TRANSITION YEARS
Reflections on Economic Reform and Social Change in Europe and Central Asia

JOHANNES LINN

THE WORLD BANK
TRANSITION YEARS: REFLECTIONS ON ECONOMIC REFORM AND SOCIAL CHANGE IN EUROPE AND CENTRAL ASIA
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Foreword

The twentieth century saved one of its biggest surprises for its last decade: the wholesale transformation of a group of countries tightly bound together under one economic, political, and social model—the former Soviet Union and the Council for Mutual Economic Assistance (CMEA)—into individual states that embrace market principles, pluralism, and civil society participation in the process commonly known as transition.

The end of the Cold War was the trigger that allowed this transformation to happen. But who would have thought that less than 15 years after the Berlin Wall fell, in November 1989, a significant number of the former CMEA countries would be ready to join an enlarged European Union? Who would have thought that barely 10 years after the rather chaotic disintegration of the former Soviet Union, the Russian Federation would have reemerged as a vibrant economy and would be reestablishing itself as the second-largest exporter of oil in the world? Who would have thought that in the early years of the twenty-first century we would be able, for the first time in decades, to use the term "Eurasia"?

All of these monumental changes have occurred, many of them during the tenure of Johannes Linn as Vice President of the World Bank's Europe and Central Asia Region.

This compendium of selected speeches by Johannes eloquently illustrates these transformations. Indeed, under Johannes' leadership, the Europe and Central Asia Region positioned itself as an intellectual as well as pragmatic leader in terms of contributing to the transition debate. The topics range from a description of individual challenges facing subregions and countries to a regionwide perspective. The speeches provide Johannes' special insights into such issues as legal and judicial reform and social concerns. They also demonstrate the relevance of lessons learned in this process to the broader development debate. These lessons come from the vantage point of one who was intimately involved in the decisionmakers' struggles to face and ultimately manage the unprecedented challenges of transition. The speeches transmit to the reader a sense of increasing understanding and learning over time of the true dimensions of those challenges: to overcome the shock resulting from the unprecedented sudden disintegration of a common economic space to the socioeconomic and political fabric and the lives of more than 400 million people.
Starting from the earliest phases of transition and through the present, the World Bank has aimed to improve the livelihoods of people in all countries in the region. Johannes never ceased to advocate that no country, however small, should be forgotten in the larger geopolitical scheme. The Bank is working to help people in Europe and Central Asia have a more optimistic outlook on life, to give them a fairer chance, and to ensure that future generations benefit from sound environmental practice and social and economic development.

The countries in the Europe and Central Asia Region can be proud of their achievements, which, if sustained, will represent a success story that all stakeholders in the development community would do well to note. The World Bank can also be proud of its contributions to the region’s success under Johannes’ stewardship and that of the late Wilfried Thalwitz before him.

Shigeo Katsu, World Bank Vice President for Europe and Central Asia
For a young German born in 1945 and growing up in Bavaria in the two decades after World War II, the world was sharply divided into East and West and North and South. In many ways, the East-West divide was much closer, more threatening, and more worrisome than the gap opening up between North and South in the wake of decolonization. The Iron Curtain and the Berlin Wall were visible and deadly barriers. The political maps showed little more than a great red expanse to the east of Finland and the River Oder and to the southeast of Vienna, with hardly a sign hinting at different countries or peoples or cultures.

This is how I grew up, in awe of the postwar division of the world, unable to imagine that this division might ever end. As a teenager and student I visited and lived in West Berlin, once or twice crossing into East Berlin to meet an East German pen pal. The impressions I took away from these visits only reinforced the picture of a world divided, with opportunity beckoning in the West and repression looming in the East. Even Hungary and Poland were largely inaccessible and unknown to us in the West in those years. Even less could we contemplate getting to know the far reaches of the huge Soviet Empire, although we might have read about the exploits of explorers who had traversed the mountains, steppes, and deserts of a mysterious and presumably long-gone Central Asian world. My own, more timid explorations took me by car from Germany to Greece, traversing Yugoslavia, then relatively open, accessible, and unified. In contrast to East Germany, Yugoslavia gave the young traveler from the West a glimpse—or as it turned out, a mirage—of what a less threatening, more humane form of socialism might have to offer.

In the early 1970s I became much more aware of and troubled by the challenges of development in the South and by the urgent need to bridge the ever more glaring gap between the two hemispheres. Having joined the World Bank as an economist in 1973, I worked mostly in Latin America, East Asia, and Southeast Asia and largely ignored the internal tensions that were developing in the “red” area on the world’s map. I was not alone. Most of us who worked on development issues had little interest, knowledge, or understanding of the communist system or of the countries and peoples behind the Iron Curtain. During the 1980s only a few people in the World Bank worked on Yugoslavia and on the
early, gradual reformers, Hungary and Poland. But then, in 1989, while I served as an adviser to Stanley Fischer, then Chief Economist at the World Bank, and as the signs of fundamental change in the East became unmistakable, the Bank organized a conference on the incipient transition in socialist countries. At this meeting we met for the first time with experts on the communist economic system and gently explored what might or might not be in store as systemic political and economic change seemed to be in the offing. In early 1990 I visited a devastated Poland for a conference organized by the World Bank jointly with a young Polish economist, Leszlec Balcerovic. At about the same time I visited Berlin, just as the Wall began to crumble, knocked down by the many small hammers of people ecstatic to see the old divide disappear. In October 1990 German unification was completed; by the end of 1991 the Soviet Union was no more.

In the subsequent years I watched with great interest the rapidly growing engagement of the international community, including the World Bank, in the countries that emerged from the now defunct former Soviet empire. As the Bank’s Vice President in charge of financial risk management and resource mobilization, I was excited and concerned about the rapid expansion of our International Bank for Reconstruction and Development (IBRD) loan exposure in its brand new members, as well as about the need to raise new funds for the International Development Association (IDA) with which to aid the poorer countries in the Europe and Central Asia Region, as the new regional office became known. From the sidelines I watched with admiration and fascination how the first Vice President for the region, Wilfried Thalwitz, built up the Bank’s institutional and staff capacity virtually from scratch and almost overnight, how he and his team plunged into the often very uncomfortable and risky worlds of political chaos, deep economic recession, and civil war that characterized many parts of the former Eastern Bloc in the immediate aftermath of the collapse of the Soviet Empire and Yugoslavia. I marveled at how they were able to establish trust with new partners and a track record of sensible advice and prudent lending. In the first five fiscal years (1991–95), the World Bank financed 163 projects in the region, totaling $18.1 billion. During the same period, the Bank made 14 loans to Turkey, for a total of $2 billion.

In the fall of 1995, Wilfried Thalwitz informed the World Bank’s President, James D. Wolfensohn, that he wished to retire at year’s end, after three decades of extraordinarily dedicated service to the institution and to its shareholders, clients, and partners. To my surprise, and consternation, Mr. Wolfensohn asked me to take over. This was a daunting step
for me, since I had been away from the Bank's operational work for almost 10 years and did not know the region except from my limited vantage point in the Bank's financial wing. However, I could not refuse the offer to be part of the historical transition of the former "red area" on the maps of my childhood and to do everything in my power to help the countries of the region recover from what had been a traumatic economic and social shock and from the scars of their communist past. On January 1, 1996, I became Vice-President for Europe and Central Asia, beginning what was undoubtedly the most exciting part of my World Bank career. In September 2003, after more than 30 years of service, almost 8 of them in the Europe and Central Asia Region, I retired from the Bank, grateful for the extraordinary opportunities I had had for so many exciting years. By the end of fiscal year 2003, the World Bank had opened offices in virtually every country in the region, employed more than half of its 1,000 regional staff in country offices in the region (rather than at Washington headquarters), had made more than $40 billion in loans to the transition economies, and could with some satisfaction consider the progress that the region had made with its support, even as much remained to be done to achieve the urgent goals and aspirations of its people.

This volume collects some of the speeches and addresses I gave between 1996 and 2003. They serve as a record of the World Bank's institutional thinking during the period of the historic transition process in Europe and Central Asia. These years, and hence the speeches, span a time of many fateful events. The countries of Central Europe embarked firmly and successfully on the path to accession in the European Union. The Russian Federation and Ukraine reached the nadir of a deep recession shortly after the traumatic 1998 financial crisis and began the long path of recovery, which after the unexpectedly deep collapse has proven to be unexpectedly rapid and sustained. The small, poor republics of the former Soviet Union in the meantime were plagued by severe economic and social problems, compounded by rapidly rising debt burdens and serious problems of governance and regional strife. While most of these countries are now recovering from their deep recession, their prospects are at best clouded. In the Balkans 1996 marked the beginning of the reconstruction of Bosnia and Herzegovina after a bloody civil war. This was followed by the upheavals in Kosovo and the collapse of the old regime in Serbia and Montenegro. Today, perhaps for the first time in centuries, it appears that the Balkans are set for peaceful integration with the rest of Europe. Finally, since 1996 Turkey went through a seesaw of political and financial crises and recoveries, and it experienced a major earthquake as well as a war in its backyard. Yet Turkey now seems
to have turned a corner, with increased domestic political stability, far-reaching and sustained reforms, and an economic recovery, all of which give hope that Turkey’s aspirations for a prosperous future, ultimately as a member of the EU, are indeed a real possibility.

Public speeches represent a somewhat curious and idiosyncratic combination of institutional and personal reflection. Preparing such speeches is a bit like tailoring a suit for oneself. Usually someone else does the first cut and stitches together various bits and pieces of information and insight into an early draft, which then requires varying degrees of repair, unraveling and reassembly, additions and subtractions, and changes in color or tone before the presenter feels comfortable with the length, content, message, and style. But in the end, it’s only once you’re at the podium that the real speech emerges, some more successful than others, some well attuned to the needs of the audience, others missing their target, some more spur of the moment and short-lived, others more in depth and lasting in their messages.

In selecting the speeches for this volume, I tried to provide a broad representation of the ideas and experiences that motivated the World Bank in its work. The speeches do not, of course, provide a complete history or overview of all that the Bank did or had to say during this time. The volume starts with overviews of regional trends and outlook in 1996 and 2002. It then presents perspectives on individual country and sectoral issues. It closes with a set of speeches addressing broader development perspectives and a summary of the regional outlook as seen in mid-2004.

These speeches cannot do justice to the courage and perseverance of the people of the region whom I served for almost eight years. While the enjoyment of newly found political freedom was palpable, the economic shock and human toll of the transition were severe. It is worth remembering that after two World Wars, the dissolution of the Soviet empire and the resulting dramatic economic recession was the third great upheaval that the countries of Central and Eastern Europe faced in a century and its successful and peaceful outcome by no means foreordained. Fortunately, 15 years after the transition started a modicum of economic prosperity is now returning to most parts of the former Soviet

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1 Readers interested in the talking points for a more complete set of speeches delivered during 1996–2003 can find them on the World Bank’s Web site (www.worldbank.org/eca). This Web site also contains many of the World Bank publications produced during the last few years by the staff of the Europe and Central Asia Region.
world, and the prospects for continued recovery, peace, and even democracy are promising. I have deep admiration for the leaders and the people of the region who made this outcome possible.

I am very grateful for the contributions my many colleagues in the Bank, especially in the Europe and Central Asia Region, have made to the transition process. Without their initiative, inputs, and support, the speeches and addresses collected in this volume could not have been credibly prepared or delivered. I am indebted to my colleague and successor, Shigeo Katsu, for pushing forward with the idea of issuing this volume and for his many years of dedication in his previous capacity as Director of Operations in the region. Miriam Van Dyck provided invaluable assistance for the production of the volume, strongly supported by Nick van Praag. Our trusted and efficient editor, Barbara Karni, made sure the talking points translated into what I hope is readable prose. Finally, I wish to thank Priscilla Rachun Linn and our children, Joseph and Natasha, for always cheerfully putting up with stress and deprivation caused by their peripatetic husband and father during more than 30 years of life with the World Bank.
List of Abbreviations

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<th>Abbreviation</th>
<th>Full Form</th>
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<tr>
<td>CDF</td>
<td>Comprehensive Development Framework</td>
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<td>CIDA</td>
<td>Canadian International Development Agency</td>
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<td>CIS</td>
<td>Commonwealth of Independent States</td>
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<td>COMECON/CMEA</td>
<td>Council for Mutual Economic Assistance</td>
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<td>DFID</td>
<td>British Department for International Development</td>
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<td>EBRD</td>
<td>European Bank for Reconstruction and Development</td>
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<td>EU</td>
<td>European Union</td>
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<td>FDI</td>
<td>foreign direct investment</td>
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<td>FIAS</td>
<td>Foreign Investment Advisory Service</td>
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<td>GEF</td>
<td>Global Environment Facility</td>
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<tr>
<td>GTZ</td>
<td>Deutsche Gesellschaft für Technische Zusammenarbeit</td>
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<td>HIPC</td>
<td>Heavily Indebted Poor Countries</td>
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<td>IDA</td>
<td>International Development Association</td>
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<td>IFC</td>
<td>International Finance Corporation</td>
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<td>MDGs</td>
<td>Millennium Development Goals</td>
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<td>MIGA</td>
<td>Multilateral Investment Guarantee Agency</td>
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<tr>
<td>NGO</td>
<td>nongovernmental organization</td>
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<tr>
<td>OSCE</td>
<td>Organization for Security and Co-operation in Europe</td>
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<td>PRSP</td>
<td>Poverty Reduction Strategy Paper</td>
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<td>USAID</td>
<td>U.S. Agency for International Development</td>
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<td>WHO</td>
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PART 1

Regionwide Progress and World Bank Engagement

The speeches in this section of the book—chapters 1 and 2—provide snapshots of the region's progress and outlook, of the lessons of the transition process to date, and of the World Bank's support for the region. In 1996 the Bank was already stressing a number of key dimensions of the transition that critics do not usually associate with the "Washington Consensus." These included social, poverty, and environmental dimensions; the need for institutional development; and the key role of a supportive business climate. It would be fair to say, however, that the Bank as an institution—and I personally—did not adequately address some important problems of transition in 1996, among them the weaknesses of the privatization processes in many of the countries (notably Russia's scandalous loans-for-shares program) and the scourge of corruption. By 2002 the Bank had begun to focus on these issues, along with a number of other lessons learned, as reflected in chapter 2.

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3. Many of these issues are addressed in much greater detail in Transition: The First Ten Years (World Bank 2002) and Anticorruption in Transition (World Bank 2000).
CHAPTER 1

The Transition in Europe and Central Asia: Progress and World Bank Assistance

From a speech given in Tokyo, November 25, 1996

Transition in Central and Eastern Europe and Central Asia is a vast and complex topic with wide political, institutional, and economic dimensions. The World Bank is trying to assist economic reform. What is the Bank doing, why is it doing what it is doing, and how is it directly and indirectly helping the private sector play a major role in the process?

How Are the Countries of Central and Eastern Europe and Central Asia Performing Today?

The countries of Central Europe and the Baltics have seen renewed growth during the past three years (although Bulgaria is likely to suffer a reversal in 1996). Belarus, the Russian Federation, and Ukraine are still experiencing negative growth, however. In Russia we expect output to bottom out at the end of 1996 and grow in 1997; Ukraine may also begin to recover in 1997.

The overall picture would look better if the largely unrecorded private and services sectors were included in the national accounts. The "pure" private sector in the Russian Federation has now reached a third of GDP. In addition, roughly another third of GNP is contributed by joint ventures and firms with other forms of mixed ownership.

In Central Asia and the Caucasus, Armenia, Georgia, and the Kyrgyz Republic are growing, and the recession appears to have ended everywhere except in Azerbaijan and Tajikistan, which still suffer the consequences of conflict.

The assistance of Marcelo Selowsky, former Chief Economist for the Europe and Central Asia Region of the World Bank and current Assistant Director of the IMF's Independent Evaluation Office, in drafting this speech is gratefully acknowledged.
Overall, the severe recession in Eastern Europe and Central Asia shows clear signs of abating; with reasonable policies, growth is likely to resume in the near future in most, if not all, countries. Poland's significant recovery since 1992 shows what is possible.

Inflation has fallen more sharply in Central Europe and the Baltics than in the non-Baltic republics of the former Soviet Union, except for a sharp reversal in Bulgaria and, to a lesser extent, Romania. Throughout the region, countries that have begun to recover have reduced inflation below 30 percent a year, confirming the notion that stabilization is a prerequisite for the resumption of growth.

Central Europe and the Baltics

The countries of Central Europe and the Baltics early on liberalized and privatized part of their economies, especially small and medium-size enterprises. They inherited market and legal institutions that have helped the process, and they had smaller military industrial complexes (for which demand collapsed). We may never be able to disentangle what part of the superior growth performance of Central Europe and the Baltics is due to better and earlier reform policies and what can be attributed to initial conditions prevailing at the outset. What we do know is that the quality of policies matters—and policies are under the control of governments.

Will growth be sustainable? Will it be hampered by macroeconomic threats, such as the reemergence of fiscal deficits and banking sector emergencies? Throughout Central Europe and the Baltics, fiscal deficits have been reduced. Public expenditures and revenues remain extremely high as a percentage of GDP; however, averaging close to 50 percent. This means that relatively small shocks on either the expenditure or the revenue side could have a significant impact on the fiscal deficit. The sudden need to recapitalize banks or compensate depositors for losses caused by banking sector crises, an increase in public sector wages, increased transfers to money-losing public enterprises as part of an electoral cycle—any of these events could have a significant effect on the deficit, which could lead to monetization of that deficit or crowding-out of the private sector. Further progress in increasing the tax base while reducing tax rates (especially the payroll tax), early resolution of banking sector problems, and civil service and social transfer reforms are thus critical to ensuring the sustainability of the macroeconomic situation and the growth process.
The Russian Federation, Ukraine, and Belarus

The Russian Federation is going through a difficult macroeconomic phase. Declining fiscal revenues have led to sharp expenditure cuts, threatening the viability of the overall adjustment program. Provided the government weather the crisis, prospects that growth will resume in 1997 are good. But markets must remain liberalized and the economy open. Efforts to artificially jump-start noncompetitive industrial sectors through trade protection or subsidized inputs and credit will simply postpone the process. Social concerns should be addressed by better targeting social assistance directly to households (particularly poorer pensioners) rather than transferring funds to money-losing enterprises to sustain output. Subsidies should be used to reach households and the very poor, not enterprises.

In Ukraine reforms started two years later than in the Russian Federation, and the country paid a price, in the form of a more severe cumulative output loss. After some hesitation in 1995, the reform program is now proceeding on a broad front. Provided the authorities keep their resolve, Ukraine could enter a growth path next year similar to that of Poland in the 1990s.

Belarus has reversed its reform efforts. Prospects for an economic recovery there remain dim.

Central Asia

The Central Asian countries are generally poorer than the Central and Eastern European countries, but four of them (Azerbaijan, Kazakhstan, Turkmenistan, and to a lesser extent Uzbekistan) are endowed with extensive oil and gas deposits that could bring considerable wealth to their people. Development of these resources will require large investments in pipelines and infrastructure, the financing of which will need to come mostly from private external sources. A development path based on oil and gas exports raises special policy challenges: how to create productive employment outside the capital-intensive energy sector and how to manage large revenue inflows without overheating the economy or indulging in wasteful showcase projects. Privatization, restructuring, and further liberalization of markets are necessary to enable other sectors (agriculture, manufacturing, and financial and other services) to grow and remain competitive in an environment of real exchange rate appreciation.
Transition Years

The pattern of agricultural development in Kazakhstan, Turkmenistan, and Uzbekistan presents a unique set of challenges. Concentration on irrigation-intensive cotton monoculture has led to the diversion of two large rivers and the drying up of the Aral Sea. Soil degradation, deteriorating health conditions, and changes in the local climate are long-term problems that will require attention and resources over several decades.

The Kyrgyz Republic and Tajikistan do not share their neighbors' rich endowments of natural resources. While heavily dependent on agriculture, they face considerable hurdles to increasing agricultural exports, including high transport costs.

Poverty throughout the Region

Poverty and income inequality have increased in all economies in transition. The Central Asian countries inherited significant poverty from the Soviet Union. About a third of the population in these countries is poor.

Slowing reforms is not the solution to poverty. Despite having delayed the reform process, the share of poor households in Ukraine increased from 12 percent to 25 percent between 1992 and 1994; in Azerbaijan the share increased from one-third in 1989 to 60 percent in 1995. In the Russian Federation the practice of using the inflation tax to finance subsidized enterprise credit to sustain production was not helpful. In 1992 the inflation tax burden on households amounted to 12 percent of GDP. That tax ended up subsidizing the financial sector and larger enterprises (by providing credit at negative interest rates). Poorer households—those least able to avoid the inflation tax—ended up financing capital flight.

The emerging evidence indicates that poverty in Central Europe is shallow, with many poor households bunched around the poverty line. This means that the recovery of growth may pull many households out of poverty. In Poland a 5 percent real annual growth rate could reduce the share of the poor from 14 percent of the population to 5 percent by the end of the decade.

In Belarus, the Russian Federation, and Ukraine, a large segment of the poor population will have to be assisted directly. The sharp erosion of minimum pensions and the increase in unemployment in company town areas call for more targeted approaches in public spending. Growth alone will not be enough.
In Central Asia, poverty is both more widespread and more severe than elsewhere in the region. For example, about one-fifth of all households in Azerbaijan and one-third of all households in the Kyrgyz Republic have expenditures that are 50 percent or more below the poverty line. In other words, a large part of the population is not just poor but severely impoverished. The level of cash benefits has plummeted, and transfers play only a marginal role in maintaining living standards. Economic recovery remains the first priority, because without it there is nothing to transfer to the poor. In Azerbaijan, Kazakhstan, and Turkmenistan, oil and other natural resource exports will lead the recovery, but they will not create many employment opportunities. Accelerating structural reforms in other sectors is therefore crucial to increase their competitiveness and provide wage employment. Better targeting of cash benefits is also important, but even then adequate minimum levels of support will become possible only with economic recovery. In the interim, health services must be improved and targeted more directly at the major causes of death and disability.

What Is the World Bank Doing Today?

During the past five years, 23 transition economies—15 newly independent states of the former Soviet Union and eight Central and South-East European countries—have become members of the World Bank. Cumulative lending commitments reached US$20 billion between fiscal year 1991 and fiscal year 1996. Annual lending to the non-Baltic republics of the former Soviet Union went from zero in 1992 to about US$3 billion during the past two years. Thirteen field offices in the region were established during that period. This has been a major effort.

While the volume of assistance is by itself significant, the key principle for Bank involvement has been to improve the environment and the incentives to attract other financial flows, particularly private flows and foreign direct investment. Thus World Bank lending and advice can be seen as "seed interventions" for the medium- and long-run private flows that will result from successful stabilization and reform programs. Eventually, Bank financing should be complemented and even replaced by private flows and foreign equity. This is what we are observing today in some of the most advanced countries in the reform process: the Czech Republic, Estonia, Hungary, Poland, and Slovenia. The natural resources-rich countries of Central Asia will, of course, attract foreign investments under almost any condition, but even there a better environment is likely to increase flows and improve the terms for the host country.
To achieve this objective, the Bank operates on two fronts. First, it improves the environment and incentives for investment and business activity: macroeconomic stability, price and trade liberalization, a credible legal system, and progress in transferring assets from the public to the private sector. Second, it provides resources to revamp public infrastructure and offers credit to the emerging private sector, as it takes time for the improved incentives to trigger a response from domestic and international capital markets. These efforts need to be complemented by creation of a dynamic and liquid financial sector able to intermediate such flows.

Key for the Bank is matching its assistance with the domestic policy effort, which it must complement. If we are too slow or too late, we unnecessarily increase the cost of reform. But if we are premature—lending too much and too early—we add to the debt burden without improving a country’s ability to repay. The Bank could thus help sustain bad policies. To maximize complementarity between assistance and policy efforts, we must adapt our instruments to the stage in which the transition economies find themselves.

The Russian Federation: An Early Reformer at a Crossroads

Supporting the reform program in the Russian Federation has been one of the Bank’s major challenges. The uneven pace of reform across sectors, fluctuating progress in stabilization, frequent changes in counterpart ministries, constitutional uncertainties, the strong role of local governments, and other factors have made the task difficult. Starting from zero, the Bank’s cumulative lending during its first four years of operations (1993-96) climbed to US$6.4 billion. Today, about 75 Bank professionals work exclusively on the Russian program. The Bank’s basic strategy has been to provide early support for the processes of stabilization, price liberalization, and privatization. It has worked closely with the International Monetary Fund (the most recent Extended Fund Facility Program was put together in close collaboration with the Bank). The objective is to achieve a “high-quality” fiscal adjustment. The deficit must be reduced, but it should be done so efficiently, equitably, and in a sustainable manner. Deficit reduction cannot rely on running arrears in contractual payments or on unsustainable cuts in social spending.

Both the fiscal adjustment (which called for a significant reduction of subsidies to the enterprise sector) and trade and price liberalization were supported by two quick-disbursing operations providing noninflationary financing for the budget. The gradual emergence of the private sector
was then supported by funding a strong technical assistance program to create a modern banking sector with international standards and by providing credit through these new banks. To avoid bottlenecks in infrastructure, the Bank has supported rehabilitation investments in the transport sector. Loans to rehabilitate oil fields to maintain export levels have also been important.

Today the Bank is focusing on supporting progress in two sectors where reform has lagged behind: the social sectors and agriculture. Despite spending of 6 percent of GDP on pensions and social transfers, the minimum pension today amounts to only 60 percent of the minimum subsistence level. Unemployment compensation payments cover only 15 percent of minimum subsistence. The Bank is in the process of working with the government on a reform program that will better protect these basic transfer payments, better target social assistance by focusing on families with large numbers of children, and improve both the tax base and the collection of contributions financing pensions and unemployment benefits. Earnings-related pensions will have to be constrained by the history of past contributions. The Bank expects to support this process through a social sector adjustment operation. This effort is being complemented by lending operations to provide some basic medical equipment to hospitals and local community health centers.

The Bank has been less fortunate in engaging Russian counterparts in speeding up agriculture sector reform, particularly land reform. Many of the actions are under the direct control of regional governments. Local and pilot-type interventions will be needed to accelerate this process.

Ukraine: Making Progress Despite a Late Start

Ukraine’s reform program began in the second half of 1994, after President Kuchma was elected. The fiscal deficit and monetary expansion were reduced, privatization was initiated, and most domestic prices were freed. In addition to providing advice, the Bank supported the process with a US$500 million balance of payments operation and a large investment project to help rehabilitate and reform the energy sector (Ukraine is a heavy gas and oil importer, with an energy import bill of about 12 percent of GDP).

The reform process slowed in mid-1995, as state enterprises and the Parliament started pressuring the government to reinstate credit and budget subsidies to enterprises and the coal sector and to hold back the
privatization process. In response, the Bank had to withhold further financial assistance.

The government took corrective fiscal and monetary measures in early 1996, and it is now taking structural reform actions on a broad front that includes large- and small-scale privatization, including agro-processing industries; elimination of restrictions on private traders in the agricultural sector and accelerated land reform; downsizing of the coal sector; and development of an electricity market. Major public sector reforms are being prepared. In response, the Bank's total commitments for fiscal 1997 may reach US$1.5 billion—with disbursement conditional on continued progress.

Belarus: Stagnation and Reversals

When Belarus became a member of the Bank, in 1993, the Bank prepared a significant program of assistance. It began with a quick-disbursing (balance of payments support) operation supporting the start of stabilization and economic liberalization. A resident mission was opened to enhance our policy dialogue. Unfortunately, that was the end of the process. Today, administrative controls have been reintroduced in the foreign exchange market, the government has announced its intention to reinstate direct controls over the decisionmaking process of the leading commercial banks, and the privatization program has been halted. As a consequence, the Bank is not preparing any new loans, although it is trying to keep the policy dialogue alive (by conducting a seminar for parliamentarians, for example). The Bank has brought in experts from other countries to share the lessons learned from privatization. Through economic missions, we are trying to better document current economic events and help the government understand the implications of different policy options.

The Baltics and Central Europe: Much Progress, But Challenges Remain

Although on average growth in the countries of Central Europe and the Baltic is recovering and inflation declining, large variations in the reform agenda remain on the structural side. Bulgaria has lagged in privatization, restructuring and isolation of large money-losing enterprises, and banking sector reform, and the banking sector is threatening the overall macroeconomic situation. The Slovak Republic's privatization program
still places restrictions on the entry of investors, jeopardizing the quality of the governance of the newly privatized enterprises. Croatia still has an unfinished agenda in restructuring state banks and privatizing large loss-making state enterprises. Romania has just begun its privatization program, but the authorities are still intervening in the foreign exchange market, creating uncertainties for exporters and the emerging private sector.

At the other extreme are the Czech Republic, Estonia, Hungary, Poland, and Slovenia, where the economies have become quite open and liberalized, privatization has had a more consistent record, and large private sectors are emerging. The best evidence that the transition is progressing is the large amount of foreign direct investment flowing to these countries. Together the Czech Republic, Hungary, and Poland are receiving about US$2 billion a year in foreign direct investment—about as much as the Russian Federation, a much larger country with greater national resources.

The Bank is adapting its instruments to particular situations. In Bulgaria it is willing to provide assistance if the government takes the necessary steps, particularly in the enterprise and banking sector. Already, the Bank is providing some US$30 million in quick-disbursing funds to help the authorities deal with the social implications of the closure of some major loss-makers. In Romania the Bank is supporting privatization through a large adjustment operation. In Croatia it is preparing several operations to support the resolution of problems in the banking sector and state enterprises.

In the more advanced countries, the Bank is focusing on ensuring the sustainability and efficiency of public finances and on facilitating private sector participation in infrastructure investments and environmental improvement. In Hungary, Latvia, and Poland it is actively supporting the design of more sustainable pension systems, which would eventually include a privately run, fully funded pillar. Loans are intended to help defray the transitional cost of such reforms and to establish an efficient regulatory framework for private pension funds. The Bank is also supporting improvements in tax policy and administration to reduce distortive payroll taxes and eliminate the unfair competitive advantages generated by lax enforcement of tax legislation. Adjustment operations to support such reforms are envisioned for Hungary and Latvia.

To encourage private sector participation in infrastructure, the Bank is supporting the establishment of an energy regulatory agency in Poland.
that provides clear rules for private provision of power services. It is also actively designing a guarantee operation in support of Poland's motorway program, in which significant private sector participation is envisaged.

Bosnia: The Beginnings of Reconstruction and Hope

Donors have looked to the Bank for leadership in the reconstruction effort in Bosnia and Herzegovina. In close collaboration with the European Union, the Bank designed a three-year emergency reconstruction program of some US$5 billion. A broad coalition of donors, who have pledged US$1.8 billion for the first year of the program, has been mobilized.

The Bank's own efforts began more than a year ago and have accelerated since the signing of the Dayton Accords. In April the Bank established a field office in Sarajevo, which will help manage projects and provide policy advice to the government. The field office will also chair overall coordination of donor activities to ensure maximum development effectiveness. The International Finance Corporation (IFC) has begun work in Bosnia to consider possible projects with the private sector.

More than 40 Bank staff work on Bosnia, implementing 13 ongoing projects with Bank support of US$325 million and preparing an additional 9 projects with Bank funding of about US$225 million, expected to be approved over the next two years. These 22 projects will be cofinanced by more than US$1 billion from other donors on concession terms. Rapid implementation is critical, and funds are expected to be disbursed within two years for these emergency projects. The impact of these investments is already visible on the ground and will become more evident during the next few months.

Central Asia: Special Programs and Challenges

The unique challenges and potential of the Central Asian republics have taken time to define and understand. In the interim, the Bank has worked with the governments of these countries to help deal with immediate problems following the dissolution of the Soviet Union. These problems are similar to those faced by other former Soviet republics, namely, the need to achieve macroeconomic stability and begin the transition to a market economy.
Initially, the Bank made a quick-disbursing rehabilitation loan to each of the Central Asian republics except Turkmenistan, which did not need the balance of payments support provided by these operations. Each country also received technical assistance loans to build institutional capacity, in particular for the management of external assistance and debt. The Bank later developed adjustment operations in line with each government's willingness to move toward a market economy.

The pace of adjustment has varied considerably across countries. The Kyrgyz Republic has been among the fastest reformers. Early on it engaged in a far-reaching price liberalization and privatization program, and it has begun to restructure its financial system. Kazakhstan has followed close behind, with privatization and financial reform programs under way. Uzbekistan has now started its privatization program. War and civil strife have delayed reform programs in Azerbaijan and Tajikistan, but adjustment programs are now being prepared for both countries. Turkmenistan has yet to begin this process.

The Bank and the International Development Association have committed more than US$1.7 billion in loans to the Central Asian republics during the past four years. Most of these loans are for rehabilitation and adjustment operations; some are for institution building and investment projects. A pipeline of investment projects has been developed, and bank lending is turning to projects that will improve basic infrastructural and social services.

The Bank's assistance strategy for Central Asia also emphasizes the mobilization of foreign capital. This is done in two ways: by chairing consultative groups for official assistance and by chairing conferences (through the IFC) for private investors. The Bank is also providing advice on how to make the foreign investment regime more attractive to private investors, something that is essential for developing the mineral resources in Central Asia.

**Emerging Common Themes**

Throughout the transition economies common issues and policy challenges have emerged. Many countries are facing the difficult challenge of downsizing large, politically sensitive, money-losing enterprises. In Poland, the Russian Federation, and Ukraine, the Bank is helping governments find a socially acceptable way to downsize the coal sector. A loan to Ukraine has been approved, and a loan to the Russian
Federation will be presented to the Bank's Board shortly. The objective is to close unviable mines and to make those that remain more competitive and eventually privatize them. Bank lending operations will help finance severance payments, retraining and job search assistance, and the transfer of social services to local governments.

In response to the increase in poverty and the decline in health indicators, the Bank is accelerating its work to better target social assistance and prevent the deterioration of basic health services. Much can be done within current budget envelopes, by reallocating subsidies that currently benefit enterprises and nonpoor households to the most vulnerable households. In many countries, people retire very early and receive pensions while earning a salary. About 14 percent of the labor force in Hungary and Poland receives disability pensions, suggesting that the transfer system is being misused. The Bank is heavily involved in identifying reforms in the area of social transfers. It is trying its best in this area, but reform is politically very difficult.

The Bank has been more successful in rehabilitating basic health services and addressing critical shortages of basic equipment for the emergency medical system. During the past two years, it has prepared such projects for Albania, Bulgaria, Croatia, Estonia, the Kyrgyz Republic, Macedonia, and the Russian Federation, and projects for Kazakhstan and Turkmenistan are being prepared.

Throughout the Europe and Central Asia Region, the Bank is trying to provide leadership by investing in environmental improvements and promoting regional environmental programs for countries facing common problems. All of the Baltic states have benefited from Bank projects to protect their shared Baltic Sea coast. The Bank is also playing a key role in the Black Sea Environmental Program, which has developed an "urgent investment portfolio" for Bulgaria, Georgia, the Russian Federation, and Ukraine. Last year the Bank completed the Strategic Action Plan for the Danube Basin, aimed at improving the quality of water in the basin and reducing the negative impact of human activities on its ecosystem. It is working closely with the European Commission in these activities.

In Central Asia a major program is under preparation for the endangered Aral Sea. The project involves the five states that share the sea's coastline and donor countries, under the leadership of the Bank and the United Nations. The program consists of country-specific as well as multicountry projects to alleviate some of the immediate effects of this ecological disaster on the population. The program will also finance
long-term efforts to stem further ecological degradation. The issues associated with this effort are extremely complex and involve water rights, hydroelectric power generation, agricultural production, and environmental management. Defining viable development strategies that manage these competing interests effectively is clearly one of the most challenging tasks facing these governments and the Bank in Central Asia.

A unique feature of Eastern Europe and Central Asia is the extensive network of pipelines and power lines carrying massive amounts of energy across borders. Investment opportunities to expand that network are significant, given the substantial energy resources in some countries and severe import dependence in others. These opportunities will become more profitable as countries achieve sustained growth. The Bank could play an important role in refereeing multicountry agreements, providing technical advice, and providing catalytic financing or guarantees, particularly if foreign direct investment is associated with such agreements.

For several Central European countries, accession to the European Union (EU) has become the main objective of economic policies as well as political strategies. Accession within the next decade will present several challenges. Per capita income differentials are much wider today than they were when the poorer EU members (Greece, Portugal) joined. Many important sectoral policies defined by the EU—in financial markets, for instance—require the existence of laws, regulations, and institutional arrangements that are still wanting in Central Europe. Other EU directives and policies—in agriculture, labor markets, and telecommunications, to name just a few areas—may not be suitable in their present forms to the realities of some of the countries, which may be more advanced in these areas than in Western Europe. The criteria for macroeconomic convergence built around the Maastricht Treaty will obviously require adaptation to the realities of the Central European countries.

Numerous agreements and discussions will be necessary over many years to make the accession a smooth and credible progress. Policymakers are currently thinking about how to maximize the synergies between the World Bank and the European Union in these matters, to the benefit of the Central European countries. The strength of the Bank’s assistance lies in its intimate knowledge of the requirements for sustained private sector-induced growth in these countries. It intends to capitalize on these strengths and play the role of an “honest broker,” offering advice to both sides by sharing lessons and providing alternative approaches. A mix of lending and policy advice will provide the basis for this strategy.
What Is the Bank Doing to Promote the Private Sector?

How do the Bank’s activities in support of stabilization and overall structural reform help the private sector? Are they too removed, indirect, or general?

**Improving the Business Environment**

Interventions aimed at improving the business environment are crucial in improving the overall environment for private sector activity and ensuring the sustainability of that improvement. Overwhelming evidence from international experience shows that investment growth and private sector activity are highly correlated with macroeconomic stability and a liberal and depoliticized functioning of markets—that is, a climate that encourages private business.

This is precisely what the Bank is trying to achieve, by fostering action on several fronts. First, the Bank is supporting the reduction in public sector deficits through sustainable measures, such as modern tax reforms that lower rates and enhance compliance, lower payroll taxes to enhance employment, reduction of inefficient subsidies while protecting the most vulnerable (key for the social sustainability of the reform process), and the focusing of government expenditures on key infrastructure needed to complement private sector investment.

Second, the Bank’s work to support price liberalization and eliminate price controls increases the predictability of future prices; trade reforms further link these prices to world prices, making them even more predictable and subject to less bureaucratic interventions. Price liberalization also reduces the room for bribery and corruption.

Third, privatization puts assets on the market, making them available to small domestic entrepreneurs as well as larger foreign investors. Privatization takes control of firms away from line ministries, which in many countries have been the main pressure groups for subsidized credit and protection. It depoliticizes economic activities and markets.

Fourth, the Bank has helped strengthen the environment for foreign investment, which will play a critical role in the future of the transition economies. The Foreign Investment Advisory Service (FIAS), operated jointly with the IFC, has conducted diagnostic assessments of the environment for foreign investment in a dozen countries and reviewed...
investment legislation throughout the region. As a result of this work, “national treatment” in the ownership of assets and in licensing rights has been eliminated from most legal codes, as have other restrictions on business activity. In Latvia, for example, after a FIAS review of the legal code, the government changed the investment law to include foreign investment in intangibles (intellectual property and goodwill). There are many such examples.

Providing Direct Support

The Bank has undertaken many actions to assist private sector development directly and ensure an enabling environment for foreign investment. These actions include a wide variety of activities supporting reforms in the financial and banking system, legal and institutional reforms, the direct promotion of foreign investments through investor conferences, and the development of new financial instruments to benefit private companies.

Supporting Financial Sector and Banking Reforms

Financial sector development lies at the core of the systemic transformation process. Without active financial markets, economies in transition, having abandoned central planning, have no alternative allocation mechanisms. Developing such markets is crucial to channel resources—domestically and from abroad, including the Bank’s own resources—to the emerging private sector.

There is, however, a complication: dealing with banks alone could mean that future lending would again be channeled to their traditional client base: debt-burdened and loss-making state enterprises. Hence there is a need to deal simultaneously with the banks and the enterprises that account for the nonperforming loans of those banks.

Through adjustment operations (enterprise and financial adjustment operations), the Bank has supported reforms to resolve the debt overhang of debtor enterprises and the portfolio problems of state banks. Both are needed to unfreeze bank lending (tied up in rolling over nonperforming loans) so that credit can be redirected to the emerging private sector. The Bank has conducted such operations in Kazakhstan, the Kyrgyz Republic, Poland, Romania, and Slovenia; it is currently preparing operations for Croatia, Hungary, and Macedonia. An integral part of
these operations has been improving governance and bank supervision, accounting, licensing, and regulations. Some recent projects support outright privatization of state banks.

In many countries Bank support has been through intensive technical assistance. In the Russian Federation, the Bank provided one of the largest technical assistance loans ever made at the Bank. This US$200 million project for financial institution development builds the capacity of 25 core private commercial banks, which will have to meet international banking standards. In Poland a technical assistance project has successfully twinned Polish and international banks. In Hungary the Bank is processing a banking supervision loan. At the governments' request, it has also provided significant technical assistance and advice to Latvia and Lithuania in dealing with their problems in the sector.

As progress is made in prudential regulation (and enforcement) and bank capitalization, the Bank uses the emerging commercial banking sector to intermediate credit to privatized enterprises and new private firms. It has done so throughout Central Europe. In the Russian Federation it is intermediating credit through the small group of qualifying banks.

Supporting Legal and Institutional Reforms

Working with other donors, the Bank has been actively involved in modernizing legal systems throughout the region. It helped draft new laws for foreign investment and sector-specific legislation that led to increased private sector participation in production and distribution in the oil and gas, power, agriculture, banking, mining, manufacturing, and transport sectors. Given the lack of legal precedence and rule of law, the Bank has coupled legal advice with technical assistance to strengthen the institutions that will enforce and regulate the new economic order. In Poland and the Baltics, for example, the Bank conducted judicial reviews and proposed improvements in the court system. In several countries it has helped design strong bankruptcy laws and worked with other donors to improve legal institutions.

In countries establishing modern national governments for the first time (Albania and some of the former Soviet republics), the Bank has played a more fundamental role. Through loan conditionality, projects have addressed a variety of problems, including market control by state monopolies, restrictions on market entry for new participants, and a myriad of licensing requirements that have impeded business development.
Another example of Bank support for institution building is the Bank's work in support of the development of Russia's oil sector. The first Oil Sector Rehabilitation Loan could not provide the billions of dollars required to cover all rehabilitation needs, but it did establish a basis for overhauling the sector. A second rehabilitation loan followed, as well as policy advice on oil taxation reform, refinery strategy, and oil transport issues. Progress has been difficult, but the Bank has helped ease administrative controls and sales allocations, and export duties have been reduced. The Bank has also directly facilitated foreign investment by bringing together private oil companies and federal and regional authorities and assisting in their negotiations. An oil rehabilitation project in Romania and a petroleum technical assistance project in Kazakhstan have had similar effects, attracting foreign investment through sector reforms and bringing private and state oil companies and other authorities together.

Promoting Foreign Direct Investment: Conferences, Service Centers, and Executive Training

FIAS supports foreign investment by helping governments establish investment promotion agencies. In Croatia the Bank helped create an investment promotion agency to attract investor interest after the war in the former Yugoslavia. The agency was set up as a 50/50 nonprofit joint venture between the government and several private companies. Several other programs also actively try to present opportunities to foreign investors. The Bank is working particularly hard in countries that have had difficulty attracting investment for political and geographic reasons.

In 1994 the Bank began a program to present investment projects to foreign investors in Central Asia. This program has identified more than 300 investment opportunities in countries such as Azerbaijan, the Kyrgyz Republic, and Turkmenistan. More than 400 multinational corporations have sent representatives to investor conferences at which country profiles, legal and regulatory reviews, and the menu of investment possibilities have been presented. In addition, the Bank is helping the governments of Azerbaijan and Ukraine set up investment service centers, and other countries are interested in following suit. These offices will act as one-stop shops to facilitate the approval of investments. Investors will no longer have to go through several bureaucratic steps to obtain licenses or permits or negotiate asset purchases only to have a different government agency interfere later. The centers will also have investment banking experts to help cut deals between foreign investors and local enterprises.
Reducing Sovereign Risk through New Guarantee Instruments

Sovereign risk is a particular constraint early in a reform program, when political and economic uncertainty is greatest and government commitment to economic liberalization is still untested. During this period, investors and suppliers (both domestic and foreign) lack confidence that the new, more liberal rules and regulations will remain in force during the life of the investment or transaction. Sovereign risk is also particularly significant in large countries, such as the Russian Federation and Ukraine, where local governments may interfere in ways that are inconsistent with federal policies.

The guarantee is a relatively new instrument with which the Bank is experimenting. It is intended to eliminate a class of sovereign risks that may impede private commercial transactions and investments. This guarantee facility requires governments to commit not to take specific actions that negatively affect the contractual obligations of business deals. If they do, they must compensate the guarantee holders for any financial losses. Typically covered under these instruments are risks such as retroactive taxes on imports and exports, revocation of import or export licenses, and restrictions on foreign exchange convertibility. The guarantees do not cover commercial or project risk.

Since political risk guarantees offered by the governments do not yet have credibility on international markets, the World Bank backstops the facilities with its own guarantee. If the government fails to pay a legitimate claim, the World Bank covers the obligation. The government must then reimburse the Bank for the liability on demand. The Bank is experimenting with two types of guarantees: individual guarantees for specific deals between an investor and a local company and umbrella guarantees that cover many lenders, foreign or domestic, and local borrowers.

An example of an individual guarantee is the Sea Launch Project, a joint venture between two international investors, a Ukrainian company and a Russian company, designed to develop a sea-based launch capability for commercial satellites. Two separate guarantees of US$100 million will be purchased, one for the Ukrainian entity, the other for the Russian enterprise. These guarantees will protect the lenders against debt service defaults caused by specific government interference with the production or export of launch components and against political force majeure.
An umbrella guarantee for US$30 million was approved last year in Moldova and is being replicated in other countries in the region. Risk coverage can be purchased for any legitimate loan to finance investment or working capital in any sector. Foreign lenders (input suppliers, commercial banks) establish a commercial contract with a local company and apply to purchase a guarantee policy if they deem it necessary. Once a contract is satisfied, the guarantee is canceled and funds are rolled over into new policies. In this way, the guarantee facility can leverage the US$30 million value several times over its five-year project life.

Providing Assistance through MIGA and IFC

The Multilateral Investment Guarantee Agency (MIGA) provides guarantees for foreign equity and leveraged investments against risks of currency transfer, expropriation, and war or civil disturbances. These guarantees usually have long terms (up to 20 years). MIGA has provided guarantees for investments by foreign banks in Bulgaria and the Slovak Republic and for investments made by foreign firms in the Czech Republic, Kazakhstan, the Kyrgyz Republic, Poland, the Russian Federation, and Uzbekistan. Almost all the transition economies are members of or are in the process of joining MIGA.

IFC assistance in the region has several elements. IFC is helping create modern financial systems, which are urgently needed to efficiently mobilize and allocate funds as well as manage the large volume of securities created by privatization. In the more advanced transition economies, IFC is supporting large, private, locally owned companies. In the less advanced countries, it is creating models to attract foreign investment. IFC is also providing technical assistance in privatization and capital market development and facilitating private participation in infrastructure.

Some of IFC's new projects are quite novel. This year, for example, it developed a US$60 million trade guarantee facility to stimulate intraregional trade. Jointly created with Raiffeisen Zentralbank Österreich AG, the project guarantees the use of bank documents in trade transactions.

Another IFC project that could have a significant long-term impact is the model of land reform being launched in Ukraine. In a pilot project stage, farms were privatized. Interest by farm communities surrounding the project area has been strong, and the project should be expanded nationally.
Closing Remarks

The Bank expects the economic recovery of Central Europe and the Baltic countries to remain on track. But decisive actions will be required on three fronts: further consolidation of public finances by reducing governments' burden on the private sector and rationalizing social transfers, closures and liquidation in the banking sector, and downsizing and eventual divestiture of large money-losing enterprises still in state hands. The Russian Federation must stabilize its public finances, resume privatization, and further liberalize its energy and power sector, ensuring increased production and competition. The social situation will not be helped by jump-starting money-losing industries that have no future in the medium term. A better policy is to promote restructuring and use subsidies and transfers to help needy households directly. Ukraine is making progress again, but everything will depend on the consensus that can be reached between Parliament and the executive branch. Belarus remains a problem. The resource-rich Central Asian countries must avoid the temptation to rely solely on their prospects for energy exports. Other sectors must be developed if productive employment is to be created, and this requires progress on a still large reform agenda.

The transition will be a lengthy process—lengthier than initially expected, particularly for the New Independent States. Because of the synergies between improved policies, capital flows, foreign direct investment, and their impact on economic results, current disparities may grow over time.

These disparities will require the World Bank to be highly flexible. In countries advancing quickly and building bridges to external capital markets, the Bank will accelerate the use of its guarantee power. In large countries in which lack of consensus about reform and weak institutions may delay progress, the Bank will have to experiment with pilot projects of a local nature, from which it can learn, test the responsiveness of institutions, and provide incentives for reform in other regions.

The Bank's role is catalytic; it cannot do its job alone. It needs partnerships with donor countries from Europe and Japan and their bilateral agencies through its joint consultative group process. It needs partnerships with the European Bank for Reconstruction and Development, the European Investment Bank, and the Asian Development Bank to enhance investments and private sector participation. And it needs to forge partnerships with the European and Japanese private sectors, which are contributing capital and know-how to these countries today.
CHAPTER 2

Progress in Transition: Central and Eastern Europe and the Former Soviet Union after a Decade of Reform

From a speech given at the Center for Research on Economic Development and Policy Reform, Stanford University, Stanford, California, May 16, 2002

Clear differences have emerged between the countries of Central and Eastern Europe and the Baltics on the one hand and those of the non-Baltic former Soviet republics (the Commonwealth of Independent States [CIS]) on the other. Central and Eastern Europe and the Baltics experienced a brief and relatively mild downturn followed by steady recovery to GDP levels above those of 1990, with some countries experiencing very strong growth (GDP in Poland, for example, was 50 percent higher in 2000 than it was in 1990). These results are consistent with the expectations of experts in the early 1990s on how a successful transition process should work.

In contrast, the CIS countries experienced a sustained downturn, with recovery beginning only after 1998. This transition recession was much more severe than expected—and much more severe than the Great Depression in the United States, during which GDP fell 27 percent in four years. The transition recession of the 1990s resulted in a substantial increase in inequality, a significant rise in poverty, and a sharp decline in public expenditures on health and education to extremely low levels, especially in the poor CIS countries. However, these trends may soon change as a result of the very high growth the CIS countries experienced between 1998 and 2000 (4.1 percent in 1999, 7.4 percent in 2000, and an estimated 6.6 percent in 2001). The rates were among the highest in

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the world—higher than rates in East Asia (excluding China) and South Asia—and they occurred despite the global slowdown in 2001.

What accounts for the different experiences of the two groups of countries? Let's look behind the numbers, at some of the key factors explaining the very different trends in the transition economies.

**The Unprecedented Transition Challenge of the 1990s: Three Transitions in One**

All countries in the region faced three simultaneous transitions: an economic transition (the breakup of the highly integrated Council for Mutual Economic Assistance [COMECON]), an institutional transition (the transition from plan to market), and a political transition (the deep political transition from dictatorship to democracy). But different countries were affected by and able to cope with these transitions in different ways.

The CIS was hit harder than Central and Eastern Europe and the Baltics in all three respects. It had a rigidly specialized economy, and activities were widely dispersed across the huge expanse of the former Soviet Union. It had a large military-industrial complex, and heavy distortions in energy and transport prices, which caused severe disruptions in trade and transport after the breakup of the Soviet Union. It also relied more heavily on central planning and had a much longer history of undemocratic institutions, a problem that was compounded by the need to set up new national public institutions in the new republics.

The poor landlocked CIS countries were especially hard hit, because they lost the subsidies they had received from the Soviet budget, as well as access to trade, transport, secure water, and energy resources. War and domestic conflict caused major disruptions, and many professionals emigrated. The Russian financial crisis in 1998 caused currencies to plummet, the nascent banking systems and capital markets to collapse, and, in some cases, exports and remittances to decline sharply.

In contrast, Central European countries, which also faced initial losses from the breakup of the COMECON, had easier access to world trade and Western capital as well as the prospect of joining the European Union (EU). They also had recent memories of democratic and market institutions and had begun to develop some basic institutions of civil society during the 1970s and 1980s.
The Western Balkan countries faced the breakup of Yugoslavia, regional strife, and blockades, but many had stronger market-based economies, easier access to European and world markets, and histories of stronger political and civil society development than the CIS countries.

With the benefit of hindsight, the big surprise of the past 10 years is not that Central and Eastern Europe and the Baltics did relatively well or that the CIS countries took a worse tumble and are taking longer to recover. The surprise is really that despite the extraordinary risks and challenges it posed, the triple transition was largely peaceful and that 10 years later most countries show real signs of success on all three dimensions.

The Role of Economic and Institutional Reforms in the Transition Process

A key question in looking back—and forward—is what role economic reforms played in meeting the transition challenge. Researchers at the World Bank have examined three aspects of reform: the role of initial conditions, the progress of economic reforms, and the politics of reforms. Two important conclusions can be drawn from this work.

First, initial conditions mattered. Econometric analysis confirms that initial conditions (as measured by repressed inflation, black market exchange rates, the share of industry in GDP, and trade dependence on other communist countries) made a difference, especially in the early years. Countries that had experience with markets and with nationhood performed better than countries that did not.

Second, economic reforms mattered, especially in the enterprise sector. Market-oriented policy and institutional reforms not only speeded economic recovery and promoted growth in the medium term, they also mitigated the effects of the transition recession.

A key factor of success was the reform of the enterprise sector. In the successful countries of Central and Eastern Europe and the Baltics, the share of economic employment provided by new small and medium-size enterprises grew rapidly in the 1990s, reaching more than 40 percent. In the large CIS countries, that share stagnated at about 20 percent.

New small and medium-size enterprises tended to be more productive, to hire more new workers, and to invest and export more than old (large)
enterprises. An important policy question is, then, what kind of reforms spur the growth of new small and medium-size enterprises?

**Key Aspects of Successful Enterprise Reform**

Successful transformation requires that labor and capital be shifted from old to new enterprises and that new investment be channeled to new enterprises. The experience of successful reformers shows that the key policy and institutional requirements for this transformation to occur are imposing discipline on old (as well as new) enterprises and encouraging new enterprises. What does this mean in practice?

**Imposing Discipline on Enterprises**

Disciplining enterprises implies a variety of policies. First, it means imposing a hard budget constraint on enterprises and banks by passing effective bankruptcy laws and eliminating tax exemptions, subsidies, directed credits, and guarantees (implicit or explicit). Second, it means improving institutions of corporate governance by strengthening minority shareholder and creditor rights, developing accounting and auditing standards, and tightening banking supervision. Third, it means encouraging competition, through free entry, free trade, and effective competition laws.

In order to exercise discipline without imposing excessive social or political costs, policymakers need to shift social assets (housing, clinics, kindergartens) from enterprises to local governments. They need to strengthen social safety nets (pensions, unemployment insurance, severance pay, retraining) and target them toward the most vulnerable.

**Encouraging New Enterprises**

Encouraging new enterprises does not mean granting particular firms and sectors special favors. It means liberalizing prices, entry, trade, and investment; reforming the tax code (by eliminating tax exemptions and reducing marginal tax rates, simplifying the tax regime for small businesses, and strengthening rule-based tax administration); streamlining business licensing, registration, and inspections; establishing secure property and contract rights (by reforming the legal and judicial systems and the land code); and improving the financial system (by closing weak
banks, privatizing banks to strategic investors, and permitting the entry of new banks satisfying prudential norms).

Encouragement without discipline will not work; the two must go hand in hand. Disciplining and encouraging firms requires an effective public sector. Reforms of public administration, of the legal and judicial system, and of the subnational government are thus essential elements in the long-term reform process.

*Privatizing Enterprises as Part of a Strategy of Discipline and Encouragement*

Privatization occurred on an unprecedented scale and played an important role in the enterprise transformation process. In the early transition years it was viewed as a way of getting around hard budget constraints, promoting restructuring, and creating demand for stronger property rights and institutions of corporate governance. It was also a way of getting the state irreversibly out of enterprise management.

The best type of privatization was the sale of enterprises to strategic investors through transparent methods—and these enterprises have indeed performed best. Where this kind of sale was not possible, there were no good alternatives. State ownership could have been continued, without a political commitment to transparent privatization outcomes or the institutional capacity to prevent asset stripping by incumbent managers. Alternatively, state enterprises could have been transferred to new private owners, without the institution of effective corporate governance that could protect minority shareholders from expropriation by those owners. Whatever view is taken about the appropriateness of alternative privatization strategies in the past, it is extremely important looking forward to clarify and strengthen the legal rights of minority shareholders and creditors and to develop the capacity to implement those safeguards effectively.

*The Politics of Reform*

If it is so clear which reforms work, why have these reforms not been implemented more widely and consistently? The answer lies at least partly in the politics of reform. A simple model of the behavior of key winners and losers from reform can help explain why transition reforms went off track in some countries and not in others.
The winners of reform are the owners and employees of new small and medium-size firms. These people incurred some initial adjustment costs as they exited jobs in the state sector, but eventually they benefited from the reforms. They include insiders and oligarchs, who gain greatly in the early stages of reform, when liberalization and privatization provide them with de facto control rights over state assets that can be converted into de jure control and cash flow rights before discipline and encouragement take hold.

The losers are employees of state-owned enterprises and government bureaucrats, who go unpaid or find their real wages decline and who may end up unemployed after old firms are restructured or liquidated. They also include oligarchs and insiders after the initial stages of reform, as additional reforms dissipate their rents.

Countries in which governments are hostage to a narrow set of private interests or in which a large public bureaucracy has “captured” the state can easily get stuck in a low-level equilibrium trap of partial reforms, in which the economic weight and political influence of the losers exceeds that of the winners. When this occurs, oligarchs and insiders face strong incentives to block reforms that seek to increase competition, strengthen corporate governance, and allow freer market entry. The costs to politicians of serving a concentrated set of powerful private interests rather than a broad but dispersed set of losers tend to be low. As a result, the political calculus can easily lead to a deferral of further reforms.

The evidence shows that there is a negative relation between state capture and the investment climate. State capture is thus associated with stalled reforms, a poor investment climate, and low growth of new, more productive enterprises. The result is the absence of sustained economic recovery.

How can countries prevent or break out of a partial reform equilibrium and move toward more comprehensive reform? The lessons from the successful transition economies suggest that dedicated reformers take the following steps:

• Help give new businesses voice (through business associations, for example).

• Tax the rents of oligarchs and insiders and reallocate public spending toward retraining workers, making severance payments (to facilitate
the exit of labor from old industries), and providing safety nets and improved social services in communities hurt by downsizing.

- Work with the media and civil society to explain reforms to the public.

Low-level reform traps are more easily overcome when there is broad-based popular consensus on the goals of transition, as there was in the Baltics, the Czech Republic, Hungary, and Poland; when reform is tied to an external goal (such as donor support for policy reform or accession to the EU or the World Trade Organization); and when domestic leadership is strong and clearly committed to reform, as has recently been the case in the Russian Federation under President Putin.

Prospects for the Region and the Role of the World Bank

Central and Eastern Europe and the Baltics have undergone far-reaching structural transformation and are poised to join the EU—a key driver of reform and a remarkable achievement. The World Bank has been associated with this process since the early transition. The leading reformers have now begun to "graduate" from the Bank. Of course, these countries still face many challenges in terms of structural and social reform. These challenges—not dissimilar to those facing Western Europe—include removing structural rigidities in industry and agriculture, reducing high unemployment, reforming unsustainable pension systems, and eliminating pockets of poverty and exclusion, such as the Roma.

The countries of the Western Balkans face much improved prospects since the change in the political situation in the former Yugoslavia. Recovery and growth are under way, but many challenges remain. Bosnia and Herzegovina, Kosovo, the former Yugoslav Republic of Macedonia, and possibly Serbia and Montenegro still face major political risks. The Western Balkans need continued reforms to improve the investment climate, increase the effectiveness of public administration, and increase social services. Such reforms will bring more external support and opportunities for integration with the rest of Europe. In support of the Stability Pact, the World Bank, in partnership with the European Commission, has coordinated donors, developed assistance programs in individual countries, and supported regional initiatives in support of cooperation and development in South East Europe.

In Kazakhstan, the Russian Federation, and Ukraine, transition has been arduous and protracted, but reforms are now beginning to pay off, as
these economies recover and poverty declines. In the medium term, the prospects for sustained recovery will depend on sustained implementation of a still substantial structural and institutional reform agenda. These countries also face threats from the rising tide of HIV/AIDS and tuberculosis, which need more urgent attention than they are receiving. Through policy dialogue, lending, and technical assistance, the World Bank has become a principal interlocutor with these countries on structural reform. It helped forestall potentially serious policy reversals after the 1998 crisis and continues to work with counterparts to strengthen the reform program currently under implementation.

Prospects are most uncertain and worrisome in the lowest-income CIS countries. These countries lack resources and access to markets, and they suffer from poor governance, high levels of debt and poverty, and the risk of conflict. Since September 11, these countries, especially those in Central Asia, have become the center of international attention. Together with the other international financial institutions involved in the region, the World Bank has launched a special initiative in support of the seven low-income countries of the CIS (known as the CIS-7 Initiative). In the spirit of the Monterrey Summit consensus, this program will help deepen domestic policy reform, promote subregional cooperation, and step up concessional finance and debt relief in the seven poorest CIS countries, Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova, Tajikistan, and Uzbekistan.

Conclusions

Several key points emerge from this review of the transition process:

1. Ten years ago the countries in the region seemed to be facing similar challenges, hopes, and uncertainties. Today one is struck by their extraordinary diversity, by the progress that many have made in the face of unfavorable odds, and by the generally good prospects for the future.

2. The economic impact of the breakup of the Soviet Union substantially explains the dramatic income losses and rise in poverty in the early years of the transition, especially in the poor CIS countries, and the difficult recovery that the CIS countries have experienced relative to other transition economies in the region. Differences in the implementation of market reforms also explain different paths in the subsequent recovery.
3. Development of new small and medium-size enterprises is critical to restructuring the enterprise sector, a key factor in successful transition. This restructuring is achieved by disciplining old and new enterprises and encouraging new ones. Doing so requires an effective public sector.

4. Political factors play a key role in explaining the differences in progress with reform. Where special interests "capture" the state, a low-level equilibrium of partial reforms often occurs, as those who would lose from further reform (insiders, oligarchs, bureaucrats, employees of state enterprises) block the interests of the more productive new enterprises, which stand to gain. Reform-minded governments, with outside assistance where needed, can move the reform agenda forward, as the government is doing today in the Russian Federation.

5. The breakup of the Soviet Union and the subsequent transition process have been very painful. Fortunately, the tide now appears to have turned. Prospects for the region, while not uniform, are more favorable than at any time in the recent past. Continued reforms—improving the business climate, making the public administration more effective, providing better social services—are needed, however, if the level of poverty and the deterioration in living standards that occurred during the 1990s are to be reversed.

6. In light of the peaceful transition, the substantial progress with reforms, and the current economic upturn in the region, the international community can be pleased by the outcome of the past 10 years of transition, and it can be reasonably sanguine about the future of the region. But continued international attention and support are essential to consolidating progress in this critical part of the world and to dealing with serious risks, especially in the Western Balkans and in the poor CIS countries.
PART 2

Country and Sub-Regional Perspectives

Ten years into the transition it had become very clear that what initially had seemed like a homogenous group of new World Bank clients turned out to be—or turned into—a very diverse set of borrowers. The next five chapters therefore present four speeches and an op-ed piece prepared in 2000 and 2002 that capture the Bank’s thinking on some of the key country and subregional experiences.

Chapter 3 delineates the four main economic challenges for the new Russian leadership in 2000: improved macroeconomic management, structural reforms for greater competitiveness and growth, reform of social policies and institutions, and public sector reform. Since 2000 the Russian Federation has made great progress in the first area and some progress in the second, but it still has a long way to go in the last two areas, as President Putin stated after his recent re-election.

Chapter 4 is a speech I gave at a donor meeting for Central Asia in 2002 in which I highlighted the challenges facing this subregion, perhaps the most troubled subregion in Eastern Europe and Central Asia. While some countries have made some progress since, the fundamental challenges of regional cooperation and promotion of systemic reforms in governance and economic policies remain to be addressed, especially in Turkmenistan and Uzbekistan.

Chapter 5 summarizes a speech given in 2000 that highlighted some of the key economic and social reform tasks then facing the European Union (EU) accession countries of Central Europe, especially reforms regarding restructuring old industries and agriculture, creating employment in the face of persistently high unemployment rates, providing social protection and inclusion, and promoting human development. These remain fundamental challenges today for these countries, even as they are just entering the EU.

Chapter 6 is an op-ed piece published in 2002 in the International Herald Tribune, in which my colleague Christiaan Poortman and I report on a car trip from Croatia through Bosnia and Herzegovina, Montenegro, and
Kosovo to the southernmost tip of Albania. We were struck by the extraordinary progress made in the Balkans since 1996 but also by the need both for governments in this fragile subregion and the international community to stay the course. This exhortation remains as apposite today as it was then.

But the reconstruction of “Stari Most,” the historic bridge in the city of Mostar, Bosnia & Herzegovina, has now been completed with the support of the World Bank and other international donors. It is a symbol of renewed hope for national and regional unity in the Balkans.

Chapter 7 presents a short speech given in 2000, at a time when Turkey was facing a major financial crisis. The reforms it recommends have since been substantially implemented, many of them with the help of the World Bank and other international partners and friends of Turkey. Fortunately, it looks as if the reforms are working and Turkey is set to stay the course.
CHAPTER 3

New Leadership, New Opportunities in the Russian Federation

From a speech given at the Fourth Annual U.S.-Russian Investment Symposium, Harvard University, Cambridge, Massachusetts, October 5, 2000

The Russian Federation has chalked up an impressive macroeconomic report card since the crisis of 1998, taking everyone by surprise. Over the first half of this year, industrial output grew 10 percent and investment picked up substantially. Current expectations are that GDP will grow 5–7 percent this year, with the federal government recording its first-ever post-transition fiscal surplus. Both output and the foreign exchange reserves of the central bank are on track to eclipse their pre-crisis 1997 levels, and the fiscal situation has enjoyed a remarkable turnaround. Remarkably, the foreign exchange reserve build-up has occurred without the matching increase in debt seen in 1997.

While good luck, in the shape of the oil and gas boom, has played a role, so has good government policy. It is easy to forget that there were widespread fears in the aftermath of the August 1998 crisis that hyperinflation and serious policy reversals would take over. To the contrary, one of the most impressive accomplishments has been a sharp change in the macroeconomic policy stance. The focus of macroeconomic management is now clearly on re-establishing control over Russia's public finances and debt dynamics—the root cause of the 1998 crisis—and the importance of keeping the real exchange rate at a level that helps both the trade surplus and industrial recovery is now recognized.

Notwithstanding this good news, questions about sustainability abound. As Mr. Illarionov, adviser to President Putin, recently noted, growth is slowing down and could even stop by next summer if current trends persist. Indeed, there are early signs that industrial output growth may be leveling off. And while the oil and gas boom has been a fiscal and balance

The assistance of the staff of the World Bank's Moscow Office, especially Christof Rühe, lead economist, in drafting this speech is gratefully acknowledged.
of payments blessing, it is inevitably putting upward pressure on the real exchange rate, which has played such a crucial role in the postcrisis industrial rebound. What will make GDP and industrial output growth sustainable? And what is the best response to the oil and gas boom? Should, for example, a higher windfall tax be levied, with the proceeds used to prepay foreign debt or help cushion the considerable social costs of transition?

The last question points to an overarching challenge for Russia: how can the level of poverty be reduced? For us at the World Bank, it is a grave concern that so many Russians today face serious economic difficulties in their everyday lives. While statistical problems and a large shadow economy make precise measurement difficult, poverty is a problem, especially among single elderly pensioners, children in one-parent homes, and the chronically unemployed.

According to official data, the number of people living below the subsistence minimum decreased from 41 percent in the first quarter of this year to 35 percent in the second quarter. The unemployment rate (based on the International Labour Organization definition) fell from 12.1 percent to 11.4 percent during the first six months of this year. Real wages at the end of April 2000 were 17 percent above the levels at the end of 1998 but still more than 20 percent below precrisis levels. Despite these encouraging trends, 35 percent of Russians still live below subsistence levels. Sustained, rapid economic growth will be needed to reduce poverty significantly, but it will not be enough. Steps are also needed to directly address Russia's poverty and social problems.

These questions can be looked at in the context of four immediate challenges that the Russian government faces:

• ensuring that public finances and public debt are placed on a stable long-run path so that genuine, long-lasting stabilization can be achieved

• completing the implementation of difficult structural reforms to ensure that the postcrisis output rebound is translated into a long-run trend based on new investment and a more competitive and efficient enterprise sector

• providing social protection and reforming the labor market to ensure that the truly needy are efficiently served while workers have the necessary information and mobility to get suitable jobs

• improving public sector management
New Leadership, New Opportunities in the Russian Federation

These challenges form the focal points of our ongoing policy dialogue with the government in the context of proposed new adjustment lending. To be sure, there are other critical issues, such as the financial sector, human resource development issues pertaining to education and health, and management of the environment and natural resources. However, we believe that these four challenges constitute the immediate priorities and that once addressed they will create a springboard for addressing the longer-term strategic issues.

But the fundamental question of implementation remains. We have learned that no matter how cogent the conditionality or frequent the monitoring by international financial institutions, it is Russian ownership that will ultimately drive successful implementation. It is therefore extremely heartening to note that in June 2001, the team headed by Mr. German Gref submitted to the government its long-term draft economic strategy, based on an in-depth analysis of economic problems and objectives. In July the government approved both the long-term program and a blueprint of priority measures for the next 18 months. The thrust of the new strategy is acceleration of market-oriented reform, including reduction of government intervention in the economy; increased efficiency in managing public funds; and radical tax and social policy reforms, establishing a level playing field for all companies. Much of this has formed part of past programs supported by the Bank and the International Monetary Fund. But the government's program is homegrown and rooted in the lessons of the transition through the 1990s, including the lessons from the 1998 crisis.

The comprehensive nature of the program will require strong and coordinated efforts on the part of the government and strong political will to pursue measures that may conflict with vested interests. There is no reason to doubt the ability of the new team to deliver. But we must recognize that the sheer scope of reform envisaged increases the risk of slowdowns and partial implementation. The program of priority actions alone, with its 18-month horizon, includes more than 130 measures, about 100 of which will require that the Duma amend federal legislation.

In this respect, it is heartening to note that the political situation is solidifying, with the erstwhile confrontational stance between the Duma and the president abating after the parliamentary elections late last year. A more cooperative relationship has been developing since Mr. Putin was sworn in in May. In this connection, Russia's long-awaited tax overhaul got under way with Duma passage this August of the first four
chapters of Part 2 of the Tax Code, relating to personal income tax, social fund contributions, value-added tax, and excises.

Given all this, we can say that the Russian Federation is indeed experiencing a period of new leadership and new opportunities rooted in the lessons of the past decade. Major challenges remain, however.

First Challenge: Improve Macroeconomic Management

While there has been a concerted attempt to turn the fiscal situation around and address the precrisis inconsistency between fiscal and exchange rate policy, the Russian Federation remains very vulnerable to economic shocks, especially to reversals in oil and gas prices, and a slowdown in growth. This is a good time to review the macroeconomic lessons of the past:

Lesson 1: Good macroeconomic management is necessary for sustained economic growth, as postcrisis events have shown.

Lesson 2: The combination of tight monetary policy, loose fiscal policy, a fixed exchange rate, and excessive public borrowing inevitably leads to macroeconomic crisis, as was the case in 1998.

Lesson 3: Russia's public finance institutions, including its tax administration, the federal treasury, the budgeting system, and the public debt management system, urgently need to be strengthened.

Level 4: Macroeconomic stabilization is not sustainable without deep structural, social, and institutional change.

Second Challenge: Implement Structural Transformation for Competition and Productivity Growth

The size and persistence of the output rebound we are now witnessing were severely underestimated. Nevertheless, concerns about long-run growth remain. While statistical problems make interpreting the data tricky, there is a strong suspicion that net investment levels were probably negative or close to zero throughout much of the 1990s. This is consistent with uncertain property rights, high marginal tax rates, a tendency toward asset stripping, and exceptionally high real interest rates combined with an appreciating real exchange rate between 1995 and mid-1998.
At the same time, the Russian enterprise sector has been marked by pervasive soft budget constraints in the form of hidden subsidies for tax and energy payments channeled through the nonpayment system. A recent Bank study estimated the size of these implicit subsidies at 7–10 percent of GDP a year during the precrisis period, with annual subsidies from energy alone on the order of 4 percent of GDP.

Subsidies through the tax system abated after the crisis, because the government stopped borrowing and therefore had to tighten tax enforcement. But the energy subsidy has grown with the rise in international prices and the sluggish adjustment of energy prices to domestic inflation. Indeed, if price distortions are taken into account, the energy subsidy from gas and electricity would in all likelihood be considerably higher than the 4 percent of GDP estimated from nonpayments alone.

At the same time, problems with the investment climate have kept new investment levels, including foreign direct investment (FDI), low. Capital flight has remained high, at US$1–US$2 billion a month, even in the postcrisis period.

This configuration suggests that a cautious interpretation of the current output rebound would characterize it largely as an increase in capacity utilization from very low levels stimulated by the expenditure switch toward domestic goods as a result of the devaluation. The pickup in investment is probably a retooling of capacity that has lain unutilized and dormant for several years.

To be sure, there is much to be happy about. The rebound has shown that Russian managers, like their counterparts elsewhere, respond to incentives and have chosen to increase output, profits, liquidity, and real wages (which are now on the rebound as well) instead of accelerating asset stripping. But the sustainability of growth will be ensured only when enterprise budgets have been hardened and the investment climate improves sufficiently to attract FDI in volumes consistent with the size of Russia’s economy and eliminate the incentives for capital flight.

Many, if not all, of these ideas are recognized in the Russian government’s own long-term strategic document. But difficult hurdles must be overcome. Efficient enterprise restructuring requires hard budgets—the foundation for a sustainable resumption of growth, as the European Bank for Reconstruction and Development’s latest Transition Report
notes. For the Russian Federation, this means that local governments have to reduce the red tape for establishing small and medium-size enterprises, which can benefit from the downsizing and unbundling of unviable, large enterprises. The success of these enterprises has proved decisive for growth in the Central European transition economies.

The Russian government must also increase transparency in privatization auctions and in the awarding of telecommunications licenses, and it must be more aggressive in dealing with monopolies, including infrastructure monopolies and monopolies created by poorly regulated acquisitions and mergers. It must foster competition. It must be seen as fair, transparent, and consistent in uniformly applying a clear set of rules to all investors, domestic and foreign. Banks and enterprises must adopt international accounting standards, and the foundation must quickly be laid for a solid financial sector, the lack of which will constrain the mobilization and efficient allocation of resources over the medium term.

The list is daunting. Based on experience, we believe that the immediate priority is a hardening of budgets constraints based on fully eliminating nonpayments for energy and taxes and eventually on rational pricing for energy based on long-run marginal costs. A natural concern on the part of regional governors is how to deal with the possible social fall-out. This is an area of great concern to the World Bank, and it brings us to the next challenge.

**Third Challenge: Craft Social Protection Policies and Create Needed Institutions**

A social protection system based on preventing enterprise exit through explicit and implicit subsidies is costly and eventually unsustainable. It is costly because it is a disincentive to enterprise restructuring, which in turn impedes new job creation and growth. It is unsustainable because implicit subsidies based on arbitrary, partial payment of tax and energy bills ultimately lead to a debt crisis (as they did in 1998) or to the decapitalization of companies such as Gazprom and RAO UES. Moreover, the untargeted, implicit nature of the subsidies is a recipe for corruption and asset stripping.

Policymakers face a choice. On the one hand, they can preserve a system based on implicit subsidies that temporarily, but very inefficiently, minimizes the social costs of transition but does not offer any long-run
upside. On the other, they can harden budget constraints to restructure enterprises and lower entry barriers for small and medium-size enterprises and other new investment. Such a policy could temporarily increase the social costs already being incurred, but it could create better jobs and long-run growth. The second option is clearly better when viewed in a strategic, long-run context, but it calls for a more effective, better-targeted social safety net that will help the truly needy during and after the transition. Hard budgets and competition must thus be complemented by policies and institutions for social protection that support structural change in enterprises and labor markets; address poverty, especially deep poverty, head on; apply the resources currently used in social protection much more efficiently; and build social protection institutions (pension system, unemployment insurance, and basic welfare support) that are sustainable in the long term.

The current social protection system in the Russian Federation does not meet these criteria. Several corrective actions could be taken to address the problem:

• Protect the poor through a simple, targeted, proxy means–tested poverty benefit scheme, while eliminating many of the current social protection programs.

• Exercise financial discipline and realign coverage and benefits in the pension fund, employment fund, and social insurance fund for better targeting and greater efficiency. A first step toward doing so has already been taken with the consolidation of the social funds tax into one tax to be centrally collected by the Ministry of Taxes and Fees (although at up to 35 percent of the payroll, this tax continues to be high).

• Flatten the benefit structure in the pension system while raising minimum pension levels. Monetize current in-kind benefits, especially housing subsidies. This is a major issue, as it will give ordinary Russians choice in their housing expenditures, improve management of the existing housing stock, and encourage construction.

• Support (sub)sectoral downsizing and restructuring of declining industrial sectors and regions (similar to the coal sector program) with comprehensive subsectoral restructuring packages, including liquidation and privatization; changes in ministerial responsibilities that focus on regulation in support of competition (not protection or promotion); and social support measures for affected employees and communities.
Fourth Challenge: Improve Public Sector Management

Lasting progress in macroeconomic, structural, and social transformation is possible only if supported by an effective, efficient, transparent public sector that increases people’s confidence in the state and sharply reduces the scope for corruption. Four key tasks deserve early attention:

• Realign a complex and duplicative government structure, by simplifying the current structure, eliminating remaining commercial and service obligations of ministries that are best left to the private sector while strengthening their regulatory functions.

• Strengthen the civil service, by improving the uncompetitive pay structure, reducing the excessive number of civil servants in some areas, and upgrading the skills base through training and renewal of the civil service.

• Strengthen the judiciary, by increasing—and paying—their low and often unpaid salaries, improving inadequate facilities, and providing technology and logistical support.

• Rationalize the complex and unclear intergovernmental relations between federal and subnational authorities, by clarifying the revenue and expenditure authority of different levels of government, strengthening the effective control of federal tax authorities over federal tax collection in the regions, providing incentives to subnational authorities to introduce efficient administration and a competitive environment for investment and productivity growth, and eliminating the reliance on ad hoc negotiated deals between the federal and oblast governments.

Conclusion

Everyone has been talking about the window of opportunity—окно возможностей—in the Russian Federation. This window means different things to different people. To short-term portfolio investors, it may represent an opportunity to speculate on the exchange rate. To long-term investors, domestic and foreign, it represents an anxious time of waiting to see whether resolute steps will be taken to improve the investment climate. To older Russians, it represents the hope of better prospects for their children, even if they have had to make sacrifices. To the government, it represents a unique opportunity to accelerate reform based on
the lessons of the 1990s, organized around the four challenges identified above. To the international financial institutions, it represents a chance to continue a policy dialogue, based on a clearer understanding of how the Russian economy works, and a better reading of priorities.

But there is also a downside scenario: If oil and gas prices fall significantly, if macroeconomic and structural reforms are not accelerated while the window remains open, if public borrowing resumes, then the Russian Federation could once again face a serious downturn, with a setback to the manufacturing sector. To be sure, there are many "ifs" in this statement, but one should guard against history repeating itself.

The way to do so is for the Russian Federation to build on recent favorable economic developments to create the sustained growth that is the essential ingredient in ensuring greater prosperity for ordinary Russians. The Bank is working closely with the government to meet the challenges that undoubtedly lie ahead. It has made clear its willingness to continue to provide strong support to Russia's economic reform efforts. It looks forward to a continued fruitful partnership.
CHAPTER 4

Central Asia: Ten Years of Transition

From a speech given at the Central Asia Donors’ Consultation Meeting, Berlin, March 1, 2002

The timing for this meeting is good, as the dust has settled a bit on the events in and around Afghanistan and heightened attention is focused on Central Asia. We at the World Bank welcome this increased attention, since we have long felt that the international community had not focused enough on the low-income countries of the Commonwealth of Independent States (CIS), especially in Central Asia.

Overview of the Transition

The Central Asian republics were among the poorest and least developed in the Soviet Union and among the least well known in the West before the breakup of the Soviet Union. The new countries of Central Asia were hit by a triple transition: adjustment to the economic shock of the breakup of the Soviet Union, the transition from state planning to market-driven economies, and an ongoing political transition.

Breakup of the Soviet Union

The breakup of the Soviet Union hit the Central Asian republics especially hard, a fact that has long been underestimated. First, trade and transit were interrupted, with new borders created; transportation costs increased, including those associated with illegal check points (a truck traveling from the Kyrgyz Republic to the Russian Federation is estimated to have to pay up to US$1,000 in bribes along the way); and traditional markets collapsed, especially in the Russian Federation. These changes reduced industrial and agricultural production in Central Asia, where they disrupted access to inputs and markets. Second, the Central Asian republics lost subsidies for budgets, enterprises, and households—directly and indirectly, through transfers for pensions and other social payments as well as through below-market prices on
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transport and energy. Third, the republics lost access to secure water and energy resources within the region, access that is key for agriculture, industry, and households. Fourth, they lost administrative structures and skilled labor, as many Russians left. Fifth, they were left with large environmental burdens, including the Aral Sea ecological disaster and industrial, nuclear, and biological waste. Finally, some countries (Tajikistan) experienced civil war. As a result of these disruptions, the Central Asian republics sustained huge economic losses, resulting in economic declines of 20–60 percent of GDP between 1990 and 1995/96, losses that far exceeded those experienced in the United States during the Great Depression of the 1930s.

Market Reform and Institution Building

Replacing state management with market-driven economic systems was—and still is—a major challenge for the new republics, which, in contrast to Central European countries, had no recent market experience. Like other former Soviet republics, the Central Asian countries initially faced major macroeconomic instability, but they were able to bring high inflation under control relatively quickly. Market-oriented policy reforms showed mixed progress, advancing most in Kazakhstan and the Kyrgyz Republic and least in Turkmenistan and Uzbekistan. Market institution and capacity building advanced slowly in all Central Asian republics. Some progress was made in setting up central banks and payments systems, basic national administrative structures, and legal systems. But fundamental weaknesses remain in the civil service, budget management, regulatory and judicial systems, and control of corruption.

Political Reform

Progress in creating democratic institutions, civil society, and social capital has been slow, and in some countries there have arguably been reversals. Regional political cooperation has been minimal, despite some regional cooperative declarations and institutions. Significant economic, political, and personal rivalries have grown among the five countries and their leadership. Meanwhile, Central Asian countries are said to be vulnerable to extremist influences and movements. But civil society, including a vibrant NGO sector, has become stronger in some countries, especially the Kyrgyz Republic.
Current Economic and Social Situation

Some economic recovery began in 1995/96, but it was dramatically interrupted by the Russian crisis of 1998. Since 2000 there has been reasonably good growth—propelled in part by Russia's recovery—giving some hope that the worst is over. Some countries, however, especially the Kyrgyz Republic and Tajikistan, are still suffering from the lasting impact of the earlier economic shock, with high debt burdens and low per capita incomes that place them among the poorest of the world's developing countries. All countries suffer from increased inequality and serious poverty (most severe in Tajikistan, where 70–80 percent of the population lives in poverty).

Social sector indicators remain relatively strong, according to official data. But some indications suggest that these data substantially underestimate the decline in some key social conditions. Social spending by governments is very low by international standards and in comparison with countries in Central Europe and even Russia. Tajikistan is a dramatic outlier even by Central Asian standards.

The disintegration of "economic space" in the region as a result of the lack of cooperation is dramatic. Maintenance of dams and irrigation systems is very poor, with enormous waste of scarce water resources and risks of catastrophic failures. Lack of cooperation and political tensions exist over intraregional water allocations. And countries are planning large, wasteful investments in water storage and transmission, based on suboptimal design at the country, rather than the regional, level. The results are man-made droughts and major economic, social, and environmental problems. Trade and transit of goods and people are growing problems in the region. Uzbekistan's currency and trade policies, for example, require tariff and quantitative controls that disrupt trade and transit for the entire region. (The government plans to reform these policies.) HIV/AIDS and tuberculosis and drug trade and use have also become regional issues. The poorest subregions within countries (the Ferghana Valley and the Aral Sea region) are hardest hit, with the poorest segments of the population bearing the greatest brunt of regional disintegration.

Challenges for the Future

The countries of Central Asia face a common set of challenges, but the intensity and impact of these challenges differ significantly from country
to country. Some challenges require country-level solutions. These include reforming markets, building institutions, improving the investment climate, meeting social service needs, and reducing high levels of external debt. Other challenges require regional solutions. These include trade and transit, regional water and energy issues, oil and gas pipeline access, communicable diseases and drugs, and environmental issues. In addition, some countries face special needs for concessional finance and all require further political reforms.

Looking at the key challenges country by country, we can paint the following broad-brushstroke picture:

- Kazakhstan is probably in the best shape and currently has the brightest economic future among the Central Asian countries, comparable to that of the Russian Federation and Ukraine. The major risk for the longer term may lie in the inappropriate use of its energy resources, which has plagued many other resource-rich developing countries.

- Uzbekistan faces serious challenges in most dimensions. Because it is a key player in the region, progress in economic reforms, improvement in its economic performance, and increased readiness to deal with regional issues in a cooperative manner would have major benefits for the region as a whole. Should the country stagnate—or worse, go into an economic and political tailspin—the implications for its neighbors, especially the poorest, the Kyrgyz Republic and Tajikistan, could be disastrous.

- The Kyrgyz Republic has made progress in reforming its economy and building a vibrant civil society. But lack of market access, severe institutional weaknesses, pervasive poverty, and an unsustainable level of debt provide tremendous challenges and risks.

- Tajikistan is similar to the Kyrgyz Republic in the nature of the challenges it faces, but the challenges are more pronounced, particularly those relating to institutional weaknesses and the risks of internal conflict.

- Turkmenistan is an outlier even within the region in its near total isolation and lack of reforms. There is no indication that its position will change in the foreseeable future. It represents a significant obstacle to any effort to increase regional cooperation in key areas, especially water.
Key Opportunities and Constraints

Several opportunities and constraints confront the international community as it considers increasing its support for reform and development in Central Asia. Opportunities include the recent economic recovery, the region's natural resources, the countries' strong human capital base, the possibly increased willingness of national leaders to push forward with reforms and regional cooperation, and the new international attention being given to Central Asia. Constraints include weak democratic institutions and social capital; weak institutional capacity and investment climate; lack of market access; limited commitment to reform, capacity building, and regional cooperation; lack of resources for public investment and social spending (in some countries); and debt overhang (in some countries).

What Can the International Community Do?

Given these opportunities and constraints, what can the international community do? Based on its experience, the World Bank has identified a few key priorities for the international community as it reinforces its commitment to support economic recovery, poverty reduction, and regional cooperation in Central Asia. The priorities can be divided into country-specific and regional dimensions.

Country-Specific Priorities

The countries of Central Asia face important country-specific policy challenges.

Democracy building and political reforms. Bilateral donors, some multilateral institutions (such as the Organization for Security and Co-operation in Europe [OSCE] and the United Nations [UN]), and international NGOs should take the lead in this area, but all donors can support the development of participatory approaches and stronger civil society in their specific spheres of involvement.

Capacity building. Technical assistance, training, and programs and projects that help reform the public administration, judiciary, and market institutions and develop civil society can be supported by a broad range of external supporters. Capacity building is an area in which the World Bank is especially active.
Transiton Years

Improving the investment climate. Technical assistance, training, and programs and projects for improving the regulatory framework, registration, inspection and licensing, property and bankruptcy legislation, and other areas that improve the investment climate are essential to support private investment, especially by small and medium-size firms. The international financial institutions have a special role to play here.

Investment in physical and social infrastructure. Direct financing and budget support for programs and projects in these areas are essential, but they need to be combined with sectoral reforms and institution building, for sustainability and effective targeting. Many donors can contribute in this area, but they need to cooperate to ensure appropriate sectoral approaches.

Concessional finance and debt relief. International financial institutions have so far been the principal source of international financial support; increased support from this source is likely to be limited. For the poorest countries (the Kyrgyz Republic and Tajikistan) increased bilateral concessional finance (linked to good performance) will be essential. Debt relief for these countries should be promoted using the appropriate instruments (Paris Club, enhanced Heavily Indebted Poor Countries [HIPC] initiative).

The Poverty Reduction Strategy Papers process. The Poverty Reduction Strategy Papers (PRSP) process for the poorest countries (borrowers from the International Development Association [IDA]) is the appropriate framework within which the countries and the international community can cooperate to formulate appropriate country-specific strategies and external support. The World Bank will continue to support the PRSP process in partnership with others. It will strengthen its own capacity in the region by placing its country director and senior technical personnel permanently in Central Asia (in Almaty, Kazakhstan).

Regional Priorities

Several important regional priorities must be addressed. For these issues, important cross-border effects mean that only regional cooperation can achieve satisfactory solutions.

Water Management

The Aral Sea Basin Program, while not without its difficulties, provides an important analytical base, institutional lessons, and programmatic
foundation for further initiatives by the international community in helping develop regional approaches to water policy and management. All donors should use opportunities for high-level dialogue to press the leadership of the five Central Asian countries to work closely together in this essential area, even if in the immediate future much of the support will likely have to focus on bilateral and trilateral cooperation among selected Central Asian countries and on country-specific reform and investments for improved water management and use. Attention will need to be paid to the role of Afghanistan as a potentially significant player in the regional water situation.

**Energy**

Donors can advise on energy, transit, and trade options and finance high-priority investments, preferably with private sector participation. Energy sector reforms, including improved payment discipline, will have to be a key aspect of such support. Attention needs to be paid to the potential for Central Asia to provide Afghanistan with electricity and the potential of routing international oil and gas pipelines through Afghanistan once the country returns to normal.

**Trade and Transit**

Donors can help by supporting Uzbekistan's incipient currency and trade policy reforms, which could help eliminate one of the major constraints to regional trade and transit. Support for investment and institution building to facilitate and provide the infrastructure for trade are also high priorities. The Asian Development Bank and the European Commission have been lead institutions in this area. Others, including the Bank, could add their support based on relevant experience elsewhere.

**Communicable Diseases**

Donors such as the World Health Organization, UN agencies, and the World Bank should press countries to recognize and combat the dual threats of HIV/AIDS and tuberculosis.

**Drugs**

Relevant UN and bilateral agencies should promote the fight against the spread of drug transit and use in Central Asia.
Implications for New Regional Donor Initiatives for Central Asia

The World Bank Group stands ready to support the countries of Central Asia and the international community in their joint efforts to improve the prospects of the 55 million inhabitants of the region and in ensuring better integration of the countries of the region with each other and with their neighbors, including Afghanistan.

The four principles on which donors and countries agreed during the recent London conference on the seven low-income CIS countries (Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova, Tajikistan, and Uzbekistan) are relevant for any regional initiative in support of Central Asia. These principles state the following:

• The CIS-7 are to reinforce their own policy reform and capacity building efforts.

• The CIS-7 are to cooperate with each other in their respective subregions (especially Central Asia and the South Caucasus).

• The international community will provide enhanced support in response to strong country performance, through enhanced trade access, concessional finance, and debt relief.

• International financial institutions will continue to provide strong and more closely harmonized support to the countries and the international community.

Several other considerations should be borne in mind as the international community considers options for developing new initiatives of support for Central Asia:

• Remain realistic and plan for the long haul. The constraints are serious, especially in the absence of a strong political umbrella for regional cooperation, such as that provided by the Stability Pact for South East Europe, which in turn is anchored in hopes for eventual EU accession of countries in that region.

• Build on country demand in developing pragmatic solutions, but stress performance and keep pushing at the highest level for fundamental change. The desire for strong reforms and regional cooperation is currently at best mixed; in some countries it is totally absent. "Opportunistic" responses (including confidence-building
steps, bilateral and trilateral initiatives, and other responses) are therefore needed, most likely leading to incremental change for now. Financial support should be linked to performance—to steps that represent real change and lasting improvements in economic and social conditions, especially of the poor. Opportunities for more fundamental changes and solutions should continuously be explored, especially in dialogue at the highest political levels.

- Work in partnership and do not duplicate efforts. The PRSP process provides the best available instrument for donor cooperation and coordination in the IDA countries of Central Asia (the Kyrgyz Republic, Tajikistan, and Uzbekistan). The principles of the Comprehensive Development Framework also apply elsewhere, but they need to be developed on more of an ad hoc basis.

- Address the external constraints affecting the prospects of the poorest countries—their need for more concessional (grant) finance and debt relief. The appropriate forums for doing so are the consultative group meetings of donors for individual countries and the Paris Club meetings.
CHAPTER 5

Economic and Social Dimensions of Enlargement of the European Union

From a speech given at a conference sponsored by the European Union Presidency and the European Network of Economic Policy Research Institutes (ENEPRI), Brussels, November 15, 2000

My friend Stanley Fischer at the International Monetary Fund likes to remark that from all the research he and his research department have conducted to explain the growth performance of transition economies, the one explanatory factor that stands out most clearly is the country's distance from the heart of Western Europe. This is consistent with my own observation from years of extensive travel throughout Central and Eastern Europe that the idea that most vividly captures people's imagination is not anything the World Bank might say or do but the idea of reducing that very distance—by joining the European Union (EU).

The potential social impact of EU enlargement is giving pause, not only in candidate countries, which may be concerned about withstanding heightened competitive pressures, but also in member countries, where fears of large-scale labor migration have been blown out of proportion. I hope that this conference will help deflate these fears. Indeed, I would like to point out how much, in my view, the interests of member and candidate countries converge in this area. Their common interests are to create jobs at home and to struggle against social exclusion.

This convergence of interest should come as no surprise, if you consider how much both sides have already gained from integrating with each other. Comparing GNP levels across Central and Eastern Europe and Central Asia in 1991 and 1999 reveals a telling story. Central Europe and the Baltics saw a contraction in GNP in 1991/92 but then

The assistance of Michelle Riboud, former Senior Economist in the Europe and Central Asia Region and current World Bank Sector Director for Human Development in the South Asia Region, in drafting this speech is much appreciated.
Transition Years

experienced a sustained economic recovery, driven primarily by exports to the EU. In contrast, the countries in the Commonwealth of Independent States (CIS) saw a continuous economic decline between 1991 and 1998. The result in terms of relative economic strength is striking:

- In 1991 the GNP of Central Europe and the Baltics was one-third that of the CIS. In 1999 it was one-third larger.

- In 1991 Russia’s GNP was seven times that of Poland. In 1999 it was barely larger.

- In 1991 Poland’s GNP was roughly the same as Ukraine’s. In 1999 it was five times larger. In 1999 more than two-thirds of Poland’s exports but less than 20 percent of Ukraine’s went to the EU.

Of course, no one claims that EU integration on its own accounts for such different trajectories. Stabilization and structural reforms were key. But no one would deny that integration with the EU provided the framework and the impetus for countries to forge ahead.

On the EU side, the countries of Central and Eastern Europe have become the EU’s second-largest export market (after the United States)—and one in which the EU enjoys a sizable trade surplus.

This is not to say that the integration process has been or will be painless. To the contrary, countries are facing critical social challenges: dealing with the ensuing economic restructuring, providing social protection without blunting incentives or compromising fiscal sustainability, invigorating labor markets, enhancing human capital, and combating social exclusion.

Economic Restructuring

At the heart of the matter is the fact that the ongoing recovery in Central and Eastern Europe has created very few net jobs. To be sure, there has been a massive amount of “labor churning,” as jobs shifted from dying industries to new, often smaller-scale greenfield operations, first in services and more recently also in industry. Reflecting on the parallel experience in the former German Democratic Republic, officials in Saxony estimate that three-quarters of the population now have different jobs than they did 10 years ago.
But even in a well-performing country like Hungary, the level of employment remains more than 20 percent below the 1990 level. In Poland it remained almost unchanged in the face of a 45 percent GDP expansion (cumulative) between 1993 and 1999, and unemployment remains high, at 13 percent of the labor force.

As a result, the incidence of poverty in Poland was higher in 1998 than in 1991. Indeed, across the countries of Central and Eastern Europe, unemployment and underemployment, particularly in rural areas, have been leading causes of the increase in absolute poverty. In most of the region, 15–20 percent of the population is poor, and the figure is as high as 40 percent in Romania. Only the most affluent countries in the region, the Czech Republic and Slovenia, have been spared.

The pressure to restructure is unlikely to let up. Across the board, continued trade liberalization will likely heighten competitive pressures, particularly as it extends to the often overmanned agricultural sector.

Implementation of EU policies (on state aid and internal markets, for example) will also speed the restructuring of declining industries (such as steel and coal) and force other large employers in sectors such as services (banking, transport) and utilities (railways, telecom, power) to shape up. More jobs will be lost in the process.

**Labor Market Policies**

To facilitate a shift in jobs from declining to growing activities, candidate countries may need to maintain a greater degree of labor market flexibility than is commonly the case among current EU members. The 25 percent ratio between minimum and average wages observed in the Czech Republic is likely, for instance, to do more to create jobs than the France-like 50 percent ratio observed in Poland.

Of course, reducing unemployment will require measures that go beyond labor market policies. More active housing markets, for instance, would also help prevent workers from being trapped in "rustbelts" after their jobs have moved elsewhere.

**Social Protection**

Appropriate social safety nets are also needed. Accession countries are already spending heavily on social security: as a percentage of GDP, they
spend as much as member countries. Per capita income is 33–66 percent lower than in the EU, however.

To finance social safety net systems, labor is sometimes heavily taxed: labor tax wedges in several accession countries exceed those observed in recent EU member countries (more than 50 percent in Czech Republic, for example, and about 35 percent in Ireland).

Without action, social protection could weaken even further. In Romania, for instance, the rate of contribution to the public pension scheme—which rose from 14 percent of wages in 1990 to 37.5 percent today—would need to rise to 62 percent over the next 50 years to keep the current system afloat. The alternative of subsiding social security systems out of general taxes is not fiscally sustainable.

Not surprisingly, a growing number of candidate countries (including Bulgaria, Hungary, and Poland) are looking for innovative ways to ensure social protection while invigorating labor markets. An example is the movement toward multipillar pension systems or the focus on targeting of cash benefits.

**Human Capital Development**

Whether or not good jobs become available over the medium term will depend fundamentally on the extent to which countries succeed in redirecting their human capital and the social programs that help build it toward the needs of a globally integrated market economy. Several candidate countries have made good strides toward reforming human capital sectors. Latvia, for example, has strengthened education, and the Czech Republic has strengthened the health sectors. Sustained efforts will be needed for these efforts to bear fruit and benefit all members of society.

**Social Inclusion**

In the meantime, one needs to recognize that economic restructuring of the magnitude experienced can strain the social fabric and raise the spectrum of social exclusion, in member and candidate countries alike. Within candidate countries, two groups are particularly vulnerable: children, who represent 18–59 percent of the poor in the region, and ethnic minorities (85 percent of the Roma in Bulgaria live in poverty). The Bank was glad to see the EU take up their causes in the context of accession.
Table 5-1. Selected World Bank Interventions in Central and Eastern Europe

<table>
<thead>
<tr>
<th>Area</th>
<th>Sector or project</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enterprise restructuring</td>
<td>Coal mining in Poland; railways in Poland and Romania; rural sector in Poland</td>
</tr>
<tr>
<td>Social protection</td>
<td>Social protection reform in Bulgaria</td>
</tr>
<tr>
<td>Labor markets</td>
<td>Employment services in Poland</td>
</tr>
<tr>
<td>Human capital development</td>
<td>Education reforms in Bulgaria, Hungary, and Latvia; health sector reforms in Latvia</td>
</tr>
<tr>
<td>Social inclusion</td>
<td>Community services reforms in Lithuania; child welfare reform in Romania</td>
</tr>
</tbody>
</table>

The candidate countries are confronted with unprecedented social challenges. It is heartening to see the innovative spirit with which they are dealing with them.

**Benefiting from and Supporting Innovative Policies**

Dealing with these challenges remains very much a national responsibility. But as the acquis (the body of common rights and obligations that bind all member states within the EU) develops in social areas, it will benefit from the lessons learned from innovations by candidate countries. The impact of these innovations will reverberate beyond the candidate countries themselves, helping Europe move forward. Indeed, they will form part of the new members' dowry to the enlarged union. The World Bank is helping these innovations flourish and spread with interventions in key areas (table 5-1).
In July, we set out for a 10-day trip through the Balkans by car along highways, byways, and rutted tracks, with the aim of getting a better sense of what has been achieved in the region and the challenges ahead.

Our trip took us from Zagreb in Croatia through Bosnia-Herzegovina, Montenegro, Kosovo, and into Albania. We had previously visited Serbia. Along the way we met hundreds of people, from senior government officials and parliamentarians to poor mountain farmers and community activists. All of them spoke of the difficulties they face, the frustrations of chaotic political systems, the lack of government capacity and infrastructure, the burdens of corruption and government interference, and the ineffectiveness of legal systems.

And yet everyone insisted that things are getting better, and most are optimistic about the future. In Kosovo, a chief editor, Veton Surroi, told us, “At last, we can laugh about things—the worst is behind us.”

Despite questions about the effectiveness of donor efforts in the region, and the sustainability of reform and the prospects for peace and EU integration, we saw firsthand that the financial and political support for the West Balkans has produced some impressive results since the early 1990s. The current danger is that the international community may lose interest as crises in other parts of the world claim attention. This would leave the job in the Balkans half done and risk reversing hard-won gains.

The international community has invested billions of dollars in the Balkans over the last 10 years, starting with Albania in the early 1990s, followed by Bosnia-Herzegovina since 1996, Kosovo, and now Macedonia and the Federal Republic of Yugoslavia.
During our trip, we saw many examples of progress on the ground. In Mostar the gulf between the Bosniak and Bosnian Croat communities is being bridged, quite literally, by the reconstruction of the Stari Most, a symbol of Bosnia’s historic tolerance for diversity among its people. In the Albanian capital of Tirana, the mayor is making heroic efforts to clean up illegal commercial development and to provide a safer environment for the citizens. And all across the region, governments are working on strategies to reduce poverty and unemployment which define a long-term vision and realistic programs for economic recovery and social inclusion.

Statistics confirm the picture of progress and stability that we saw in the Balkans. All the economies of the region have experienced rapid economic growth in the last few years, especially Albania, which has quadrupled its per capita income since 1992. Bosnia-Herzegovina and Kosovo have also grown rapidly since the fighting stopped, and Yugoslavia has started its recovery since the departure of Slobodan Milosevic and the start of serious economic reform.

A building boom is under way as individuals pour their savings and remittances from family members abroad into houses, shops, and other small businesses. Crime and violence are down, and refugees are returning to their homes in unexpected numbers.

The international community has provided basic security through its military presence. It has also helped to rebuild public buildings, schools and roads, power and water supply systems. It has worked to privatize public enterprises and banks. It has assisted in building government institutions where none or only weak ones existed before. And by supporting democratic and participatory processes, it has given civil society the chance to engage and grow.

The Stability Pact for South East Europe and the Stabilization and Association Process of the EU, combined with the political changes in Yugoslavia and Croatia, provide the framework for cooperation and regional integration. This offers a political anchor for economic and social reforms and provides a sense of political and economic stability for the first time in years.

So far so good. But the job is only half done, and there is a risk that expectations may outrun progress. Weak institutions and corrupt politicians may slow or reverse the process. Large pockets of poverty and social exclusion could become endemic. Meanwhile, mountains of
garbage and plastic debris spoil the splendid countryside, rivers, and
beaches, and untreated sewage pollutes the aquifers and coastlines,
causing sickness and discouraging tourists. Too often, the countries' edu­
cation, pension, and health systems fail the young, the old, and the sick.

While the challenges remain daunting, donor support is slated to drop in
Albania, Bosnia-Herzegovina, and especially Kosovo, while Serbia is only
at the start of its reconstruction program. Private foreign investment
remains low, as foreign investors have not yet recognized the progress
made on the ground or are turned off by the remaining difficulties.

The long time horizon of EU integration and the high hurdles of the
industrial countries' visa regimes give a sense—particularly to the
young—that they remain second-class citizens, isolated from Europe and
the rest of the world.

What can be done? All partners must stay the course. Governments and
politicians need to improve their policies and performance. They must
take on corruption and crime and deal openly with their electorates and
civil societies. And they have to manage the rapidly growing expecta­
tions of their people.

The international community must continue to support governments
which move forward with reforms. This means sustained efforts to open
up Western markets, as well as financial support for investments in safe
roads, clean water, and reliable power. It also requires help to develop
sound institutions and assistance for education, health, and a clean
environment.

Much has been achieved in the last few years by the countries of the
Western Balkans and by the international community. Now we must
consolidate the gains through continued engagement, effective coordi­
nation, and financial support, not at postconflict levels but high enough
to make sure that progress continues.
CHAPTER 7

Structural Reforms for Sustainable Growth in Turkey

*From a speech given at the conference “Structural Reforms for Sustainable Growth,” Istanbul, November 29, 2000*

Turkey enters the twenty-first century with enormous opportunities. Its young population, dynamic private sector, and pivotal geographic location give it the ability to move to the forefront of emerging markets. Turkey's potential to become a member of the European Union (EU), a regional leader, and a major world economy was recognized at the Helsinki EU Summit and by its inclusion in the G20. Its success will be a boon for its people, an example and engine of growth and source of stability for the region, and a boost to the global economy.

To release Turkey's full potential, the government has launched a major economic reform program. This program responds to three core economic challenges:

- taming chronic inflation and breaking the grip of high real interest rates through permanent fiscal adjustment designed to put public finances on a sustainable path
- raising productivity and stimulating growth through second-generation structural and institutional reforms aimed at creating a world-class environment for private investment
- empowering all of Turkey's citizens and addressing disparities in economic opportunities through public investment in health, education, and social protection

The assistance of Ajay Chhibber, Country Director for Turkey, and the staff of the Turkey Country Office in drafting this speech is gratefully acknowledged.
The Context of Reform

Twenty years ago Turkey embarked on a journey to integrate into the global economy and modernize its economic institutions. Turkey's economy, like that of many developing countries, was inward-looking and closed, relying on import substitution to spur development. In the early 1980s, Turkey carried out sweeping reforms designed to shift to an outward orientation, opening the economy to external competition and liberalizing the financial sector. These first-generation policy reforms met with much success. Trade accelerated, competitive private industry and finance emerged, and Turkish entrepreneurship thrived in this more liberal environment.

Today Turkey is engaged in the second stage of its journey, tackling vital structural and institutional reforms. These second-generation measures aim to ensure that private entrepreneurship moves toward productive activities and away from rent-seeking. Critical to success are efforts to strengthen public management and accountability and establish transparent regulation in line with international standards in banking, telecommunications, and energy. Strong and credible public institutions will support private sector development and help attract the foreign direct investment that Turkey needs to sustain high growth, technological innovation, and external competitiveness.

The government has recently taken important steps to modernize Turkey's public institutions. It established the Banking Regulation and Supervisory Agency and an independent telecommunications regulator. It has also taken action to tackle corruption. The government's recent request for Bank support for its anticorruption efforts is an important signal of its resolve in this area.

Second-generation reforms are as difficult as they are essential. The road ahead will be long, and potential pitfalls are many. But Turkey can draw encouragement from the tremendous achievements of the past 20 years and from the progress with reforms over the past 18 months under the current government.

Priorities of Reform

The World Bank's recent Economic Report demonstrates that credible fiscal adjustment is central to addressing inflation and a prerequisite for sustainable growth. In the past, unsustainable fiscal policy put repeated
pressure on the lira and contributed directly to chronically high inflation. It left the country vulnerable to crises; when crises hit, as in 1998, fiscal policy options were limited to contractionary measures to ensure financial stability, exacerbating in a procyclical fashion the impact of internal and external shocks. The report also suggests that economic growth has remained below potential due to macroeconomic instability, low productivity growth, and insufficient investment in human capital—all related directly or indirectly to weak fiscal policy.

Beyond this focus on fiscal policy, the Economic Report underscores the fundamental need for structural reform to achieve sustainable fiscal adjustment and promote economic growth. Improvements in public expenditure management will help ensure the quality of fiscal adjustment and protect vital public spending for health and education. Social security reform is addressing financial imbalances in the public pension system and opening the door to private sector participation through voluntary supplemental pension schemes. Reforms in telecommunications and energy are paving the way for much greater private participation and steadily increased competition in line with World Trade Organization and EU standards. Energy reform will also address the threat to fiscal stability posed by the growing stock of government guarantees. Agriculture reform targets a reversal of the decline in agricultural productivity, which is undermining rural living standards. The shift to direct income support for farmers will replace costly indirect subsidies; accompanying measures to privatize state-owned agricultural enterprises will promote private participation in processing and marketing activities. Reforms in the financial sector are raising productivity by increasing the efficiency of financial intermediation. By strengthening enforcement of prudential standards in line with international norms, financial sector reform will also reduce the risk of costly bank bailouts in the future. Within this context of deep structural reform, privatization will play a pivotal role in redefining the role of the state, generating productivity gains, attracting foreign investment, and helping reduce the burden of public debt.

World Bank Support

The Bank is strongly supporting the Turkish government's reform program, as it supported the first-generation reforms launched two decades ago. During the 2000 fiscal year (July 1999–June 2000), the World Bank Group provided about US$2 billion in new loans and investments to Turkey in support of economic reforms, social development, earthquake
emergency recovery, and reconstruction assistance. The Country Assistance Strategy for the next three years foresees US$5 billion in new Bank lending under a scenario of sustained reform. Bank support will also encompass economic analytical and advisory work—building on the results of the Economic Report and the earlier Living Standards Study—including a Public Expenditure and Institutional Review, which is under preparation.
PART 3

Key Thematic Perspectives

The third group of chapters presents five speeches dealing with cross-cutting thematic issues of special relevance for the transition economies in the region. Chapter 8 deals with good governance, chapter 9 with legal reform. The issues raised in these speeches, which were given in 2001, are as relevant today as they were then. They are also among the more difficult and long-term reform challenges facing the transition economies. All stakeholders, including the World Bank, still have much to learn about how best to craft the institutions and the political will needed to ensure lasting improvements in governance, in the battle against corruption, in legal and judicial reform, and in capacity building.

Chapters 10, 11, and 12 deal with key sectoral policy and reform challenges in the energy sector, in the social area, and in environmental protection. These are core areas of continuing concern in all countries in the region, even as the specifics of reform needs vary across countries and subregions. Long-term sustainable growth in the region will clearly depend on how effectively the challenges in these three areas are addressed.
A new body of research confirms these interrelationships, although the direction of causality is not always clear. Evidence suggests that a state with transparent and effective institutions is associated with higher income growth, national wealth, and social achievements; institutionalized democratic competition and meritocratic government; policies and a legal framework that are not "captured" by vested interests; and a civil society and free media whose independent voice enhances the accountability of the government.

There is also clear evidence of the severely negative impact of ethnic fragmentation and ethnic tensions on economic development. Ethnically fragmented countries (and regions within countries) tend to provide fewer and lower-quality public goods, such as education. Institutions that guarantee minority rights and that provide opportunities to resolve conflicts have been shown to offset the side effects of polarized societies.

So what is new in the recent focus on good governance is a much deeper appreciation of the complementarities of reforms across different realms—economic, political, social, and regional. Although the Bank has been in the business of good governance since its very inception, this recognition has had a profound influence both on what we do and how we do it. Let me briefly summarize what this new understanding has meant in practice.

**Changes in What We Do**

We are placing much greater emphasis on public sector management reforms. Two innovative adjustment loans, to Albania and Latvia, have been designed as multiyear programs of support to strengthen governance. They address the roles and responsibilities of government ministries and agencies, develop conflict of interest legislation and asset disclosure rules, and enhance the judicial system.

We have made fiscal transparency a key goal of adjustment operations. In the Russian Federation, for example, we are focusing on developing a treasury system that provides the basis for timely audits of fiscal accounts. Similar programs have been developed in Hungary and Kazakhstan and are under discussion in other countries in the region. In Albania we have supported a more open process of budget formulation through a Medium-Term Expenditure Framework. This framework makes government policies and their link to proposed budget outlays clearer and available to the public.
Good Governance and Transparency in the Transition Economies

We are dealing head on with the scourge of corruption, which often allows nontransparent institutions and inefficient policies to survive despite their damaging social consequences. Six countries in the region—Bosnia and Herzegovina, Kazakhstan, the Kyrgyz Republic, Poland, Romania, and the Slovak Republic—received assistance this year for diagnosing problems of corruption and developing strategies for reform. The Bank conducted governance and anticorruption workshops in several countries, including Bosnia and Herzegovina, Poland, Romania, and Turkey.

We are giving greater attention to local-level capacity building and community-driven development. The Local Initiatives Project in Bosnia and Herzegovina is a good example of local-level institution building. The project gives low-income microentrepreneurs access to credit through NGOs that serve as microfinance institutions. Half of the loans went to women and one-fifth to returning refugees or displaced persons.

We are also introducing better monitoring and evaluation procedures of our own operations, both to encourage greater accountability among counterparts and to enhance safeguards in our lending activities. In our operations aimed at reducing red tape, bribes, and other extra costs of doing business, for example, we are starting to monitor impact by directly surveying local firms (an example is the fourth Structural Adjustment Credit for Armenia).

We are taking our research agenda to new frontiers, exploring such issues as the impact of civil wars, state capture, and even the structure of political institutions on the quality of governance, economic growth, and poverty alleviation. A major new report, Transition after a Decade, highlights the critical role of new businesses as the engine of growth in transition economies. Another report, Anticorruption in Transition, for the first time, investigates the patterns, levels, and causes of corruption and provides ideas and recommendations for designing and implementing effective anticorruption strategies.

Changes in How We Do It

In developing our Country Assistance Strategies, we are engaging in extensive consultations not only with national governments but also with civil society groups, the private sector, and local governments and national legislatures. During the recent consultations on the new Country Assistance Strategy for Armenia, for example, we talked with
particular, the tasks of enhancing regional security, fostering conflict resolution, and promoting democracy continue to be essential preconditions for improving governance in the economic realm, especially in transition economies.

The success of the World Bank’s work in the region is highly dependent on the success of the OSCE—and other agencies and donors—in achieving their political mission. In Bosnia and Herzegovina, and now in Yugoslavia, the Bank’s work began only once the efforts to resolve conflict and promote a stable political framework had achieved success. In Kosovo and Macedonia, our operations are highly dependent on the capacity to resolve ethnic tensions. Our work in the Caucasus requires the continued efforts of the OSCE and others to resolve regional security issues. In Belarus and many Central Asian countries, we hope that efforts to promote democracy and participation will create new opportunities for kick-starting the reform agenda.

Democratization, enhanced regional security, and free markets can be achieved and consolidated with external support, giving scope for organizations such as the OSCE, the World Bank, and its many partners. Our complementary actions and the potential synergies arising from our close cooperation can and should enhance stability and prosperity.
Legal and Judicial Reform in the Transition Economies of Europe and Central Asia

From a speech given at the conference “Empowerment, Security, and Opportunity through Law and Justice,” St. Petersburg, July 11, 2001

The Importance of Legal and Judicial Reform in the Europe and Central Asia Region

Why is a separate session being devoted to Europe and Central Asia when just this morning we completed a global conference on legal and judicial reform? The reason is that the Europe and Central Asia region faces particularly difficult challenges in the area of legal and judicial reform.

December 2001 will mark the 10th anniversary of the end of the Soviet Union. For a decade now, the countries of this region have struggled to emerge from centralized economies and nondemocratic regimes to become democracies with free market economies.

One of the biggest shifts in our understanding of transition over the course of this decade has been on the role of legal and judicial institutions. At the start of the transition, legal and judicial reform were not at the top of the agenda. Part of the reason was that the transition economies faced several critical tasks—fighting runaway inflation, halting the initial decline in growth, establishing some order in the fiscal system—that required immediate and urgent policy reforms. But it is also true that at the start of transition, there was a belief that the rapid development of private property ownership and the entry of new businesses and entrepreneurs would create the demand for the development and enforcement of a legal framework to protect property and contract rights. It was recognized early on that legal and judicial reform could not

The assistance of Friedrich Peloschek, Lead Counsel in the World Bank's Legal Department, in drafting this speech is gratefully acknowledged.
Other countries have also taken key steps forward. The process of appointing judges in Georgia through judicial qualification examinations set the standard for appointing judges throughout the region. Several countries, including Latvia, Moldova, and Romania, have established judicial training centers. Poland leads in introducing practice-based teaching methodologies at its law faculties to ensure that future lawyers are equipped to handle real-life challenges.

Contributions of the Donor Community

Systemic legal and judicial reform requires fundamental reforms of key institutions—a process that takes time and requires considerable commitment from the countries themselves. Where there is commitment, donors can help.

Donors have played a role in the judicial reform process. In Armenia and Georgia donors are assisting local counterparts in a comprehensive judicial reform process that includes establishing a new court administration system and modern case management procedures, strengthening the enforcement function, upgrading the institutes responsible for judicial training, and carrying out a professional public information campaign to communicate the new roles and responsibility in the justice systems. In Albania and Georgia assistance was provided for the difficult process of recertification of judges. The World Bank is involved in assisting new judiciaries in Bulgaria, Croatia, and Kazakhstan, and it may soon start activities in other countries.

Donors have also contributed to education and outreach efforts. The European Union, Germany's GTZ, USAID, Canada's CIDA, Britain's DFID, and the Soros Foundation have provided crucial support in establishing judicial training centers around the region and in supporting associations of judges that are advocating for change. The Central and Eastern European Law Initiative (CEELI) and the Soros Foundation have also led the way in creating legal clinics that give law students an opportunity to obtain practical experience while providing needed services to their communities on issues ranging from small business development to obtaining unpaid salaries and other benefits for laid-off workers.

In the Russian Federation, the Russian Foundation for Legal Reform—funded through a World Bank loan—has been instrumental in developing
textbooks and educating the public about the rule of law. The foundation has also helped make the law more accessible, through its support of public interest law centers around the country.

Donors, then, clearly can play a useful role in supporting legal and judicial reform. But it is important that we carefully coordinate our assistance, pursue an appropriate division of labor, and remain modest in our expectations about how much can be achieved how quickly by outside advice and finance.

Future Challenges

The most important reason for our gathering today is to identify and prioritize the challenges ahead. I have already touched on what I believe to be the basic challenge: converting the law from words on a page into a reality for the citizens of the region. Four sets of actions are needed to make this happen.

First, we need to establish an independent, efficient, and accountable judiciary. Doing so requires a well-trained, well-funded cadre of judges who decide cases not based on connections or pressures or payments but according to the law and the facts before them. Such a judiciary must also be empowered to review the acts of the executive branch, through a process of administrative review.

Justice must be administered efficiently. In too many countries in this region, the adjudication of a simple civil matter can take several years. Court administration processes need to be modernized and clerks and other support staff better trained so that judiciaries can dispense decisions more quickly.

The judiciary must be accountable—easy to say and difficult to achieve. Transparency, publicized opinions, clear standards and procedures, peer review, and a vibrant free press and civil society are likely to be the key ingredients of judicial accountability.

Second, we need to make sure that the judicial system is accessible: a well-trained, independent judiciary is of little value if it is not accessible to all elements of society. We must work together to ensure that we do not create a system that serves elites only. Increasing access to justice and educating the public about their rights are also key concerns.
About three years ago, in our work with the Russian Federation, we concluded that one of the most significant areas requiring reform is the level of explicit and implicit subsidies provided by the energy sector to the economy as a whole. This is, in effect, a simple measure of the financial viability of the sector. It also broadly measures whether the sector will be able to sustain and expand its services over time, whether it allocates scarce energy resources efficiently, and whether it relies on quasi-fiscal flows that could endanger the macroeconomic stability of the country. While some assumptions have to be made concerning the true economic value of the energy being supplied, it is possible to calculate these subsidies on a sufficiently consistent basis to chart progress in a specific country and to compare progress across countries.

At the beginning of the transition, energy supplies throughout the region, particularly in the CIS, were heavily subsidized. The three components that make up the subsidies—nonpayments for energy consumed, tariff structures that do not recover the full cost of the energy supplied, and excessive losses that reflect both operating inefficiencies and theft—reflect the legacy of widespread expectations that energy should be provided at little or no cost. Let’s take a brief look at each of these components.

Strengthening payment discipline is a critical first step in reducing implicit energy sector subsidies. Doing so requires both securing a high level of payment compliance and replacing barter transactions with cash transactions. It involves an extensive effort aimed at all categories of customers. Measures to address nonpayments among industrial, commercial, and residential customers have to be coupled with the introduction of hard budget constraints, since in several countries state-owned and budget-funded enterprises represent the largest part of the nonpayment problem. Without putting in place effective measures to deal with nonpayments, efforts to increase tariffs to full cost recovery levels can be seriously undermined.

In order for a country’s energy sector to be efficient and remain financially viable, tariff levels need to be high enough to recover costs. In the short run this means that tariffs have to cover input, operating, and maintenance costs. Over the longer term, tariffs also have to contribute the funds required for the capital investment needed to sustain the sector. Depending on the circumstances in a particular country, this means setting tariffs equal to either long-run average cost or long-run marginal cost (taking into account the discount factors applicable to future investment requirements).
Increasing tariffs to full cost recovery levels has consequences. Tariff increases can be difficult politically, and timing may become critical in determining a government’s willingness to take necessary action. In an ideal world, an independent regulator should be able to act on tariffs without being influenced by political considerations. But in this region, we are some way away from achieving that level of regulatory independence.

There is also an issue of affordability and social impact, which makes it important that governments develop and implement social safety net measures to accompany any significant increase in tariff levels. A variety of social safety measures have worked with varying degrees of effectiveness in different transition economies.

The so-called “lifeline” block tariff approach involves providing a low-cost, low-volume block of energy (for example, 50 kilowatt hours per month of electricity) to all consumers. Provision of this energy may be cross-subsidized from a second or third block of energy consumption (for example, from consumption in excess of 300 kilowatt hours per month) from (presumably wealthier) consumers. This system worked well in Hungary and some other countries in Central and South East Europe. In other countries, however, it has acted as an incentive for meter tampering and other forms of theft.

Vouchers targeted to the neediest families provide a specific subsidy to pay for energy consumption. A third option, the so-called “notional burden approach,” is designed to deliver social protection in the form of housing allowances. Financial support is provided to pay the cost of utility services that exceed a certain percentage of a family’s income (thresholds of about 20 percent of a family’s income are typical). Payments can also be channeled through family allowance programs, where they exist.

These approaches depend on effective measures to identify the needy. But properly designed for a specific country’s circumstances, a targeted approach is clearly more efficient and more affordable than the untargeted approach that results from across the board energy subsidies.

Of course, one way to avoid having to raise tariffs is to lower costs. Cost control, therefore, is another important avenue for lowering the need for energy subsidies. An important source of costs is excessive losses. One of the most common sources of these losses is the use of consumption “norms” for consumers who are not metered. Poor network maintenance can also cause excessive operating losses. In some countries, energy
theft—in the form of meter tampering, bypassing meters, and colluding with energy utility employees (such as meter readers)—is a major problem. Georgia and the Kyrgyz Republic, for example, have experienced theft levels of more than 20 percent of generated electricity. Dealing with excessive losses requires a clear commitment on the part of energy companies and governments to introduce metering, properly maintain networks, and enforce laws addressing theft.

What are the consequences of these subsidies in the energy sector? Let me return to the example of the Russian Federation. Implicit subsidies in the Russian energy sector in the past generated unsustainable economic trends that were partly responsible for the 1998 financial crisis. These subsidies undermine the investment climate in several ways. First, the low effective prices for energy delayed much needed restructuring of the old enterprises by effectively subsidizing them, encouraging inefficient energy consumption by both firms and households and making the Russian Federation 15–20 times more energy intensive (in terms of energy use as a share of GDP) than advanced energy-efficient economies such as Germany and Japan. Second, smaller financial surpluses in the energy sector have led to underinvestment in the long-term productive and generative capacity of the sector.

The effective energy subsidy in the Russian Federation (defined as the shortfall in actual payments relative to long-run marginal cost) remains high. The 1998 ruble devaluation pushed these subsidies to their 1999 peaks. Since then the subsidy has gradually declined. At the beginning of 2002, the effective subsidy for electricity was 50 percent, down from 95 percent in 1998; the effective subsidy for gas was 58 percent, down from 92 percent in 1999. The reduction in these subsidies reflects an active program by the government and service providers that includes the tightening of financial discipline to strengthen cash collections, phased increases in real tariffs, and the establishment of mechanisms for better budgeting for energy use by budget entities. The past practice in which oblast governors and large incumbent enterprises devised schemes of mutual noncash offsets in which the enterprises were forgiven a part of their tax debt in return for political complacency and social protection is now widely discredited. Cash collections are now at about 100 percent for both electricity and gas. Consequently, the main subsidy is the difference between the current prices for electricity and gas in the Russian Federation and the true economic cost of service provision.

According to our estimates, the total size of subsidies in the Russian gas and power sectors is now on the order of US$20 billion a year. Both
Gazprom and RAO UES have identified the domestic tariff levels they believe are necessary to provide full financial viability in the energy sector and are pressing for tariff increases to these levels. Of course, it will be essential to ensure appropriate governance of these two energy giants so that the financial resources mobilized by higher tariffs are actually channeled into better and more efficient services for consumers.

Across the region, progress in achieving financial viability within the energy sector has varied significantly. In Central and South East Europe, the EU accession countries are all well on the way to achieving sustainable financial viability in the energy sector; only some of the non-EU accession countries still have to address this challenge effectively. In contrast, almost all of the CIS countries still maintain significant energy sector subsidies.

The countries of Central and South East Europe generally charge higher tariffs, at levels that, according to broad industry experience, can be expected to cover costs. The CIS countries still tend to charge much lower tariffs, which clearly do not cover costs. As a percentage of GDP, current subsidy levels remain high in several transition economies, especially in the CIS and the Balkans. Fortunately, many CIS countries are now focusing on subsidies in the energy sector. Ukraine, whose cash collections in the electricity sector were less than 20 percent as late as 1997, is now collecting almost 90 percent of its current receivables for both electricity and gas. Azerbaijan is implementing a program to improve cash collections in the electricity and gas sectors from less than 50 percent to 100 percent over a five-year period. To do so, it has initiated a program to attract private sector involvement in the domestic gas and domestic power sectors. Moldova is clearly showing the benefits of private sector involvement in its electricity distribution business. And Armenia has privatized its power distribution business and is supporting the efforts of the new owners to improve collections.

Looking ahead, how can the countries that lag behind best address the issue of financial viability? The first step is to acknowledge the problem. This may seem an obvious suggestion, but several CIS countries do not yet appear to have recognized energy sector reform as a pressing concern.

The second step is to develop a work-out plan with appropriate sequencing. Our experience has suggested that attention initially needs to be directed at the point at which energy is transferred to the end consumer. This means dealing with payment issues. It also means that the distribution end of the business needs to be made financially viable if the rest of
the sector is to become so. As part of the work-out plan, careful consid­
eration needs to be given to developing and introducing a social safety
net to mitigate the consequences for the poor of a transition to full cost
recovery tariff levels.

During the implementation phase, governments would benefit from pri­
ivate sector involvement. Unfortunately, the interest of strategic
investors in purchasing and investing in privatized energy utility compa­
nies, particularly in the poorer countries of the CIS, has diminished sub­
stantially in recent years. There remain, however, opportunities for
private sector participation through concessions and management con­
tracts. In addition, there is the possibility of public-private partnership
arrangements. The Pamir power plant project in Tajikistan, which is
supported by the Aga Khan Foundation and is receiving financial assis­
tance from the World Bank and the International Finance Corporation,
is an excellent example of how a public-private partnership arrangement
can generate financing for an energy sector project in a very poor
country with a difficult investment climate.

In conclusion, the benefits associated with energy sector reform—espe­
cially addressing the financial viability of the energy sector in a coun­
try—are substantial and can extend well beyond the sector itself. The
energy sector plays a significant role in the overall economy of the tran­
sition economies; without energy sector reform and viability, the transit­
ion process is much more difficult and delayed. This is not to suggest
that achieving energy sector viability will, in and of itself, enable a
country to successfully complete the transition process. But it does sug­
gest that without addressing this component of the overall reform
agenda, a country will have difficulty completing its economic transit­
ton. We at the World Bank Group are fully committed to working with
the countries and partners in the region to complete the reform agenda
in the energy sector.
CHAPTER 11

Transition in Central and South East Europe and the CIS: The Social Dimension


Transition in the region has not been easy. For six years, beginning in 1990, output declined dramatically, with measured GDP falling by a third. The region then stagnated for another three years. Fortunately, in 1999 a vigorous economic recovery began for the region as a whole.

There were, however, significant differences between Central and South East Europe and the former Soviet Union. In Central and South East Europe, the transition recession was short and relatively shallow, lasting only two to three years, with a loss of 10–20 percent of GDP. The recession was followed by a steady recovery, which raised GDP to about 20 percent above GDP in 1990. In contrast, in the former Soviet Union the initial decline lasted much longer (seven years) and caused GDP to fall by as much as 50 percent (more in some countries, such as Georgia, where GDP declined by two-thirds). Since 1999 the recovery has been rapid and sustained, with growth rates of 4–5 percent—above those of Central and South East Europe. However, GDP in 2002 remains about 30 percent below its 1990 level.

These economic developments resulted in dramatic social impacts, especially in the former Soviet Union:

• Inequality increased, with Gini-coefficients rising substantially. In some countries, such as Armenia, income inequality is among the highest in the world.

The assistance of Pradeep Mitra, Chief Economist for the Europe and Central Asia Region, and the staff of the Chief Economist’s Office in drafting this speech is gratefully acknowledged.
• The incidence of poverty increased significantly, to more than 30 percent in the Russian Federation immediately after the 1998 crisis and to more than 70 percent in Tajikistan, the poorest former Soviet republic.

• Living standards dropped in most countries: in the Russian Federation, male life expectancy fell to 57 years, five years below that of India.

• Spending on and the quality of social services and safety nets dropped dramatically, especially in the former Soviet Union. In 1999 measured annual per capita spending on health and education in most of the poor former Soviet Union countries did not exceed US$20. The Russian Federation spent less than US$100—much less than the $350 the EU accession countries spent and far below levels in Western Europe.

In sum, at the outset, the social impact of the transition recession was dramatic, especially in the Commonwealth of Independent States (CIS) (the non-Baltic former Soviet Union republics). Inequality and poverty increased, living standards fell, and the quality of social services and safety nets declined. Indeed, we might want to add a fourth transition dimension—the social transition—to the triple transition (political, institutional, and economic) these countries had to weather.

In the initial years of the transition, scant attention was paid to the social implications and costs of the transition process, presumably because it was assumed that the traditionally low levels of inequality and poverty and the high levels of social services and safety nets of the socialist era would readily carry over into the postsocialist period. The depth of the transition recession in most CIS countries, combined with the dramatic and generally highly unequal reallocation of assets from the public to private owners, made this turn out to have been a false assumption.

The better performance of countries of Central and South East Europe in terms of social conditions is attributable partly to the less severe and shorter transition recession. But it was also the case that these countries paid greater attention to their social services and social safety nets and were generally more successful in redistributing state assets in a more transparent and egalitarian manner. In contrast, the CIS countries tended to neglect the social aspects of transition in the early years. In the Russian Federation, for example, only during the second
half of the 1990s was the World Bank able to get a serious dialogue going with government counterparts on matters of social policy; in Ukraine such dialogue started only in 1999. Often the change in policy focus came with a change in political fortune of the governments in power, as the negative social impact translated into protest votes in national elections.

But it is also fair to ask whether the economics profession more generally paid enough attention to the social aspects and costs of the transition process since 1990. Most reviews of the transition experience that I am aware of focused on the economic and institutional dimensions of the transition process until, in 2000, the World Bank put the spotlight on poverty and inequality in the region in a major publication. Even this, one might argue, came somewhat late, although the analysis in this report was based on country-specific investigations that had started in many cases years earlier.

Fortunately, times have changed: there is now a near universal recognition in the region of the importance of the social dimension of the transition process and the need to deal with many of the pressing social challenges. This follows not only from the recognition that better social policies are needed for better social outcomes but also because it is now increasingly recognized that better social conditions have a direct feedback to better economic performance and greater political stability.

What are the most important social policies? The standard trio is of course education, health, and social protection. But I believe we also need to add two other aspects of social policy: the need for growth-oriented policies and the need to empower citizens to manage their own community affairs and express their demand for better governance.

Education

Education is a key element of social policy. For the individual, educational achievement is a key determinant of employment and income earning opportunities and of whether or not an individual ends up poor or well-off. For a country, educational achievement and support for lifelong learning are essential underpinnings of long-term productivity growth and of the ability to compete in the modern world of knowledge economies.
Key objectives of an appropriate educational policy framework are improvements in accessibility, quality, and efficiency. Key elements of such a policy include the following:

- a rationalized school network that reflects changing demographics
- higher teacher salaries and improved training
- modern curricula and teaching methods, which rely less on rote learning and more on stimulating students' curiosity and developing their problem-solving capacities
- use of modern information technology and distance learning
- a focus on adult learning as part of a life-long learning framework—something that is especially important given the relatively old populations in the transition economies
- improved administration and financing of education at all levels of government

Health

Good health is important for the welfare of individuals; sickness and disability are major causes of poverty. Health is also a key ingredient in economic performance. Recent estimates for the Russian Federation, for example, have shown that if the current trends in the HIV/AIDS epidemic go unchecked, Russia's economic growth potential will decline significantly.

Key elements of an appropriate health policy include the following:

- a sharper focus on prevention rather than merely on curative medicine, including promotion of better lifestyles regarding alcohol, tobacco, and drug use as well as sexual practices
- adoption of modern treatment practices and efficient management of health facilities
- higher salaries and improved working conditions for public health workers
- introduction of sustainable health insurance systems
- a policy framework for developing a competitive pharmaceuticals industry

- improved administration and financing of health at all levels of government

Social Protection

As poverty increased, employment in traditional sectors declined; traditional pension systems became financially unsustainable in many transition economies in the wake of the transition recession. With a rapidly aging population, reform of social safety nets, unemployment insurance, and pension systems took on a high priority.

Central European governments managed to maintain social protection systems and were able to begin to reform them gradually, albeit imperfectly to date. They still face high unemployment, due in part to inflexible labor markets, poor work incentives, and high labor taxes. And while much progress has been made in some of the Central European countries with pension reform—indeed some of the most advanced pension reform initiatives are to be found in Hungary and Poland—much remains to be done to put these systems on a sustainable footing.

Some former Soviet republics, including the Russian Federation and Kazakhstan, have also come some way in reforming their social protection system. In the Russian Federation, social safety net and pension reform were initiated as part of a program of structural reforms supported by World Bank adjustment loans.

Big challenges remain, however, in completing the reforms, that is, in ensuring financial sustainability, low marginal labor taxes, efficient targeting of benefits to the most needed, strong administrative capacities, and, for the multipillar pension systems, in developing well-functioning domestic financial markets in which to invest private pension funds.

Growth-Oriented Policies

Much of the increase in poverty created by the transition recession can be—and has begun to be—reversed with economic recovery and sustained growth, which increases incomes and employment and creates the fiscal resources needed to resuscitate social services and safety nets. Hence
there is a need to create a favorable investment climate, which is a key ingredient for growth, and social policy. There is a need to avoid policies that reduce economic growth—subsidies for unprofitable enterprises, subsidies for energy and communal services, unsustainable fiscal policies that engender inflation and indebtedness—which often are introduced in the name of social justice. In fact, these policies not only endanger growth, they also undermine precisely the social goals they are intended to support.

Empowering Citizens

A final key element of social policy is empowering people to participate in their communities' affairs and to be informed about and provide feedback on the quality of government policies and programs. This can take various forms: consultation and participation of NGOs and other civil society organizations in policy formulation and program design, as well as in implementation; the direct involvement of communities in projects affecting them; and the use of surveys and explicit feedback mechanisms to allow people and enterprises to express their views about the quality of public services, regulations, and other public sector activities that affect them. We have found in our project work that when we involve local people in local decisionmaking, projects show better and more sustainable economic and social results.

We have learned a lot since the transition started. We now better understand the disruptive impact of the political, institutional, and economic disintegration of the centrally planned economies in Central and Southern Europe and the CIS during the early years of the transition. We understand that market-oriented reforms are essential for long-term recovery but also that they take time and are hard to design and implement, not least because of the tough political choices they impose on the champions of reform. Finally, we have learned that appropriate social policies—in the broadest sense of the term—are an essential ingredient of a successful transition process. Building up the institutions that effectively respond to the social needs of a country takes time and may involve difficult tradeoffs in the financial, economic, and political spheres. In the end, managing the transition—like managing any process of deep social change—is as difficult as it is essential. This is a lesson that is being learned the hard way today in industrial countries, especially in Japan and Germany.
CHAPTER 12

Progress and Challenges in Meeting Environmental Goals in Europe and Central Asia

From a speech given at the Fifth Ministerial Pan-European Environment for Europe Conference, Kyiv, May 21, 2003

The World Bank is pleased to be involved in the Environment for Europe process and to see our collective efforts since the first conference in 1991 come to fruition. Clearly, much remains to be done on the regional environmental agenda. But the Bank has also witnessed significant improvements in environmental quality over the past decade. I will begin by highlighting a few of the achievements that lay a strong foundation for future progress. I will then lay out the case for action on Millennium Development Goal seven, which aims primarily at ensuring environmental sustainability, including access to safe drinking water and sanitation, carbon emissions, forests and protected areas, and improving the situation of slum dwellers.

Celebrating Progress to Date

One of the most important regional accomplishments of the past decade has been in the area of energy efficiency. For Europe and Central Asia as a whole, carbon emissions have declined 28 percent and energy efficiency has increased 21 percent since 1992. Almost all countries are showing some improvement in this area. Much of this reduction has come about simply because of the economic collapse in the region, but many countries have implemented structural changes and restored GDP growth without a return to old levels of pollution and contamination. In fact, incentives have been adopted almost everywhere to improve efficiency and reduce emissions of greenhouse gases per unit of GDP. The reduction in implicit and explicit energy subsidies has been especially

The assistance of Jane Holt, Sector Manager for the Environment in the Europe and Central Asia Region, in drafting this section is gratefully acknowledged.
important, since such subsidies promote excessive use of energy. In Ukraine, for example, authorities collected only about 20 percent of receivables for electricity as recently as 1997. Today collection rates are almost 90 percent for both electricity and gas. Over that same period, Ukraine experienced a more than 24 percent increase in energy efficiency.

We have already seen some major improvements in the provision of clean water for human use and irrigation—high priorities throughout the region. In Kazakhstan, for example, rehabilitation of the water supply in several small cities and rural settlements has already improved the health and sanitation of nearly 1.6 million people, or 10 percent of the country's population. In Uzbekistan additional trunk mains and household connections have been provided to some 2 million rural people who did not have access to safe and reliable water.

Institutional reforms and more economic pricing have led to more efficient use and provision of water, thus reducing associated pollution. In the Baltic region such reforms, together with the installation of meters to measure consumption, cut daily per capita water use by more than 100 percent, reducing the amount of water needing treatment and enabling utilities to meet European Union (EU) hygiene requirements. The utilities have used the improved cash flows to improve services, reduce leaks (in some cases cutting losses by half), and install more energy-efficient pumps.

The Bank has also seen important successes in efforts to tackle transboundary water problems, particularly around the regional seas. Overuse of fertilizers combined with municipal and industrial wastewaters from 17 countries have seriously degraded the Danube River and the Black Sea ecosystems, disrupted fisheries, reduced biodiversity, posed health threats to humans, and resulted in billions of dollars of losses to the economies of six countries. Since 1992 there has been a concerted effort to identify the major sources of point and nonpoint pollution and to begin addressing them. This is being done by restoring wetlands to trap nutrients along the Danube River, reducing nutrient runoff from agricultural practices, and improving or introducing municipal wastewater and sewerage treatment before discharge into the sea. In the broader context of the Danube Black Sea Program, the Bank welcomes the opportunity to support development of cooperative water programs for South East Europe and the Mediterranean that were endorsed at the Athens conference on sustainable development for a lasting peace held earlier this month.
A similar multicountry, integrated approach is under way to tackle the main point and nonpoint sources of pollution threatening the Baltic Sea. The estimated total nutrient load per year is about 750,000 tons of nitrogen and 37,000 tons of phosphorus a year, most of it from agriculture. Early results from demonstration projects to support better agricultural practices promise runoff reductions of about 28 kilograms of nutrients per hectare, and efforts are under way to replicate these new practices on a large scale.

The Balkan countries have joined longstanding programs to clean and safeguard the Mediterranean, following strict provisions of the "blue flag" program to certify beaches and coastlines for swimming and tourist use. In the Caspian Sea, the five littoral states are beginning joint efforts to tackle potential oil spills, prevent the introduction of invasive species, and protect sturgeon populations. And recent improvements to irrigation and drainage systems in Central Asia go some way toward saving at least part of the Aral Sea.

Major efforts are under way to make more sustainable use of the region's forests. Certification is being promoted as an incentive to apply sounder managerial methods, and countries in the region are increasingly adopting fees for the felling of trees. From Bosnia and Herzegovina to Bulgaria to the Russian Federation, efforts are under way to ensure that forests are better safeguarded from fires and pests, as well as from illegal logging and unsustainable practices. Where areas are already under commercial use, regulations are being put in place to require sufficient replanting to ensure sustainable growth.

The amount of forest area under national protection has also increased significantly since 1999, with the latest data showing that 7 percent of land is in protected areas. Since the early 1990s about 500,000 hectares have been brought under improved management, and efforts under way will include an additional 800,000 hectares of forest ecosystems in these protected areas.

Emissions trading in carbon rights is also beginning to take off. The countries of Europe and Central Asia have enormous potential to benefit from participating in this market. Countries in the region can implement carbon reduction programs at a relatively low cost and sell carbon rights to other countries that find it less expensive to buy rights abroad than to undertake carbon-reducing measures at home. The World Bank has supported these efforts, first with a Prototype Carbon Fund and more recently with a Community Development
Fund. These facilities provide financing for projects that reduce carbon emissions through carbon sequestration. By reforesting 6,000 hectares of degraded agricultural land, for example, Romania will sequester almost a million tons of carbon dioxide equivalent over 15 years. In compensation, the government will receive payments from the Prototype Carbon Fund.

Another area of major accomplishment has been the phasing out of ozone-depleting substances, primarily in the Russian Federation but also in Belarus, Ukraine, and several Eastern European countries. Funds from the Global Environment Facility, the World Bank, and other donors compensate enterprises in these countries that phase out the production of chlorofluorocarbons and halons, the most potent ozone-depleting substance. Seven Russian enterprises have participated in this program.

Last, but certainly not least, has been the adoption of EU environmental directives by the accession candidate countries, together with a plan for implementing them. These new entrants should be congratulated for their political leadership and commitment to the environment. Of course, the costs of meeting the environmental component of the EU acquis are high—about US$100 billion over a 20-year period for Bulgaria, Romania, and the Eastern European candidate countries—but these countries are committed to this process.

All this progress shows that there is heightened recognition that environmental considerations are critical to the health and prosperity of people and a key factor in ensuring sustainable growth and poverty reduction. In turn, the importance of the environmental agenda has brought an increasing awareness of the vital role of ministries of environment in the region and the role they will need to play as the transition proceeds. This is especially important since the vigorous economic recovery that began for the region as a whole in 1999 is set to continue in 2003 and beyond, making the region one of the most economically dynamic in the world. We want to be sure that this recovery does not lead to a revival of the old environmental threats.

Much of the improved understanding of environmental issues can be traced back to the Environment for Europe Process and its continued focus on moving the environmental agenda forward. Notwithstanding the progress and good news that I have highlighted, I hope this conference will spotlight the most important of the outstanding environmental problems and renew our commitment to help tackle this unfinished
Meeting the Challenge of the Environmental Millennium Development Goal

The Millennium Development Goals (MDGs) were developed by the United Nations and endorsed by the heads of state of virtually all countries. They offer a widely accepted approach for moving forward on the unfinished development and transition agenda in a way that integrates environmental issues into a comprehensive development framework and focuses on real monitorable outcomes. I am delighted that the government of Ukraine is using the MDG framework to shape its economic development plan more broadly.

The MDGs consist of eight goals with the overarching objective of halving the share of people living in poverty by 2015. They were adopted at the Special UN Millennium Summit of the UN General Assembly in 2000 and reiterated at the Johannesburg Summit in 2002. MDG Seven requires governments to commit to meet target indicators concerning levels of safe drinking water and sanitation, carbon emissions, forests and protected areas, and conditions of slum dwellers.

What do these goals mean for the countries of Europe and Central Asia? I would like to share with you our preliminary assessment and to draw attention to subregions and sectors in which we will need to increase our collective efforts over the medium term if these targets are to be met. The Bank has also started to assess the potential costs of the required effort, to help set priorities and determine financing gaps as we move forward on this agenda.

The greatest challenge to meeting the environmental targets seems to be in water supply and sanitation. Although official data show that 91 percent of the population have access to improved water supplies, poor water quality constitutes a major health threat. Among the countries in the Eastern Europe, Caucasus, and Central Asia region, the Central Asian countries will need to mount the biggest effort in this area. Within Central and Southern Europe, the biggest gaps are in Albania and Romania. The Bank has serious concerns about the sustainability of many urban water companies, especially in secondary towns, but most effort needs to be made in rural areas, where access to safe drinking water and sanitation is significantly lower than elsewhere. Roughly
30 percent of rural households in the region do not have access to piped water, and much of the piped water is of poor quality. In rural Moldova 60 percent of water sampled from water supply systems did not meet water quality standards. Even in Ukraine 25 percent of nonpiped water does not meet bacteriological and chemical standards. We therefore have to be sure to measure the right dimension of water access, that is, access to safe water.

For basic sanitation, the current level of access is 93 percent and the target value is 95 percent, a relatively small increase. The main problem in this sector is that sewage systems are in a serious state of disrepair and need immediate attention if the situation is not to worsen in the coming years. The situation is most serious in Albania, Romania and the countries of Eastern Europe, the Caucasus, and Central Asia.

Let me turn to the challenge of forests. With 40 percent of its land surface covered by forests, Europe and Central Asia has a higher than average share of forest cover (the world average is 30 percent), and its forest areas are increasing, according to official statistics. Albania is the only country in the region with declining forest cover. However, the quality of these forests, as measured by canopy and old growth forests, continues to deteriorate. And illegal logging is a problem in some countries.

In the energy sector, energy efficiency has improved, but the Europe and Central Asia Region still remains the least energy-efficient region in the world in terms of GDP per unit of energy use. An increase in efficiency of 58 percent is needed if the region is to reach the same energy efficiency level as other countries at similar levels of development. The removal of subsidies, which remain high, would help a great deal in this regard, especially in the non-Baltic former Soviet republics and the Balkans. If the Russian Federation were to remove energy subsidies, its energy efficiency would increase significantly and carbon dioxide emissions would fall 17 percent. Throughout the region, carbon emissions need to be cut in half to reach the same per capita level as other countries at similar levels of development.

In addition to these sectoral challenges, meeting the MDGs will require a sharper focus on implementation and monitoring of results at the country level. This, in turn, will require increased joint work to establish credible data, differentiated by rural and urban areas, to identify gaps and prioritize actions for meeting the targets.
The mandate to meet goal seven greatly increases the responsibility of ministries of the environment, whose task it will be to drive and monitor the agenda in this area. In many cases, doing so will require strengthening the capacity of ministries and developing horizontal links with other ministries responsible for water, sanitation, energy, forestry, and biodiversity. Of course, many of the investments most directly affecting the environment will be made by line ministries or municipalities. This means that ministries of the environment need to forge partnerships with these other entities. In this regard, I am delighted to announce that the Bank and its capacity building arm, the World Bank Institute, have teamed up to mobilize US$1 million for capacity building of environment ministries in the Russian Federation, Ukraine, and the five countries of Central Asia over the next three years for this purpose.

We all need to work together to continue the important efforts that have already begun in these areas, to identify those interventions that have worked well, and to make a special effort to scale up or replicate those that have achieved significant progress. Meeting the challenges I have mapped out requires a substantially increased effort by the international community and by the countries themselves.

The World Bank's Europe and Central Asia Region has projects under implementation totaling US$1.9 billion and projects under preparation totaling US$1.5 billion (including funding from the Global Environment Facility [GEF]) dedicated to improving the environment. We will also continue our many efforts of analysis and technical assistance designed to help improve our knowledge and understanding of the environmental problems and solutions in the region and to build improved national capacities to deal with them, in close cooperation with our partners. On behalf of the World Bank, I want to pledge our continued support for the Environment for Europe process and our strong wish to work with you in the years to come.

That said, clearly each country has primary responsibility for its own development and for folding the MDG targets into national policies and development strategies. I hope all countries in the Eastern Europe, Caucasus, and Central Asia region will follow Ukraine's lead in using the MDG framework as a means of setting specific targets for carrying out the environmental strategy they have collectively brought to this conference.

I believe we owe a debt of gratitude to the United Nations Development Programme for defining the MDG goals and targets and for its efforts to
assist in their monitoring. Environmental sustainability is closely linked with all of the MDGs, particularly those aimed at reducing child mortality and combating disease. Environmental action may be among the most cost-effective ways of achieving many of these other goals and protecting the richly diverse ecosystems of the region, from the taiga to the Carpathians.
PART 4
Beyond Europe and Central Asia

The fourth group of chapters includes two speeches that reflect a broader context beyond the Europe and Central Asia region. Chapter 13 summarizes the implications of the new global approach to development agreed on at the Monterrey and Johannesburg Summits for the small, poor countries of the Commonwealth of Independent States. At these summits, developing and industrial countries agreed to a compact under which the developing countries committed to undertake the necessary reforms needed to generate sustained development in their countries while the industrial countries committed to make available the incremental financial assistance needed to finance reforms, investment, and debt relief in the developing world. Chapter 14 takes an even broader perspective, by sketching a number of key ideas on how to address the long-term sustainable development challenges the world faces. This was a very brief speech I delivered at a workshop of German development experts as a member of a panel of three, whose other members were billed, respectively, as the richest man in Germany and as an aggressive spokeswoman of the antiglobalist coalition "Attac."

The volume closes with a postscript in chapter 15, based on a speech I gave in late September 2003, shortly after my retirement from the World Bank (the piece was updated in February 2004). As a summary of the state of the region and its outlook for the future, this chapter rounds out and brings up to date my thinking on how far this region has come and what are the key risks, opportunities, and tasks for the future. With all the risks and challenges that remain—and there are many, even and perhaps especially for the newly minted EU member countries—I am struck by how far the region has come in 15 years; how fundamental and irreversible the changes have been; and how integrated, open, and increasingly successful the newly unified Eurasia region has become, having overcome 80 years of division into hostile and systemically opposed camps, separated by seemingly insurmountable barriers both on the ground and in peoples' minds. It is my fervent hope that future generations in the region will be able to live peacefully and prosperously together on their interlocking continents now that the walls and curtains and systemic divides have largely disappeared.
CHAPTER 13

A New Global Approach to Development

From a speech given at the Consultative Group Meeting on the
Kyrgyz Republic, Bishkek, Kyrgyz Republic, October 9, 2002

This meeting comes at a pivotal time. The international community, like the Kyrgyz Republic, has internalized the principles of the Comprehensive Development Framework—country ownership, inclusion, donor partnership, and a focus on results—and is looking for ways to implement this new approach to development, as agreed at the Monterrey and Johannesburg Summits. This meeting also comes as we see the completion of the first round of Poverty Reduction Strategy Papers in Central Asian countries and as we increasingly recognize regional issues through forums such as the CIS-7 initiative. It also comes at a time when the international community is giving Central Asia increased attention, including in connection with the forthcoming Global Mountain Summit. If we can use this opportunity to weave all of these trends together, we will indeed have a very successful meeting. Let me try to capture for you some of the key ideas and initiatives that are emerging in the international development dialogue.

The Monterrey and Johannesburg Summits

The Financing for Development Conference held in March 2002 in Monterrey, Mexico, marked an important turning point in meeting our aspirations on development, as embodied in the UN Millennium Development Goals. At Monterrey the international community reached consensus on an architecture of mutual responsibility for achieving the UN Millennium Development Goals, based on two pillars:

The assistance of Lilia Burunciuc, Central Asia Country Program Coordinator for Europe and Central Asia, in drafting this speech is gratefully acknowledged.
that will help track progress, assess the poverty reduction impact of policies contained in PRSPs, and signal the need for corrective action. This is a difficult area—an area in which the Kyrgyz National Strategy for Poverty Reduction will need continued strengthening.

As the focus shifts from preparing PRSPs to implementing the strategies they set out, a number of additional challenges are emerging. A key challenge for countries like the Kyrgyz Republic is to continue to extend the participatory process for the elaboration and monitoring of PRSPs. For the longer term, the most important and most difficult challenge is to implement and monitor the progress of pro-poor growth policies and programs outlined in the PRSPs.

For the multilateral and bilateral development agencies, the challenge lies in better prioritizing and coordinating programs in line with country strategies while helping countries implement agreed upon country strategies and over time helping further improve the strategies in a process of continuous and joint learning.

The CIS-7 Initiative

Since the dissolution of the Soviet Union, the Bank has become increasingly aware of the very severe economic and social disruptions experienced—especially by the smaller and low-income republics, including the Kyrgyz Republic—as a result of the disruption in trade, financial, water, energy, and institutional links that had been so important in the Soviet Union before 1992. As a result of these disruptions, but also because of a history of conflict and uneven progress with policy reforms and institution building, the low-income countries in the Commonwealth of Independent States (CIS) now face an urgent need to accelerate poverty reduction and economic growth while ensuring fiscal and external debt sustainability. They also face the challenge of regional cooperation and reintegration in key areas such as trade, energy, water, and human development. The World Bank has partnered with the Asian Development Bank, the European Bank for Reconstruction and Development, the International Monetary Fund, bilateral donors, and the concerned governments to launch a collaborative international effort to enhance poverty reduction in seven CIS countries: Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova, Tajikistan, and Uzbekistan.

The CIS-7 initiative places strong emphasis on renewed reform and regional cooperation efforts by countries. The Kyrgyz Republic has been
in the forefront of putting such efforts into action. It has made a tremendous effort to develop a full-fledged national strategy for poverty reduction and has generally demonstrated a persistent commitment to reform implementation. It has also consistently supported initiatives for regional cooperation.

For the donor community, the CIS-7 initiative is also an avenue for mobilizing support that rewards good performance. The Kyrgyz Republic has already benefited from the Paris Club debt flow restructuring, which gave the country some breathing space for the next three years. The Paris Club have expressed a willingness to consider further debt relief actions, including a possible debt stock reduction at that time. They will revisit the issue in 2004.

This Consultative Group Meeting is a unique opportunity for the Kyrgyz government and the donor community to jointly take hold of the country's national strategy for poverty reduction agenda and to commit to each other, in the spirit of the CIS-7 initiative, to move forward in further developing clear priorities, implementing the agreed upon agenda, and mobilizing the much needed financial support for the Kyrgyz Republic.

Today's Consultative Group Meeting is one of the concrete steps meant to make the Monterrey and Johannesburg agreements and the CIS-7 initiative a reality. It is an excellent opportunity for the government and the donor community to commit to implementing the new global development agenda in the Kyrgyz Republic in key priority areas of its ambitious National Strategy for Poverty Reduction. I would like to appeal to this distinguished group of donors to lend their hand of support as the Kyrgyz Republic moves forward with implementing a difficult and courageous reform agenda for sustainable recovery and poverty reduction.
invested nearly US$2 billion in global environmental protection initiatives.

Since the end of the Cold War development assistance has declined, but assistance is more effective today than it used to be, because it is less often misused for political reasons.

Thesis No. 3 (Fact): The next 50 years will be decisive for the future of mankind and marked by great opportunities and great risks

In the coming 50 years the course will be set for the long-term survival of humanity. By the year 2050 the world’s population will probably increase by two to three billion before stabilizing. Given 3 percent annual growth, global GNP will quadruple by 2050. The demand for food will double unless consumers fundamentally change their consumption behavior in relation to GDP growth. Energy demand will increase sharply. Some 150,000 new power plants worldwide will each generate 1,000 megawatts of power by 2050. Environmental pollution will worsen dramatically, with carbon dioxide emissions rising from 6.8 gigatonnes to 25–26 gigatonnes. Migration pressures, the risks of war, and terrorist actions will increase.

Against this backdrop, mankind has the opportunity to radically restructure production, consumption, and income and property distribution, setting in motion a development process that will lead to less poverty, more stability, and preservation of the environment. If no such restructuring takes place, the risk that poverty will grow, political instability increase, and environmental harm become irreversible will become extraordinarily great.

On the basis of these three theses I would like to put forward seven propositions for future discussion.

Thesis No. 4 (Proposition): We must find and implement comprehensive, overlapping, and integrating approaches and solutions

The industrial countries must make it an urgent priority to speed the pace of their structural reforms and develop better technologies, especially in energy and transportation. In the developing countries we must concentrate primarily on achieving the Millennium Development Goals (MDGs) by the year 2015. We must accept the concept and the now
Ensuring Peace, Alleviating Poverty, and Protecting the Environment

generally recognized practice of the Comprehensive Development Framework (CDF) as a framework for better cooperation between host and donor countries. In this connection, host countries' will to act and the broad-based participation of the general public and civil society in these countries are essential. Protection of the environment is also an integral component of the CDF.

Thesis No. 5 (Proposition): Energy generation and use must become more efficient and environmentally friendly

We need pragmatic and politically acceptable approaches to energy, including investments in environmentally friendly generation and transmission methods; more intensive research on new technologies in energy generation and use; and elimination of energy subsidies—which in the developing countries alone could result in savings of US$100 billion dollars—together with targeted financial assistance for the poorest users. Similar policies are needed in water supply and agriculture.

Thesis No. 6 (Proposition): We must involve the private sector by emphasizing the "triple bottom line"

Private enterprises are increasingly realizing the enduring benefits of the financial, social, and environmental aspects of their work. Greater transparency is also needed.

Thesis No. 7 (Proposition): The participation of the population at large, of civil society, and of communities in the decision processes affecting them is decisive

When people feel they have a say in decisions affecting them they assume more responsibility for the consequences of their actions. Implementation and outcomes, especially in the environmental sphere, improve.

Thesis No. 8 (Proposition): We must pay more attention to the role of women, not just in education and health policy but also in legal and financial reforms, environmental and agricultural policy, and other areas

We have been talking for years about the special role of women in child-raising and health. Women also need legal safeguards and access
to financial resources, including microcredit. They must be more specifically considered in the context of environmental and agricultural policy.

All of these propositions and their implementation form the basis for the next thesis:

Thesis No. 9 (Proposition): We must double development assistance, especially by funding debt relief for the poorest countries and providing assistance for global protection of the environment.

In practice, this means more money for bilateral government programs, more support from public and private sources for NGOs and other organizations of civil society, and building up of the multilateral funds, including the International Development Association, the GEF, Heavily Indebted Poor Countries initiative, the HIV/AIDS Fund, and UN agencies.

Assistance should be increased in a way that reflects the new Monterrey Consensus. In this connection, host countries have undertaken to do more in the economic, social, and environmental policy spheres, while donor countries intend to open their markets wider and provide more development aid.

Thesis No. 10 (Proposition): We cannot overlook the dangers currently threatening us—such as the conflicts in the Middle East and Kashmir—and their possibly catastrophic outcomes for peace, poverty, and the environment.

Are we doing enough in the various high-level international bodies to bring about peaceful solutions to these conflict situations?
CHAPTER 15

Postcript: The Economic Outlook for Eurasia: From Transition to Sustained Growth and Integration?


Fifteen years have passed since the start of the transition from Communism to democracy and market economics in the countries of the former Soviet empire. Looking back, it seems like a short time span that has brought many and major changes to the region. One profound change was that, as the Soviet Union and its political and economic empire disintegrated, the divide that had stretched across Europe and through Turkey into southwestern Asia also disappeared. This permitted an old, long-forgotten geographic concept—Eurasia—to gain new currency and meaning, with profound economic and political significance. The peaceful and prosperous integration of the countries and economies of Eurasia is now a real hope after many decades of forced separation that had followed many centuries of uneven economic and social development punctured by wars spilling across countries and continents.

What is the economic outlook for Eurasia, particularly the former Soviet Union, Turkey, and Central and South Eastern Europe? These countries represent the part of Eurasia left behind in the spurt to prosperity and democracy that benefited Western Europe, North America, and Japan during much of the twentieth century. The isolation and misdirected economic management under Communism—and in the case of Turkey the legacy of the failed Ottoman Empire and the incomplete modernization and transition of the country under Ataturk and his successors—caused these countries to fall behind their Western neighbors. The question is whether these countries have firmly embarked on a path toward sustained economic growth after the painful transition following the collapse of the Soviet Empire and the reintegration of economic space in Eurasia.
The short answer is that after nearly a decade of economic collapse and social stress, there are now good prospects for this region and its population of about 500 million people. Recently, it has been one of the most dynamic regions in the world in terms of economic growth, with annual per capita income growing at an average rate of about 4–5 percent over the past four years, even as recession gripped much of the rest of the world. Prospects for continued economic growth in the region also remain strong. At the same time, with a few exceptions, there is now peace in the region. And democracy, while still a work in progress in many countries, may have a greater chance than ever before of succeeding in the long term. One of the main drivers of this positive development has been the great pull exerted by the European Union (EU), with prospects of joining now much enhanced for those Eurasian countries closest to it. And even for those that cannot or do not aspire to membership in the EU, the example of EU institutional and political development and many of the European, transatlantic, and global institutions (the Organization for Security and Co-operation in Europe, the Council of Europe, NATO, the World Trade Organization [WTO], the Bretton Woods institutions) exert a strong pull towards economic and institutional modernization, integration, and peaceful democratic development.

Of course, the countries in Eurasia face many challenges and risks in bringing about a prosperous, peaceful future. Since the region is highly heterogeneous—and opportunities and challenges hence vary significantly across countries—it is best to look briefly at individual countries and subregions to get a better sense of the outlook piece by piece and then assemble the pieces of the puzzle into one big picture.

The Russian Federation

Russia's economic recovery since the financial crisis in 1998 has been buoyed by persistently high oil prices, but also by the cumulative impact of 15 years of economic reform and recent political stability. Since 1998 the Russian economy has grown by about 30 percent; in 2003 GDP grew 7.3 percent. High oil prices, the effects of a drastic devaluation in 1998, and the ability to employ underutilized capacity explain much of this dramatic recovery. But business surveys (such as the so-called BEEPS surveys conducted by the European Bank for Reconstruction and Development and the World Bank) also show a notable improvement in the perception of the investment climate in Russia since 1999, which helps explain the flow of capital and a recent revival of investment (albeit still heavily concentrated in the natural resource industries).
With personal income growth outstripping sustained high economic growth, per capita consumption is now estimated to exceed its 1990 level by 20 percent, and a new middle class is rapidly emerging.

Continued economic and institutional reforms are needed if Russia is to maintain its strong economic performance of recent years. Further improvements in the business climate through civil service reform and improved governance at the federal, provincial, and local levels are essential, as are reform of the banking sector, rehabilitation of infrastructure (including information technology infrastructure), and modernization of education and health services. Early accession to the WTO is another important factor and with recently announced agreements between Russia and the EU, the prospects for Russia's early WTO membership have much improved. President Putin has made it clear that he aims to maintain strong economic growth, and he is expected to revive economic reforms by mid-2004, having successfully completed the parliamentary and presidential election cycle. Perhaps the greatest challenge for Russia in the longer term is establishment of firmly democratic institutions, of secure property rights, of effective legal and judicial bodies, and of an efficient, honest, and impartial civil service at the national and subnational levels. Without such changes, economic growth—while sustainable in the near term, especially with continued high oil prices—will likely falter in the longer term.

Given Russia's size and centrality, a buoyant, stable, and democratic Russia will be essential for the economic and political integration of Eurasia. Recent efforts to create a common economic area covering Belarus, Kazakhstan, the Russian Federation, and Ukraine can be seen as an initiative to promote regional cooperation and integration. Past efforts of this kind (including the Commonwealth of Independent States [CIS]) have not been successful in creating a common economic space. Much will depend on whether Russia can convince its neighbors that its intentions are non-hegemonic and that it is not aiming to set up a regional trading block that will prevent its members from seeking closer cooperation with the EU and integration with the world economy.

Ukraine

In many ways Ukraine's good economic performance over the past four years has presented the greatest surprise to those following developments in the region. Despite low ratings on most comparative indicators of good governance and the lack of significant energy resources, Ukraine's economy has enjoyed sustained economic growth of at least 5 percent a
year—a surprising turnaround. Among the reasons for this unexpectedly good performance are strong economic growth in the Russian Federation, the cumulative impact of domestic economic reforms, increasing political stability and predictability in economic management (even as the domestic political situation remains murky for the outsider), and Ukraine's increasingly solid orientation toward the EU. One underappreciated fact about Ukraine is that Kiev has become one of the most attractive cities in Europe.

The economic prospects for Ukraine are good if continued reforms—including WTO accession, improvements in governance, and continued orientation toward the EU—are combined with political stability in the run-up to and following the 2004 presidential elections. Like Russia, however, Ukraine faces downside risks for the longer term. Continuing internal divisions between the east and west of the country, tensions between democratic and nondemocratic forces, and the pervasive corruption that still hampers the business climate and life of the average citizen are all factors that can derail Ukraine's progress with political and economic reforms. The outcome of the next presidential election—and the manner in which it will be conducted—will be the weather vane that will tell whether democratic and economic progress will continue or whether serious detours and setbacks must be considered likely.

Other CIS Countries

Many of the smaller CIS countries were especially hard hit by the disintegration of the Soviet Union and the collapse of the Russian economy in the wake of the financial crisis of 1998. But most have also shared in the economic recovery of the Eurasia region over the past four years, partly because of Russia's revival, but also because of domestic economic reforms and their gradual integration with the world economy. Future prospects for these countries are mixed, however.

Among the positive surprises are Armenia, Azerbaijan, Kazakhstan, and Tajikistan, where economic reforms and political stability have combined with improved regional economic conditions to produce significant economic turnaround and reasonable prospects. Among the more disappointing performers are Georgia, Moldova, Uzbekistan, and, of course, the outliers and nonreformers, Belarus and Turkmenistan.

Several cross-cutting factors will determine the medium-term outlook for these countries:
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- Settlement of regional conflicts: Central Asia's prospects would be much enhanced by peace in Afghanistan and Iraq, normalization of international relations with Iran, and improved cooperation among the Central Asian countries themselves. Settlement of the Armenia-Azerbaijan conflict over Nagorno-Karabakh and of the division of Georgia with its breakaway region, Abkhazia, would help regional development in the South Caucasus. Settlement of the Transdniestria conflict would help Moldova's development and regional integration with Ukraine. International political support for the settlement of these conflicts will be essential.

- Economic and governance reforms: Continued improvements in economic management and especially improvements in governance (including transparency in the management of natural resources) are critical. The recent peaceful political change in Georgia holds out some hope that the country's internal divisions and corrupt management can now be turned around, but the economic and political challenges facing the new president and his government are severe. The oil and gas wealth of Azerbaijan and Kazakhstan and the recent introduction of oil funds in Azerbaijan and Kazakhstan bode well for continued sound economic management and prospects in both countries, but the long-term outlook for democracy and good governance and hence for political and economic stability remain uncertain. For Central Asia, economic reforms in Uzbekistan are essential, given the country's size, its central location, and the fact that its current restrictive economic policies severely inhibit regional trade and cooperation.

- Regional integration and access to world markets: Most of the smaller CIS countries are still isolated from world markets by a combination of landlocked and remote location, poor domestic policies, lack of transport infrastructure and regional cooperation, and lack of access to industrial country markets, especially the EU. EU trade policies, especially policies regarding agricultural trade, remain unfavorable toward these countries. The future of these small countries will to a large extent depend on peaceful and effective integration of their economies with each other and with the rest of the world.

Turkey

During the past 18 months Turkey has been able to overcome many of the symptoms of the economic and financial crisis that have plagued the country in recent years. Economic growth has revived, inflation and real
interest rates have dramatically declined, improved relations with Syria, and enhanced domestic political stability since the national elections in late 2002 have improved the outlook for continued financial stabilization and economic growth. Turkey still faces major challenges, however, that, if not addressed, could yet derail the recovery and improved prospects.

- **Iraq**: As long as the security and economic situation in Iraq remains unsettled, Turkey will not be able to normalize its trade with this important neighbor. The perception and reality of regional security risks will remain, as will risks of continued confrontations over the issue of the Kurdish minority and of possible frictions with the United States and the EU.

- **Economic and financial risks**: Turkey has a long history of stop-and-go reforms and of recurrent economic and financial crises. Only persistent fiscal, structural, social, and governance reforms will address the underlying causes of instability. The program of the current government is generally pointing in the right direction, and with its clear majority in parliament it has the political clout to implement reforms quickly and effectively. But progress with key structural and social reforms has been uneven, possibly because of diverging interests within the governing party and because of the lack of strong cohesive leadership in the economic sphere.

- **EU accession**: Turkey’s prospects for eventual EU accession have been greatly enhanced by the decisions made at the EU Summit in Copenhagen in 2002 and by the government’s fast pace of domestic political reforms. However, the recent failure of the UN, EU, Turkey, and the Cypriots to reach a settlement in Cyprus, an unfinished economic and political reform agenda in Turkey, and continuing deep divisions within the EU about Turkish accession all imply that prospects for a positive decision about the start of membership negotiations in late 2004 remain uncertain for now.

- **Foreign direct investment**: Turkey has a surprisingly poor track record in attracting foreign direct investment, considering its favorable location relative to European markets and its well-developed private sector. Failure to attract foreign investment has many causes, including investors’ perceptions of regional security risks, of poor governance and high corruption, and of an inhospitable local business community. The current government has vowed to change the reality underlying these perceptions and to open up the country to foreign
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investors. Progress in this area will be a major indicator of progress toward economic reforms and EU integration.

The Balkans

Compared with 3–4 years ago—and particularly compared with 8–10 years ago—the political and economic outlook in the Balkans has greatly improved. The political changes and ensuing economic reforms in Croatia and Serbia in 2001 in particular have led to a quantum leap in the prospects of the region, reinforced by the salutary effects of the South East Europe Stability Pact. The EU’s decision to offer the Balkan countries the long-term prospect of EU membership provides an essential umbrella of political stability and an incentive for economic and governance reforms that will, as elsewhere in Central Europe in the past decade, help propel governments in the right direction of regional cooperation and improvement of the business climate.

There are, however, still substantial risks in the short to medium term. The unsettled territorial and political status of Kosovo with continuing serious internal divisions, the domestic political uncertainties in Serbia (and the as yet uncertain prospects of the union of Serbia and Montenegro), and the legacy of the Bosnia conflict and of the Dayton Agreement, which have burdened Bosnia and Herzegovina with a huge liability of unresolved governance problems, are key issues yet to be addressed by each country and by the international community. Additional challenges arise out of the unfinished economic and governance reform agenda in the region and the continuing difficulties of the region to access EU markets, especially for agricultural products. As long as these risks and challenges hang over the region, regional economic prospects, security, and integration with European markets will remain uncertain. The sooner these issues are addressed, the better.

The EU Accession Countries of Central Europe

Although by now taken largely for granted, it is an extraordinary historical development that eight Central European countries, including three former republics of the Soviet Union, joined the European Union in May 2004. Bulgaria and Romania will probably join the EU in 2007, and Croatia may be admitted that year as well—all this within less than 20 years of the fall of the Iron Curtain. One can only be amazed by the extraordinary progress and success of the transition
from command to market economy and from dictatorship to democracy in Central Europe.

Even before the EU enlargement, foreign investors grasped the opportunities that this transition offered them, with levels of foreign direct investment in recent years in this region exceeding those in most other emerging markets. Investors have taken advantage of the rapid improvements in these countries’ business climates and financial institutions, of their highly educated but still relatively cheap labor forces, and of the ease of access to Western markets, with the prospects of early integration into the unified EU markets.

Looking forward, however, Central European countries face great challenges, each of which also represents an opportunity. If the Central European countries, their governments, and their people can respond effectively to these challenges and opportunities over the next 10 years or so, they will be able to replicate the extraordinary successes of Finland and Ireland — relatively recent EU members that were able to convert their rather backward economies into highly dynamic and successful modern knowledge economies. If they fail to respond, they will stagnate, at least in relative terms, and fall behind, as Greece and Eastern Germany did in the recent past.

The challenges—and opportunities—include the following:

• **EU constitutional reform**: The new member countries have an opportunity to influence the expected new constitution of the EU and to ensure that the decision making processes and institutions of the enlarged EU function effectively and credibly. The disappointing outcome of the Brussels Summit in December 2003 attests to the difficulties that the enlarged EU will face forging consensus and making decisions.

• **EU economic performance**: The new member countries will be much affected by the overall economic performance of the EU. To a significant extent this will be determined by the ability of the larger members of the EU, especially Germany, to carry out much-needed structural reforms and to maintain a prudent fiscal and monetary policy mix that limits undue indebtedness and keeps interest rates low.

• **Continued economic transformation in the new member countries**: Many of the new member countries, especially the larger ones, are burdened by old industries and relatively large rural sectors, high unemployment
and inflexible labor markets, high and rising social spending requirements for an aging population, significant infrastructure investment requirements, and large environmental liabilities. Making the structural, social, and environmental reforms and investments while maintaining a prudent fiscal stance will be difficult and politically challenging. The influx of large financial transfers from the rest of the EU to the new and poorer members will help in financing the needed investments, but the institutional capacity needed to absorb these funds effectively will need to be created. Managing the fiscal stresses that especially the larger accession countries (Hungary and Poland) are under, with record budget deficits and rising debts, will be a major challenge.

- **EU external economic policies:** The new member countries have an important opportunity to influence the approach of the EU toward "Wider Europe"—as the neighbors to the east and south of the enlarged EU are now increasingly referred to—and toward important global economic issues, such as WTO negotiations (and especially the EU's agricultural policy), the international debate on the global financial architecture, and international support for the economic and social transformation of the developing world with a view to reducing global poverty and disparities.

Concluding Observations

Looking back over the past 10–15 years of political, economic, and social transformation in Eurasia, one can only marvel at the overall progress and success that are now becoming apparent after the painful and difficult political disintegration and transition recession that gripped the entire region during the early years—and for some during much of the 1990s. The countries themselves and the international community can take pride in the achievements of the transition process in Eurasia. The prospects for continued progress of peaceful integration and continued economic growth are good for now, especially as the largest countries of the region—the Russian Federation, Turkey, and Ukraine—are set to continue their recent recoveries and as the Central Europeans are set to join the EU.

Of course, progress and prospects are not uniform across the region. At a time when the world focuses on Afghanistan, Iran, and Iraq, it is important to remember that the belt of countries from the Balkans through the South Caucasus and Central Asia still represents major challenges,
as a number of temporarily "frozen" regional conflicts and several weak and troubled states could very quickly turn into major sources of regional and global instability.

Many challenges remain for the countries of the region and for the international community. Among these challenges three stand out:

• Each country needs to ensure the appropriate fundamentals of economic policy and democratic governance and to foster regional economic cooperation in order to create a favorable business environment for foreign and domestic investors alike.

• The process of integration of the Eurasian economy needs to continue. Doing so requires efforts on the part of the enlarged EU not to let a new divide grow on its eastern border. It also requires cooperation among all countries with their neighbors. Above all it requires the existence of a peaceful, prosperous, stable, and democratic Russia that acts as a good neighbor across the two continents.

• The international community needs to provide continued support, especially to the smaller and economically weaker countries; to help ensure an early settlement of still potent regional conflicts; and to support the economic and social recovery of these countries, many of which—especially in the Balkans, the South Caucasus, and Central Asia—are still among the poorest in the world.
The Europe and Central Asia (ECA) region has experienced unprecedented challenges since the dissolution of the Soviet Union in December 1991. This vast region of 28 countries and 500 million people faced a triple transition: moving from central planning to market economies, from integrated to fragmented economic space, and from communism to democracy. Johannes Linn was a close observer of and participant in this process as vice president of the World Bank’s ECA regional office from 1996 to 2003.

This collection of Linn’s speeches and addresses spans a period filled with momentous events: from financial crises in Russia, Ukraine and Turkey, and civil war in the Balkans, South Caucasus and Central Asia, to the recovery of sustained growth in the Former Soviet Union, the reconstruction and peaceful integration of South East Europe, and the accession of Central Europe to the European Union. This volume provides insights into the triumphs and tragedies of a diverse and fascinating region.