table). Most of the chemical and food processing industries are in
the AAA group and most of the light industry manufacturers in the A group.

The table compares the achievers (AAA group) with the loss-makers (A group), based on a number of indicators constructed from data reported in the study. What emerges from this comparison is that, contrary to predictions, at least half of the state-owned enterprises and commercialized firms are doing fine. This seems to contradict the proposition that only radical change of property relations can salvage the industry from extinction. Also, there is no systematic difference between the performance of state-owned enterprises and state enterprises that have been commercialized.

Other observations in this context:

- **Adjustment.** Although the index of industrial output declined by 36 percent between 1989 and 1992, the achievers on average succeeded in holding up volumes of sales. All firms were successful in shedding excess employment, and the productivity of achievers clearly increased. Their profitability for 1991—when many of the effects of marketization had already been felt—was impressive.

- **Financial management.** The achievers were able to get credits for investment, but the loss-makers failed on that account. The level of working capital to operating costs hardly changed over the past two years.

- **Budget constraint.** The achievers succeeded in reducing the level of interfirrm lending, while the loss-makers built up arrears. Achievers had only insignificant tax arrears; arrears of loss-makers, on the other hand, amounted on average to 50 percent. Evidently, tax arrears were the most important manifestation of the remaining softness of budget constraints of firms.

- **Wage setting and decapitalization.** It has been widely presumed that without real owners assets are dissipated as excessive wages. But the achievers' ratio of wages to gross value added (21 percent), is outstanding, even by Western standards. Another contention is that the best method for decapitalization is to pay wages from depreciation funds. Again, the high ratio of investment to depreciation disproves this hypothesis.

The study also addresses the attitude of managers toward their firms' adjustment problems—and their future role in it. Perhaps most interesting were the findings on managerial motivation and incentives. Present financial incentives are insignificant; the study observes that the top manager's salary rarely exceeds five to seven times the average wage or the firm's base wage. Most managers have no personal stake in their firms; rather, they receive separate performance-linked bonuses.

Managers' motivation is instead an implicit one: the quest for excellence and public recognition, and a commitment to their firms. The goal extends beyond simple survival of the firm or keeping it in a holding pattern, and includes the firm's restructuring and long-term adjustment. The financial reward is expected to materialize in the future when the firm is privatized and the manager with a successful track record is offered higher salary differentials by new owners.

The validity of the study's conclusions can be disputed for several reasons. For instance, the sample is not a true random sample. The method of arriving at conclusions—through a mixture of inductive generalizations from interviews and qualitative interpretation of sample data—may be judged soft. But such objections do not invalidate the powerful message of the study, which runs counter to the common wisdom about state enterprises.

**Achievers and Loss-Makers—Performance of Interviewed Polish State Enterprises, 1990-92**

<table>
<thead>
<tr>
<th>Performance indicators</th>
<th>Achievers (AAA)</th>
<th>Loss-makers (A)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjustments</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real sales, January 1990 to mid-1992</td>
<td>stable</td>
<td>fell 40%</td>
</tr>
<tr>
<td>Output inventories/sales, May 1990 to mid-1992</td>
<td>stable 30%</td>
<td>rose to 40-100%</td>
</tr>
<tr>
<td>Employment, mid 1992 (end 1989 - 100)</td>
<td>79%</td>
<td>67%</td>
</tr>
<tr>
<td>Unit labor cost, mid-1990 to mid-1992</td>
<td>stable</td>
<td>rose 20%</td>
</tr>
<tr>
<td>Underlying profitability/sales 1991</td>
<td>24%</td>
<td>-20%</td>
</tr>
<tr>
<td>Financial management</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment loans, mid-1992 (December 1989 = 100)</td>
<td>1,200%</td>
<td>200%</td>
</tr>
<tr>
<td>Working capital loans/operating costs, mid 1992 (March 1990 = 100)</td>
<td>106%</td>
<td>281%</td>
</tr>
<tr>
<td>Budget constraint</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interfirm lending/sales mid 1992 (March 1991 = 100)</td>
<td>60%</td>
<td>negative</td>
</tr>
<tr>
<td>Tax arrears/taxes January-June 1992</td>
<td>3.7%</td>
<td>50.8%</td>
</tr>
<tr>
<td>Wage Setting and Decapitalization</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average wages mid-1992 (mid-1990 - 100)</td>
<td>236%</td>
<td>218%</td>
</tr>
<tr>
<td>AAA/A June 1992</td>
<td>117%</td>
<td>100%</td>
</tr>
<tr>
<td>Investment/depreciation 1991</td>
<td>144%</td>
<td>80%</td>
</tr>
<tr>
<td>Wages/gross value added 1991</td>
<td>21%</td>
<td>85%</td>
</tr>
</tbody>
</table>

Sample: Number of firms
- State owned enterprises: 31
- Commercialized enterprises: 16
- Private enterprises: 2

c. Underlying profitability = gross profit + turnover tax - other income - net extraordinary gains.
Source: Study authors.

**Martin Schrenk**
**Policy Research Department**
**The World Bank**

July-August 1993
The Polish National Bank devalued the zloty by 8 percent against a weighted basket of Western currencies on August 27. The average exchange rate for the U.S. dollar rose to 19,728 zlotys, compared with 18,344 zlotys a day earlier. National Bank president Hanna Gronkiewicz-Waltz said the devaluation was necessary to reverse Poland's negative trade balance and halt the decline in hard currency reserves. Convertible currency reserves held by the central bank slipped to $3.5 billion from $4.3 billion at the beginning of 1993, and the trade deficit in the first six months of the year grew to $1.1 billion. Government officials predict that the devaluation will cause only minimal additional inflation of about 1 percent.

A private Polish-U.S. firm plans to invest up to $2 billion to build modern telephone networks in Poland and, in so doing, compete against the state-owned telecommunications monopoly. RP Telecom SA said it had started building an $80 million telephone network for 100,000 subscribers in the town of Pila. The company, backed by capital from the IFC, said it also planned to install eight other telephone networks across the country under a project that could eventually cost up to $2 billion.

On August 30 the National Bank of Yugoslavia issued a billion-dinar bank note in an attempt to keep up with soaring inflation. The new note is worth only $3 at the current exchange rate. The Yugoslav economy is collapsing because of international sanctions and the burden of financing Serb fighters in Croatia and Bosnia. GNP has fallen some 70 percent since 1991. More than half the work force is either unemployed or on extended leave of absence. The latest monthly inflation figures released by the government place the July rate at 1,880 percent—an annual rate of about 1.7 billion percent.

Slovenia lost more than 1.4 billion German marks in revenue during the first half of 1993—some 50 percent more than during the same period in 1992. Analysts at the Bajt Institute in Ljubljana asserted that half of Slovenia's 23,300 companies, which employ more than 486,000 workers, are on the brink of collapse. Over the past few months, nearly 2,500 companies have had their bank accounts frozen, and close to 100 of the former leading companies in Slovenia face bankruptcy. Unemployment, which stood at less than 2 percent in 1988, is currently 14 percent. The country has lost some 17 million consumers from the republics of the former Yugoslavia; it will take years to regain those markets, which in 1990 accounted for some 35 percent of the total goods sold.

During the first half of 1993 the Czech Republic's gross domestic product was 0.5 percent to 1.3 percent lower and industrial production 5 percent lower than during the same period in 1992. According to the Czech Statistical Office (data were released on August 18), prices grew by 12.1 percent from January to June 1993. Wages were 36.8 percent higher and consumer spending 39 percent higher in June 1993 than in June 1992. The unemployment rate in June 1993 was 2.63 percent, with 138,581 unemployed and 74,400 vacancies. Jiri Pospisil, monetary director at the Czech National Bank, predicted that the Czech economy would begin its recovery in the second half of 1993 and expand more rapidly in 1994. "Private consumption is growing. The government is relaxing its restrictive policy and we expect a rise in public consumption in the second half," he said, adding that "there has been a rise in imports of investment goods, and the construction sector is doing well."

Prime Minister Vaclav Klaus of the Czech Republic called on Western leaders to show more courage in helping former communist countries deal with economic problems. Speaking in Stockholm on August 30, Klaus said that recession, protectionism, unemployment, and domestic politics have combined to reduce aid from the West. "I would expect more courage from Western politicians to tackle that issue," Klaus added. The Czech prime minister also said that his country will be ready to apply for membership in the EC within two years. He said the Czech Republic already could fulfill entrance requirements better than almost all current members.

The Czech Republic's privatization minister, Jiri Skalicky, announced that the second round of voucher privatizations will begin on October 1, 1993. After that date, Czech citizens older than eighteen will be able to purchase privatization vouchers for a symbolic fee (the equivalent of $35). Vouchers can later be exchanged for shares in more than 800 companies slated for privatization. Skalicky said that, as of July 20, more than 548 of these companies (worth 79 billion koruny or $2.3 billion) were prepared for the second round of privatization.

On July 8 the Hungarian National Bank (HNB) devalued the forint by 3 percent and raised by 3 percent the open-market interest rate at which banks borrow from the National Bank. HNB president Akos Peter Bod said that the devaluation, Hungary's fourth this year, was necessary because of a considerable fall in exports as a result of the recession on foreign trade markets, several years of drought, and the UN embargo against rump Yugoslavia. The decline in exports could cause an increase in the deficit of the six-month current balance of payments to $1.5 billion, Bod said. Hungary's industrial production was up 1.6 percent in the first half of 1993 from the same period last year, an official said. Production in the first half was valued at $11.93 billion, including $2.5 billion in exports.

China's gross national product is expected to grow 13 percent in 1993—the same as in 1992—despite regula-
tory measures to prevent the economy from overheating, according to Zhu Rongji, the deputy prime minister and central bank governor. The government program was designed to slow an economy that had posted growth of 25 percent in industry and 61 percent in fixed asset investment in the first half of the year. Zhu said the government believed it had been able to withstand and control changes in the broad economy. He also indicated that China would give priority over the next few years to reforms in fiscal, investment, banking, and planning policies, as well as to continued reform of state-owned enterprises. The success of the Chinese experiment depends most of all on good economic management.

Zhu Xiaohua, a vice governor of the People's Bank of China, said China was considering modeling its central banking system on the U.S. Federal Reserve. Reform of the financial system would become the core of China's restructuring in the 1990s. Zhu, addressing a Hong Kong seminar, listed a number of areas for improvement in the central banking system, including setting up a comparatively independent system for implementing monetary policy to avoid administrative interference. If a monetary reform committee were set up, it could use the Fed's Open Market Committee as a model. China could also be divided into several economic zones. People's Bank of China governors from each zone would sit on the committee to reflect regional differences on economic policy. Zhu indicated that China should introduce a system for setting interest rates similar to those in industrial nations.

The Russian finance ministry proposed new measures to cope with rising inflation, vowing to slow the use of the dollar and to issue new securities to pay off companies' debts. Companies' mutual debts would be converted into securities with a maturity of between three and twelve months. Companies unable to pay would be declared bankrupt. The ministry put August inflation at 25 to 30 percent.

The World Bank estimates that per capita income in Russia declined by 17 percent over the past year—from $3,220 in 1992 to $2,680 in 1993. Income declines were also seen in other former Soviet republics. Russia's decline reflects the steady drop in the country's output since the collapse of the Soviet Union. The IMF has recorded Russian production falling rapidly since 1990—by 19 percent last year. Clifford Gaddy of the Brookings Institution claims that the figures only reflect what used to be the state-owned sector. "Household surveys—asking Russians how much they earned from their main jobs and how much additional income they had from second jobs—reveal that the secondary income amounted to about 65 percent of the total income," Gaddy said.

A bumper grain harvest in 1993 means Russia will not need to import grain next year, according to Alexander Zaveryukha, deputy prime minister responsible for agriculture. Zaveryukha said that the grain harvest would be as much as 120 million metric tons, and that this year's imports would be restricted to feed grain and oilseed meal under a humanitarian contract already signed with the United States.

Russia will privatize 60 percent of its oil and gas industry within twelve to eighteen months, Prime Minister Viktor Chernomyrdin announced during his early-September visit in the U.S. Chernomyrdin also detailed some of the projected costs of halting the decline that has been seen in Russian oil output since 1989. Up to $12 billion in investments would be needed, he said, to restore the thousands of oil wells in Russia that are not operating efficiently enough to produce, and another $10 billion to improve output levels at producing fields. By the year 2000, he added, a total of about $65 billion would be needed to build up other aspects of the energy sector, such as developing new oil fields and building up the oil field equipment industry.

Ukraine and Russia agreed in early September that Russia would provide an additional 12 million tonnes of oil a year to Ukraine beyond the 20 million already pledged. Prices are to rise to world levels by 1994. Transactions would be arranged through the Swiss firm Nordex Group Holding Co., which would buy Russian oil and sell Ukrainian farm and other goods throughout the former Soviet Union. Russia's 1994 crude oil output is expected to fall to 327 million tonnes from this year's 340-350 million.

In Tallinn on September 12, Prime Ministers Mart Laar (Estonia), Valdis Birkavs (Latvia), and Adolfs Slezevicius (Lithuania) signed the Baltic Free Trade Agreement; a joint declaration on regional security; and the declaration on regional security; and a message to the European Community in which they express their willingness to sign free trade agreements with the EC. Estonia and Latvia also agreed to take measures to prevent double taxation and tax evasion.

Efforts to slow the output decline in Kazakhstan's economy in the first half of 1993 were unsuccessful, the country's cabinet of ministers concluded. Industrial output was down a quarter in comparison with the same period in 1992, with the worst results shown by the coal, oil, gas, metallurgical, chemical, and machinery sectors. Although an excellent grain harvest is expected, livestock production is down. Price increases for energy have fueled the inflation rate, which has averaged 30 percent a month. No improvement is expected before the end of the year (see World Bank/IMF Agenda, page 18).

Kazakhstan auctioned off fourteen shops, launching the first stage of its program to privatize state-owned property. Private entrepreneurs spent about $322,000 to buy the shops, most of which are grocery stores, at an auction organized with the assistance of the World Bank. Under the terms of the sale, new private owners must maintain the current services and goods sold at the shops for the next five years. Shop auctions are scheduled to take place in five other cities of the country in the upcoming months.
World Bank and IMF Agenda

World Bank and IMF Support Reform in Kazakhstan...

The World Bank in early August approved a loan of $38 million to support economic reforms in Kazakhstan. The loan will cover some of the cost of technical assistance, which will help restructure or privatize state-owned enterprises and modernize the financial sector. A new resident mission, under the directorship of David Pearce, began operation in August in Alma Ata (the capital of Kazakhstan). Telfax: (73272) 627-378. The IMF, for its part, has approved a credit of roughly $86 million under the systemic transformation facility (STF) to support the Kazakhstan government's economic program from July 1993 through June 1994. The central objectives of the program are to contain the decline in output experienced in 1993, sharply reduce the inflation rate, and keep the fiscal deficit at 6 percent of GDP.

... in Belarus ...

A World Bank loan of $8.3 million to Belarus—approved in early August—will provide technical assistance to build up government agencies in charge of economic management and reforms. An IMF loan of $98 million STF credit has been approved to support the Belarus government's economic program over the twelve months through June 1994. The main targets include reducing monthly inflation to about 5 percent by the end of 1993 and limiting the decline of GDP to about 15 percent in 1993 and 5 percent in 1994.

... and in Slovakia

The World Bank approved a $55 million loan to Slovakia in mid-July to support a $231.5 million program to upgrade the country's telecommunications network. The loan is the Bank's first to Slovakia since it joined the institution on January 1, 1993. The European Investment Bank is cofinancing the project with a $55.3 million loan, and the European Bank for Reconstruction and Development pitched in $55 million. Almost 85 percent of Slovaks do not have telephones at home. Under the plan 425,000 new telephone lines will be installed, and 225,000 new subscribers will have access to telephones. (At present 125,000 Slovaks are waiting for telephones, and the wait can be as long as five years.) The IMF's first loan in the area has been a credit of $89 million under the systemic transformation facility (STF). Slovakia is aiming for an inflation rate of 30 percent in 1993, and wants to slow economic decline to an annual 9 percent. A 10 percent devaluation of the Slovak koruna in July 1993, supported by continued wage restraint and a flexible exchange rate policy, could help improve Slovakia's external payments position.

IFC Credit Line to Moscow Bank

The IFC and International Moscow Bank (IMB) signed an agreement establishing a $15 million credit line for the bank. IMB will use the credit line to lend to private companies and joint ventures in Russia. Loans of up to $2 million will be made for the purchase of equipment and other fixed assets in the oil, gas, agriculture, tourism, and telecommunications sectors. This credit line is IFC's first effort to expand resources of private financial institutions in Russia.

Front-Line Borrower: Albania

The Albanian housing sector will speed its recovery with the help of an IDA credit of $15 million, approved July 13. The project loan will finance completion of a substantial share of the country's unfinished rental housing. Also, some 4,500 individual households will be able to buy flats under new mortgage and condominium arrangements. The Albanian government will contribute $25 million to the project, and the U.S. Agency for International Development (USAID) has offered a $1.5 million grant. Using another $20 million IDA credit, Albania will launch an 18-month structural reform program in the agriculture sector, including a credit line for rural entrepreneurs. And the IMF has approved a three-year loan equivalent to $59 million under the ESAF (enhanced structural adjustment facility); the loan is to support Albania's economic program between 1993-96.

First Bank Loan to Slovenia

The World Bank on July 22 approved an $80 million loan to Slovenia (population 2 million) to support the privatization of state enterprises and banks and to assist in pension reform. The fast-disbursing component of the loan ($75 million) will finance general imports and related services.

Poland: Three New Loans

The World Bank has approved three new loans for Poland worth nearly $900 million. The first loan—$450 million—will go for restructuring Polish enterprises and the banking system. The second—$300 million—is for developing agricultural infrastructure. In early August a third loan—this one for $146 million—was approved to protect Poland's forests and to help develop forestry and timber production.

Boosting Bulgaria's Private Sector

A recently approved $55 million World Bank loan to Bulgaria will help provide financial and technical assistance for private enterprises, privatized state enterprises, and private exporters. With the expansion of private and privatized enterprises 15,000 new full-time jobs can be created.

Armenia and Georgia Join the IDA

Armenia joined the International Development Association (IDA) on August 25, Georgia on August 31. IDA membership now totals 154.
IDA Supports China's Health Care...

The IDA in August approved a credit of $110 million to China to improve health care in rural areas by providing training to health care workers.

Local Government in Mozambique...

The Mozambique government will use an IDA credit of $23.2 million to fund local government reform. The project will help improve public sector management, create an enabling environment for private sector development, and reduce poverty.

The Petroleum Industry in Madagascar...

An IDA credit to Madagascar of $51.9 million was approved in early August to support modernization and privatization of the state-owned petroleum industry.

Agricultural Research in Nicaragua

A $44 million IDA credit, announced on July 22, will help the government boost agricultural research and set up a new titling and registration system.

Hungary's Taxpayers, Rejoice

In early July the World Bank approved a $29 million loan to Hungary, as part of an ambitious overall program of $55.6 million that is aimed at modernizing the Hungarian tax system and beefing up tax collection. The Hungarian tax system annually handles about $9 billion worth of tax revenue. Under this program, tax procedures will be streamlined and the tax information system modernized, with new computers and software improving processing capacity. The number of taxable private businesses has shot up from 10,000 in 1988 to 69,000 in 1992, while the number of annual value-added tax returns is expected to rise from 200,000 in 1992 to 2.4 million this year.

Antipoverty Support to Ethiopia

IDA is supporting Ethiopia's economic policy with a credit of $250 million. The government aims to reduce poverty through rapid labor-intensive growth and a fundamental transformation of the economy to a market-based system. The IMF has also approved a loan to Ethiopia—some $29.6 million is to be transferred under the Structural Adjustment Facility (SAF). Ethiopia's program aims at an economic growth rate of 5.8 percent in 1993 (last year it was 7.6 percent), an inflation rate of 10 percent (same as last year), and an increase of international reserves to the equivalent of 10.6 weeks of imports (in 1992/93 it was 8.6 weeks.)

Aid Donors Contribute to Tanzania

Tanzania will receive financial assistance of up to $1.2 billion from a group of aid donors whose representatives attended a World Bank-sponsored meeting in Paris July 12-13. The Consultative Group of sixteen countries and eight bilateral and multilateral institutions committed $840 million of project assistance, including technical assistance, and $360 million of balance of payments support. Separately, the International Development Association will contribute $24.5 million for institutional changes in Tanzania's Ministry of Agriculture and improvements to its agro-information system.

New Head of EBRD Visits Washington

The governor of the Bank of France, Jacques de Larosière, will take up his new post as president of the European Bank for Reconstruction and Development on October 4. He was to have joined the EBRD September 27, but the date was pushed back to allow him to attend the IMF/IBRD Annual Meetings in Washington. (Mr. de Larosière was the Managing Director of the IMF between 1978 and 1987.)
Conference Diary

For the Record

“What You Need to Know Today to Successfully Do Business in Russia”
August 20–21, 1993, Vail, Colorado

This conference, sponsored by the Russian-American Chamber of Commerce, was to provide up-to-date information on the Russian marketplace in the areas of economic forecasting, project financing and taxation, property rights, and contract law. Topics included economic and political assessment, including risk analysis; problems in trade and project financing; recent legal developments in taxation, property rights, and contract law; insurance and investment protection; enforcement issues and arbitration of commercial disputes; and dealing with bribery and corruption.
Information: Russian-American Chamber of Commerce, 6200 South Quebec, Suite 210, Englewood, Colo. 80111. Tel. (303) 689-8739; fax (303) 689-8762.

First Steps toward Economic Independence for a Selection of Former Soviet and Yugoslav Republics and Slovakia
August 23–24, Stockholm, Sweden

The workshop, sponsored by the Stockholm Institute of East European Economics, was to be held at the Stockholm School of Economics. Participants were to present their papers in a forum that would permit the exchange of ideas and experiences and the refinement of papers before submission for publication. Topics included how to establish a currency and an independent central bank; how to create a payments mechanism for trade with former fellow republics; and how to survive divorce proceedings within the former federations. Other issues examined include: restitution of property nationalized by the communists, and attracting foreign investment.
Information: Michael L. Wyzan, Associate Professor, Osteökonomiska Institutet, fax (468) 316-422.

The Belarus National Environment Strategy Conference
September 6–10, Minsk, Belarus

The conference was hosted by the World Bank to help the Government of Belarus develop its environmental policies and to assist other donor agencies in targeting assistance and in avoiding duplication of effort.
Information: Suzy Yoon or Laszlo Klottschen, and Faustino Rivero Moll ted by Yurii V. Petrov, chairman of the SIC, and by the top leadership of the Volgograd oblast.
Information: Nancy Ward or Robert Waltemyer at Geonomics, 14 Hillcrest Avenue, Middlebury, Vt 05753. Tel. (802) 388-9619; fax (802) 388-9627.

Forthcoming

The Second Annual World Economic Development Congress

Sponsored by the World Economic Development Congress. Speakers to date are: Henry Kissinger, Jacques Attali, David K.F. Li, Sir John Templeton, Dean LeBaron, William Ruckelshaus, Karlhermann Kottischen, and Faustino Rivero Morales. The conference will feature three independent summits on institutional investors, growing companies, and economic policy, as well as fourteen intense half-day global industry roundtables.
Information: Bay Colony Corporate Center, 1000 Winter Street, Suite 3700, Waltham, Mass. 02154. Tel. (617) 487-7900; fax (617) 487-7937.

Financing, Guaranteeing, and Collateralizing Commercial Ventures and Regional Economic Development in Russia: A Volgograd Perspective
September 23–26, Middlebury, Vermont

Sponsored by the Geonomics Institute, this is another Gateway Seminar. In...
The conference is being organized by the Royal Institute of International Affairs in association with the Centre for Foreign Investment and Privatization, Petroleum Intelligence Weekly, and Russian Strategic Services Ltd., Moscow. Attendance will include Rem Vyakhirev, President of Russia's Gazprom, and Boris Vasilenko, Deputy Chief of Rosstrogazifikatsiya, as well as more than a dozen general directors from regional and republican gazproms. Delegates will participate in smaller parallel sessions on pipeline and compressor station refurbishment, pricing and tariffication, privatization, and legal and tax reforms. Sessions will include: Reserves and Production in the Russian and CIS Gas Industry; Transport and Storage Issues; Russian Gas Production and Transport: A View from the Regions; Regional and Sectoral Gas Demand, Distribution, and Prices in Russia; The Role of Foreign Direct Investment and Cooperation; and Trade in Gas with Western and Eastern Europe.

Information: The Conference Department, The Royal Institute of International Affairs, Chatham House, 10 St. James Square, London SW1Y 4LE, United Kingdom. Tel. (4471) 957-5700; fax (4471) 957-5710.

How to Fund Investments and Exports to Eastern Europe and the Newly Independent States

October 29, Los Angeles, California

Sponsored by ANTIC International Associates, the conference will inform American companies how to tap into $24 billion in World Bank and EBRD contracts in the expanding free market economies in Eastern Europe. An impressive array of speakers from the World Bank, EBRD, International Finance Corporation, U.S. federal agencies, and American companies will be highlighted, including Mark Collins, Alternate Executive Director, World Bank and Francis J. Skrobiszewski, Vice President, Polish-American Enterprise Fund. Topics will include a look at the World Bank and EBRD's procurement procedures. Information: Bill Collins, Conference Coordinator, ANTIC International Associates. Tel./fax 1-813-572-8035.

New Books and Working Papers

PRDTM regrets that it is unable to supply the publications listed.

World Bank Publications

To receive publications of the World Bank, order from World Bank Publications, P.O. Box 7247-8619, Philadelphia, PA 19170-8619. Tel. (202) 473-1155, fax (202) 676-0581; or visit the World Bank bookstores: in the U.S., 701-18th St. NW, Washington, D.C., or in France, 66, avenue d'Iena, 75116 Paris.


China's economy began a strong expansion in early 1992. In the past eighteen months, economic growth has reached an annual rate of 14 percent, and the robust expansion already this year begun overheating the economy. In 1992-93 imports grew at about 25 percent, while export growths fell to less than 5 percent, reflecting diversion of export supply to the domestic market. Money supply increased about 30 percent in 1992, and at a similar rate in 1993. The strongest growth booster has been fixed investment demand, currently rising more than 30 percent in real terms. The paper describes a set of measures that the World Bank considers most critical in the short term: slow the growth of money supply and credit and reduce investment demand through • Fiscal prudence; prevention of over-spending, especially on administration • Liberalization of imports regime • Foreign exchange reform, with eventual unification of the yuan exchange rate • Restraint of investment in the state-owned sector.


A rich legal tradition in CEE countries, which dates from presocialist times, was suppressed but not eliminated during forty years of socialism. The legal system is being revised and augmented as the countries move toward a private market economy. Extensive progress has been made in putting private ownership and business activity on an equal footing with public enterprises and in freeing up the entry of new private firms through company and foreign investment law. Progress has also been made in strengthening protection for intellectual property and in defining clear exit mechanisms through bankruptcy law.

The most difficult and contentious challenges involve allocating real property rights, designing rules for the exit of ailing firms, and creating the conditions for free and fair competition, largely because these tread so heavily on existing vested interests. Progress so far in CEE shows that setting impersonal legal rules—such as rules of property ownership, con-
tract, or entry-is relatively easy. Actually choosing winners and losers through judicial or administrative action is more difficult if it involves property allocation, bankruptcy adjudication, or enforcement of competition norms. Although the legal structure is evolving rapidly in most areas, practice is still very uncertain. The generality of many laws leaves wide discretion for administrators and courts, and there has not yet been time to build a body of cases and practice to further define the rules of the game.


Since the breakup of the USSR, trade has contracted sharply for the fifteen new independent states, both with each other and with the rest of the world. To restore interstate trade and integrate their economies effectively with the broader international economy, governments of the new independent states should

- Phase out remaining price controls and related export restraints and import subsidies
- Strengthen competition by terminating state trading, promoting entry of private trading firms, and encouraging enterprise-to-enterprise trade
- Improve the institutional infrastructure, especially the domestic and international payments system
- Increase intergovernmental cooperation in addressing trade and payments issues.

The international community should support these countries' institutional capabilities—through provision of technical assistance and policy advice—and eliminate or reduce trade barriers that could hamper industrial and agricultural exports of the new independent states.

**IMF Publications**


**Working Papers**


In recent years a number of countries in the former Soviet Union and Eastern Europe have chosen to issue their own currencies, and more are likely to do so in the future. This instruction book on implementing currency reforms deals with

- Macroeconomic and operational measures required for the orderly transition to the new currency, including the choice of exchange regime, the issuance of coupons and the costs and benefits of currency reforms
- Issues relating to the production of the new currency bank notes
- The main features and terms of the conversion, as well as handling speculative inflows and old currency contracts
- The operation of the foreign exchange market, and maintenance of exchange rate stability in the period immediately following the introduction of the new currency. The appendix covers the technical aspects of currency handling, accounting, and management.


This paper reviews lessons in i consolidation for the former St. Union that emerge from the experience of Central and Eastern European economies in transition. A central lesson is the need to support macroeconomic stabilization with front-loaded fiscal adjustment. Consistent with this adjustment pat structural reform in the tax and expenditure areas should be aimed at allocative efficiency and fairness, and its sequencing predicated largely on administrative constraints. In the face of the uncertainty of fiscal projections, formulation of contingency measures is necessary. Elimination of submerged fiscal imbalances, stemming from quasi-fiscal activities of state-owned nonfinancial enterprises and financial institutions, is just as important as correcting the measured budget deficit.


Although various factors point to a more arduous and longer transition in Russia than in Eastern Europe, the broad policy approach should be similar. A necessary condition for effective macroeconomic stabilization is the imposition of hard budget constraints on enterprises. Financial assistance from the government and the central bank to enterprises must be strictly controlled to ensure compatibility, with both inflation objectives and the creation of incentives for reform. Although Russia needs external financial assistance, it must be willing and able to pursue economic policies that ensure that the assistance has the desired effects, especially macroeconomic stability and systemic reform.


Successful economic transformation requires the simultaneous attainment of macroeconomic stability, political support, and adequate private invest-
ment. Macroeconomic stability is defined as fiscal balance; political feasibility is related to the income gains and losses of different population groups; and private investment is linked to public infrastructure investment. Attainment of the multiple requirements for successful transformation may necessitate a "big push," with external financial and technical assistance. Productivity gains can be achieved when workers are induced to make occupational choices consistent with their comparative advantages.

**Books**


The book analyzes resource allocation strategies, from budget formulation to service delivery, and compares expenditure management systems in the industrial nations, the developing world, and the transition economies. Relationships between the executive and legislative branches of government in the transition economies are discussed in detail.


Countries in transition have experienced the consequences of four gaps: (1) the information gap: due to their past isolation, little was known about the institutions of the transforming countries; or about the institutions of market economies; (2) the conceptual gap: economists lacked experience and literature on the process of moving from central planning to market economies; in the past it usually worked the other way round. Domestic and foreign experts thus have to address the dilemma of how far they can go to adapt Western models in institution building and the sequencing of reforms; (3) the skills gap: despite the high level of literacy and general cultural sophistication of the population in the transition economies, the lack of certain technical skills (such as legal, accounting, financial, and other related skills) has slowed the transformation process; (4) financial gaps: output and income in most transition countries have sharply dropped, and the resources for new investments and infrastructure are scarce. Without enough domestically generated savings, foreign capital and assistance is badly needed. Helping to fill these "black holes," the authors (mostly IMF staff members) analyze their experience with fiscal reform, including issues of privatization, fiscal federalism, and social safety nets.

Latest of the IMF Economic Reviews Series:
No. 4, Estonia, 1993, 84 p.
No. 5, Kazakhstan, 1993, 121 p.

**Other Recent Publications**

Kazimierz Z. Poznanski, ed., *Constructing Capitalism: The Reemergence of Civil Society and Liberal Economy in the Post-Communist World*

The book identifies major economic and political challenges that societies face as they attempt to build democratic governments and market economies simultaneously. Those challenges include the ideological (Stalinist) heritage; the political economy of East-East trade; the role of property rights and issues of ownership and coordination; and the dissected state assets. The small- and medium-size private businesses are at the forefront of the economic transition, but built-in barriers—the discriminating taxes, lack of legal protection, and the remnants of the state bureaucracy—remain daunting. For the market economy to function, a strong state is needed to reform the system and to provide an adequate regulatory framework. Public understanding of individual ownership—the responsibilities as well as the rights—is essential to build markets and democratic civil societies.

On the political front, [postcommunist] governments face dilemmas when they attempt to implement economic reform requiring short-term sacrifices and, simultaneously, build democratic institutions. Reform measures often require concentration of power in the executive and rapid decisionmaking, as opposed to consensual politics. Yet democracy demands consensus and, in particular, the support of those who have played a crucial role in the fall of communism—even though they may not be well versed in democratic practices.

The paradox of the day is that the collapse of communism virtually destroyed the state, yet the transition to democracy and markets require a strong state. That dilemma may prevent the peaceful evolution to capitalism and democracy, and raise the danger of radical, even authoritarian solutions.


In the final chapter, "Communalities and Differences in Transformation" (pp. 285-97) Csaba emphasizes that historical, cultural, and political factors that are outside the scope of economic analysis, as well as the social environment and the larger international setting are heavily influencing individual strategies of transformation. Grand designs of how to transform a socialist economy into a market economy might be of academic interest at best and hardly instrumental in shaping the actual course of events. Yet standard economics is still relevant in the postsocialist region. For example exchange rate changes in Poland and the Czech Republic did influence elasticities of supply and demand. Expansive monetary policies in Russia did bring about the demand-pull inflation, as expected. So the standard framework
does have a lot to offer in analytical terms, concludes Csaba.


The book is a captivating dialogue between the head of a hypothetical, formerly socialist Eastern European country and a fervently market-minded American adviser. Their spirited give-and-take highlights the monumental political and economic complexities currently faced by former Soviet block countries as they struggle to transform themselves into free market economies.

Walter Adams and James Brock depict the American expert as an advocate of radical reform. "I am delighted to share with you the extensive experience that Western economists, especially American experts, have accumulated over the years in dealing with these problems," he says. But the Eastern European prime minister views the adviser's lectures as "boilerplate," in many ways too simplistic for the situation of the newly liberated nations. While agreeing with the adviser that a "bitter pill" or "big bang" may be necessary to rehabilitate a comatose socialist economy, he knows the cultural and political barriers to such extreme measures—strong medicine may be required, but an overdose could kill the patient.

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The problem with relying on international competition rather than domestic policy to counter abuse of monopolistic power is that it is probably neither feasible nor credible. The countries in the region have limited foreign exchange reserves, and are likely to face very high levels of unemployment in the medium term as they restructure away from heavy and defense industries. Moreover, domestic suppliers are for the most part financially weak, inexperienced in operating in a market system, and not competitive in either price or quality.

Hungary, Poland, and the Czech Republic have largely followed Central European, and especially German, tradition in establishing a judicial policy framework that facilitates the use of fines as penalties for infringements. The laws also follow German/EC practice in focusing on dominance (with the definition of monopolization involving relatively low market shares—30 to 40 percent—for such open economies), rather than emphasizing the direct promotion of competition. The bulk of anticompetitive practices also appear to be illegal on the basis of the "rule of reason."

Given the severely imperfect market structures, it would seem attractive for competition policy to seek to extend competition itself, rather than to protect consumers directly by preventing abuse of dominant positions. Given the lack of experience (and perhaps authority) of the judiciary, clear-cut legislation outlawing anticompetitive practices might be more suitable than "rule of reason" cases that depend on good judgments and case law. Important steps in the same direction can, however, be achieved through the use of guidelines in the competition office.

Significant private incentives to eliminate anticompetitive practices, with injured parties being able to bring civil actions against monopolists, might also help in establishing both the rule of law and in breaking down collusive practices.


Five multilateral development banks (MDBs)—the World Bank and the African, Asian, European, and Inter-American development banks—will approve about $410 billion in loans and credits for projects in developing countries between the years 1993 and 2000, predicts the report. During fiscal 1990–92 the World Bank alone disbursed, directly or indirectly, $50.2 billion to suppliers of goods and services throughout the world. In fiscal 1992 the level of World Bank payments to U.S. firms, at $1.32 billion, was less than it was five years earlier, and 22 percent less than in 1990 when it reached $1.7 billion. In the past three years Germany has overtaken Japan as the second-ranking destination of World Bank payout.

MDB-financed business is open to international competition from any firm in all 174 nations that are now members of the World Bank and the regional MDBs. The lending commitments of these five development banks, including cofinancing, are now at a record $48–49 billion a year. A growing amount of consultancy, worth $30–35 billion, will be funded by the banks during the eight-year period, 1993–2000. Of the total forecast MDB-lending, about $60 billion will be committed for agricultural projects, $60–65 billion for energy, and $50–55 billion for industry and the financial sector, $48–50 billion for nonproject loans, and $50 billion for transportation projects, according to the report.

Cofinancing will enlarge the market, which is to be funded by the banks during the eight years to $570 billion. In fiscal 1992 the five development banks approved loans and credits worth $37.4 billion for countries in Africa, Asia, Eastern Europe and the former Soviet Union, the Middle East, and Latin America and the Caribbean. Cofinancing leveraged these funds by at least $12 billion. As of January 1993 about $120 billion was still available to be paid out to suppliers of goods and services on already approved MDB projects.


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Asia


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