

# TRANSITION

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Transition Economics Division

Policy Research Department

The World Bank

## “Our Assistance Includes Ideas As Well As Money”

Interview with Michael Bruno, Vice President and Chief Economist of the World Bank

What role should the World Bank play in promoting reforms in the transition economies? What are the major issues the research staff should focus on? How important is the new drive within the Bank towards glasnost [openness]? These are some of the issues Michael Bruno, Vice President and Chief Economist of the World Bank discussed in the following interview with *Transition* editor Richard Hirschler. Mr. Bruno has been appointed to oversee the Bank's research activity in September, 1993. Earlier he served as Governor of the Bank of Israel from 1986 to 1991, after playing a key role in the design of Israel's successful stabilization program. Mr. Bruno has contributed several pieces to the development literature and has been published widely in topics of macroeconomic theory, the design of stabilization policies and the experience of transition economies.

**Q. In your analysis of the road from Marx to market, you have always cautioned researchers and decisionmakers against uniformity in dealing with the individual economies of Central and Eastern Europe. You were getting at the “marked differences of the initial micro-structures and institutional environment” of these countries.**

**In 1994 these differences seem to deepen further, even between the parties to the Visegrad Agreement—Poland, Hungary, the Czech Republic, and Slovakia. What could be the major factors behind this uneven evolution?**

A. Let me list a few. First of all, initial conditions are important. For example, the Czech Republic did not have to deal with the foreign debts, that are a painful legacy of Hungary's and Poland's so-

cialist pasts. Second, policymaker's approach differently such major economic issues as stabilization, privatization, and restructuring. Three years ago for example, Hungary seemed to have gained the title of “best macroeconomic performer” in the contest with Poland and Czechoslovakia. But now Hungary's macroeconomic indicators are trailing somewhat behind, though the country is still the preferred Eastern European destination of foreign direct investments. Poland was the only single transition

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economy that had a positive growth rate last year. The Czech Republic has a balanced budget, checked inflation, and perhaps the most advanced privatization program. Interestingly, Czechoslovakia traditionally had prudent fiscal policies and low debt. Soon after the Austro-Hungarian empire splintered, following World War I, it introduced its own currency and stabilized its economy. There must be some traits that have stuck with them through the communist era. It does seem, in fact, that since the collapse of Eastern Europe's communist regimes, certain characteristics that were basic to these countries prior to the communist takeover have reemerged.

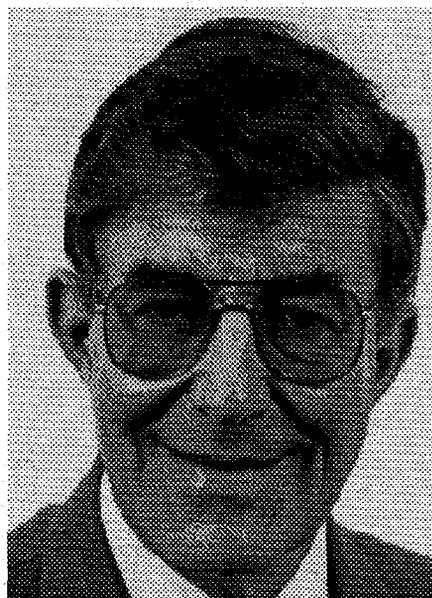
Furthermore, the ability of a government to form a coalition of different forces in the society, plays a role. In other words, can the government build broadly-based public support for stabilization during hard times with the promise of better times ahead? In a democratic society that type of consensus is vital to a great extent and determines economic performance.

**Q. The big bang seems to have backfired in Russia—the country's economy is in a mess right now....Why?**

A. Russia did not have its act together when it launched its version of the big bang in early 1992. The country had not dealt with its monetary overhang during the Gorbachev era. In Poland before the Balcerowicz program was introduced in 1990, prices went wild and hyperinflation, to a large extent, "ate up" the monetary overhang. But Russia in 1992 did not decontrol all prices—for example energy prices remained fixed. Another problem is that the growing fiscal deficit has not been sufficiently checked. In Poland and Czechoslovakia, stabilization measures—taken in the context of monetary restrictions and fiscal discipline—were supported as part of a multiple anchor approach that included fixing the exchange rate and getting wages under control. None of

this happened in Russia. Some argue that Russia had a window of opportunity to stabilize in 1993. I am much less sure about this—one disturbing feature all along has been that the government (including the central bank) did not seem to be of one mind about stabilization. At any rate I do not believe that foreign aid was the limiting factor.

By the end of 1993 the Russian economy was running a monthly inflation rate of 12 percent. This did not seem sustainable since the exchange rate was kept stable for quite a while, while prices



continued to increase. The budget was accumulating—and continues to accumulate—large arrears. And now the ruble is losing ground again against Western currencies. So if fiscal and monetary fundamentals are not in place, and if large subsidies continue to be poured into the enterprise sector, inflation will accelerate. It doesn't look like serious stabilization is in the cards right now.

**Q. Now that Gaidar and his team have gone, can the Russian government shift economic policy away from fighting inflation toward more emphasis on investment and production? Can structural reform suc-**

**ceed without waiting for stabilization? Can privatization continue amid price instability?**

A. Russia could certainly go ahead with privatization. Progress in this area had been quite impressive to date. Mr. Chubais has done a great job and could continue doing well under the new government. The questions is whether structural changes are being done in the right way? And, what distortions occur in the economy as a result of inflation? Our cumulative experience from Latin America, Israel, and other countries confirms that sustainable growth under high inflation is hardly possible. There may be periods of increased economic activity, but the economy doesn't really take off. So it's not a question of shifting emphasis from inflation to restructuring. Falling back on the inflation front in Russia would eliminate the efforts and sacrifices made so far.

**Q. Is there a lesson to be learned from the approach China has taken? That is, the "two-track approach" in which radical reform is undertaken in the nonstate sector, while politically essential but apparently wasteful subsidies are provided to inefficient state industries? Can this justify a more lenient policy toward Russia's industrial heavyweights?**

A. Many experts who are familiar with both countries' economic development agree that comparison of China and Russia is a tenuous one. They point out that, unlike Russia, China is still a predominantly agricultural economy. About 70 percent of the labor force is employed in agriculture, which traditionally has been self-financing. The post-1978 liberalization resulted in a one-time huge jump in agricultural productivity. Surplus workers easily found jobs in labor-intensive but still highly productive export industries, many of them in the town and village enterprises (TVEs) that employ about a fifth of the labor force and account for roughly a quarter

of China's total industrial output and exports.

In Russia initial conditions have been completely different. The country is overindustrialized, with only 14 percent of the labor force employed in a highly inefficient agricultural sector. In the past nearly the entire labor force was employed in state enterprises and organizations, enjoying subsidized employment and job security, thanks to soft budget constraints. The oversized heavy industry has to be restructured—and partly dismantled—presenting an incomparably more difficult economic and political challenge to the Russian government than the streamlining of China's much smaller state sector. Furthermore, personal freedom and political democracy in Eastern Europe and in countries of the former Soviet Union mean that reaching consensus within these societies is more complicated than in a one-party state. And expectations are high: the public is looking for rising living standards, which will certainly imply an increase in public expenditures.

**Q. Can the public sector be viable in a transition economy? Can it be disciplined by hard-budget constraints and become profit oriented?**

A. In China, although public sector enterprises have lower productivity than, say, the TVE sector, there is evidence that more binding financial constraints lead to improved performance. In my view, the move from a state-owned enterprise to private enterprise has intermediate stages in which the intensity of the budget constraint has key significance. The study by Brian Pinto, Marek Belka, and Stefan Krajewski on the adjustment of Poland's state manufacturing firms to market conditions argues that the present management and work force in state firms, expecting ownership changes, exercise greater discipline on wages, and become more cost-sensitive. This is also clear from the many surveys of Russian enterprises. Those without access to soft loans and

subsidies (typically smaller enterprises) are faster to adjust.

Experience from Israel has shown that companies of the Histadruth trade union federation, which are formally private sector enterprises, behaved like publicly owned firms when operating under soft budget constraints. Only after hard budget constraints were imposed on them, were they ready to undertake decisive restructuring efforts. Privatization can also fall short if privatized firms fail to get off the budget hook and continue to keep government credit lines open. In those cases, enterprises will not alter their behavioral norms, despite ownership changes.

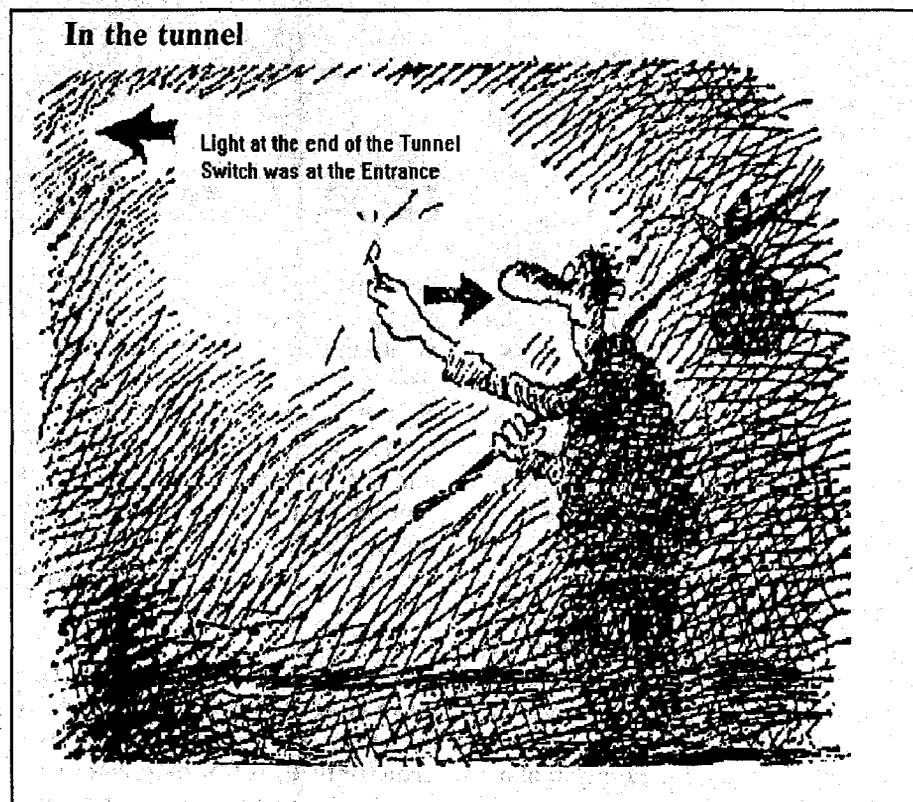
**Q. After the dramatic and unprecedented output fall in Central and Eastern Europe, can we expect a definite turnaround in 1994-95?**

A. We are already witnessing the changes. The Polish economy hit rock-bottom, and now its output is increasing.

The Czech Republic seems to be moving in this direction, and Hungary may follow suit. The Baltic states are doing relatively better than other new countries of the former Soviet Union. One factor is their proximity to the Western markets. Had Western Europe come out of its doldrums more intensively I think we might have seen a stronger revival and growth in exports for some of the countries of Central and Eastern Europe.

**Q. As the World Bank prepares for its golden anniversary in 1994, some critics claim that the Bank cannot play a leading role in the growth of the private sectors in developing countries. Do you think that the Bank needs to adopt new strategies that allow it to promote economic reforms in the developing world, but also in the transition economies?**

A. The World Bank can lend to the private sector with government guaran-



From the Khabarovsk (Russian) daily *Tikhookeanskaya Zvezda*

tees, and in principle that is something that can be done in any country. However, the Bank cannot and should not compete with the private sector. It should use its comparative advantage in working with governments to enable the private sector to operate more efficiently, and to develop all aspects of the infrastructure, including the marketing institutions, the financial sector, and the legal system particularly the laws regulating contractual relations, property rights, and bankruptcy. These improvements will also attract more private foreign investment to these countries.

**Q. What are the major transition issues, the research staff should focus on?**

A. We have learned a lot from looking at comparative experiences in different countries over the past few years. There is a lot more to be learned. For example, restructuring is handled differently in various countries. An important question is, who picks up the tab for enterprises' losses and who mediates for them? In the Czech Republic the owners of the new enterprises are expected to do this, in Poland the banks, and in Hungary the government, through the liquidation process regulated in the bankruptcy law. Privatization, too, is an area for further research. The approach across countries differs. As to the effects of changes in ownership, little systematic analysis has been done. As transition progresses, we will learn more and we will have more countries to compare. I think the Bank's comparative advantage is its ability to do serious cross-country analysis, based on solid empirical work, to find out what has worked, and why. Another important research area is the labor market. What do differences across countries in transition tell us, with regard to the nature and size of unemployment, and related issues—the social safety net, and the degree of social consensus?

**Q. What is likely to be the major debate at this April's Annual Bank**

**Conference on Development Economies?**

A. The ABCDE conference will take a fresh look at macroeconomic outcomes in the Eastern Europe countries and the former Soviet Union. With three-to-four years hindsight we will have something to say on enterprise restructuring, on China's experience and on institutional economics.

**Q. Would you comment on the new drive within the World Bank toward openness and increasing dissemination of research findings?**

A. Dissemination is of primary importance. Some of the Development Economics (DEC) studies written for a more

general audience have a high readership. The World Development Reports, and our flagship reports, the Asian Miracle Study and the forthcoming African Adjustment Study, are receiving a lot of attention. I would encourage researchers to spend part of their time and resources to promote dissemination of their findings. This implies dissemination within and outside the Bank. Documents should address problems of common interest and should be set and written in language everyone can read. We should focus on advice to policymakers in our client countries. The World Bank's assistance includes not only money, but also—and this is increasingly important—ideas. I'm not sure that we have really reached the optimum in this respect.

**Bottoming Out--For Some: Predictions from Vienna**

*Some Central and East European countries should enjoy renewed economic growth in 1994, showing that the region bottomed out of its postcommunist recession in 1993, according to predictions by the Vienna Institute for Comparative Economic Studies. Even countries whose gross domestic product (GDP) does not grow should see a slower decline. The only country that will not show some improvement is Romania whose GDP is expected to contract 2 percent in 1994 as tighter credit policies bite.*

*Poland will again lead the region in economic growth, with GDP rising another 4 percent in 1994. The Czech Republic and Slovenia should also enjoy modest growth, Hungary will stagnate and in Slovakia and Bulgaria the decline in GDP should slow markedly. Growth in Croatia, still embroiled in war, will slump by 5 percent, but that is an improvement over 1993's 9 percent drop. Inflation will slow down in most countries, holding steady 11 to 20 percent in the Czech Republic, Slovakia, and Slovenia. A higher 25 percent rate in Hungary reflects a policy of devaluations to stimulate exports; and Poland, which only a few years ago was suffering hyperinflation, is forecast to show 28 percent inflation for 1994.*

*Inflation in Bulgaria and Romania will slow, but only to 55 and 200 percent re-*

*spectively. In Croatia it remains to be seen whether the initial successes of the ambitious stabilization program introduced in late 1993 will hold. Unemployment will worsen everywhere except Hungary, where a steady rate of 12 to 13 percent of the work force will be due not only to people dropping out of the jobless registration system but to an improvement in employment.*

*The institute provided the following economic estimates for 1993 and forecasts for 1994.*

**Economic indicators in transition economies, 1993 and 1994 (percent)**

Country	GDP		Inflation		Unemployment	
	'93	'94	'93	'94	'93	'94
Czech R.	0	+2	21	11	4	7
Slovakia	-6	-2	23	18	15	18
Hungary	-2	0	24	25	12	12
Poland	+4	+4	39	28	15.5	18
Slovenia	-1	+1	30	20	15	18
Bulgaria	-5	-2	75	55	17	18
Romania	0	-2	300	200	9.5	12
Croatia	-9	-5	1600	n.a.	18	20

Notes: GDP and inflation percentages measure the change from year to year. Inflation figures are based on consumer prices. Unemployment figures measure the percentage of the work force unemployed at the end of the year.

# Banking Reform in the Transition Economies: A Hard Nut to Crack

Following the fall of communism throughout Eastern Europe and the former Soviet Union, debates, both public and professional, focused mainly on the macroeconomic stabilization and privatization issues of the transition process. Relatively little attention was paid initially to the reform of postsocialist finance and banking, and related topics, including bad debts, corporate finance, and governance. But the experience of the past three years has shown that financial institutions and instruments play a critical role in the rapid growth of the new private sector; both small and strategic investors need access to credit, investment capital, and convertible currency, whether to start new businesses or to transform large, state-owned enterprises into profitable private ventures. [See also a review of the paper "The Role of Financial Institutions in the Transition to a Market Economy" on page 21. The editor.]

## Remains of the Socialist Days

It is early 1994 and the financial and banking sector is still the Achilles heel of the transition economies. The payment systems in most countries are inefficient; the bank portfolios are deteriorating; bad debts and interenterprise credits are accumulating. Despite the growing number of private banks (in many cases with full or partial foreign ownership), huge commercial banks, detached from the socialist monobank system, still dominate both the loan and deposit market (see ensuing article on Hungary and Poland). In most countries these spin-off banks are still owned or at least controlled by the state. Regulation and supervision are inadequate, as proved by a recent series of bank scandals. If banks cannot function as proficient vehicles of resource allocation (for example, if they are unable or unwilling to provide credit to the new private sec-

tor), the result is high inflation and deteriorating living standards, which, in turn, cause popular discontent and could undermine the democratic institutions.

Most CEE countries, as well as the Baltic countries and Russia, set up stock exchanges; these are still relatively small, however, and have only a limited role to play because of institutional barriers, lack of appropriate legislation, inexperience, and the slow pace of privatization. New financial intermediaries—mutual funds, private pension funds, and insurance companies—can also play a useful role, but this will take time. Access to capital and credit is still dominated by the large banks, which probably will retain, for years to come, their role as the major source of external funding. This makes fundamental reform of the banking sector even more urgent. But the process is hampered by large nonperforming loan portfolios held by commercial banks. By international accounting standards, many banks and large state enterprises are technically insolvent.

## Variation to a Theme

The best known policy options for the financial restructuring of commercial banks and enterprises are the following:

- *Debt cancellation.* "Let bygones be bygones." Government eliminates bad debt legacy with a stroke, canceling out bad debt from the balance books of both the banks and the delinquent enterprises. This solves a problem for which the present administration is not responsible. If both lender banks and debtor enterprises are state owned, it is assumed that no net losses are involved. Nevertheless, this policy option has so far been used to a limited extent only because debt cancellation means enormous re-

distributive transfers to many unsalvageable enterprises.

- *Debt transfer.* Debt obligations remain in the firms' books, but bad assets are transferred from the commercial banks' balance sheets to a "bad debt" bank. The book value of the commercial banks' assets is reduced and government securities are issued to recapitalize the banks. This technique has been adopted by several Central and Eastern European countries. In the Czech Republic, the Consolidation Bank is a good example of a specialized bad debt institution.

- *Debt repayment.* Banks, which accumulate provisions against bad loans to meet capital adequacy requirements, are encouraged to obtain repayment from their clients, either through debt workouts or bankruptcy procedures. Commercial banks are presumably in a good position to determine the viability of their debtors. In this case, however, profitable companies carry the burden of restructuring through higher costs of bank services. Most Eastern European countries are using a combination of debt transfer and debt repayment,

The indebtedness of banks and that of enterprises are closely linked—enterprises' inability to repay debts threatens the solvency of the banks. Financial restructuring needs to include debt-equity swaps between banks and heavily indebted enterprises. As part of the restructuring program, public enterprises can be divided into three categories:

- *Candidates for restructuring and subsequent privatization (manufacturing enterprises).* Their debts should be reduced before, or as a part of privatization.
- *Candidates for closure (enterprises battered by ongoing financial crisis).* A clear timetable should be drawn up, and explicit subsidies provided for

gradual labor shedding, if immediate closure is not feasible.

• *Candidates for transformation into public utilities and regulated state enterprises.* (This applies mostly to enterprises in the service sector.) Government regulations should be established to restructure these enterprises into commercial public services.

### Activating the System

Most transition economies, initially, have assigned a passive role for the banks, and opted for a gradual reform of their financial system. But the banking reform cannot wait for enterprise restructuring and privatization, as bad debts burden both state enterprises and banks. The financial and banking sector should play an active role in transition, allocating credit efficiently through screening borrowers, monitoring and sanctioning enterprises, and providing both public and private enterprises with access to credit. The government and the central bank should limit their own activities to regulating and supervising. (For example, governments may encourage the establishment of financial institutions to service small private businesses and may introduce temporary quotas for commercial banks to lend to the private sector.)

Factors that determine the speedy and proficient restructuring of the financial sector include the progress of reform in macroeconomic stabilization, trade reorientation, and privatization; the availability of skilled banking professionals; access to technical assistance from abroad; fiscal constraints; and country specific conditions.

To sum up the proposed measures under discussion:

• Simultaneously restructure banks and enterprises, starting early in the transition process; ensure an active role for the commercial banks in the financial restructuring of enterprises; and finance bad debt write-offs from the budget, in

a transparent manner. After the cleanup, recapitalize banks by issuing government bonds, financed from the budget.

• Restructure and partially recapitalize banks at the earliest possible date (through either state write-offs of bad debts or debt-for-equity swaps); then, immediately privatize state enterprises, leaving any additional restructuring to the private owners in order to improve the incentive structure and avoid the moral hazard problem.

• Instead of recapitalizing the old system, use the same public funds to develop an entirely new banking system. Cut back existing state banks to a viable core, and create new private financial institutions.

No matter what strategy or combination of strategies the policymakers select, financial restructuring should be complemented with improvements in the payments system, the demonopolization of

banking, changes in enterprises ownership structure (mainly privatization), and early adaptation of market-based financial legislation.

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*The article is based on the study "Financial Policies in Socialist Countries in Transition," published as a Policy Research Working Paper (no. 1242, 1994). To order: Mani Jandu, the World Bank, N-9037, tel. # (202) 473-3103. (An earlier version was presented last year in Rome at the October symposium on Transition in Formerly Communist Countries, held at the Vatican's Eastern Institute, Research and Study Center "Ezio Aletti.")*

### Whistle blower in Eastern Europe



From the Hungarian daily *Nepszabadsag*

# Czech Banking: Impressive Performance with Nonperforming Assets

Following the 1990 collapse of Czechoslovakia's socialist monobank system, six successor financial institutions emerged—four commercial banks and two savings banks. [These are the Komerční Banka (Commercial Bank), the Investiční Banka (Investment Bank), the Československá Obchodní Banka (CSOB, Czechoslovak Trade Bank), and the Všeobecná Uvěřovací Banka (VUB), which became Slovakia's major commercial bank; and the Česká Spořitelna and Slovenská Spořitelna (the Czech and Slovak savings banks)]. To facilitate privatization of the large state-owned banks, the authorities took several steps between 1990 and 1993:

- In 1991, simultaneously with the launching of Czechoslovakia's radical transformation program, loans worth Kcs 110 billion (approximately one-fifth of total loans held by the banking sector at that time) were carved out of the commercial banks' balance sheets. These loans accounted for the bulk of the so-called permanently revolving loans on inventories (totaling Kcs 180 billion), that enterprises had been forced to assume during the 1970s—with infinite maturities and nonmarket interest rates. These enterprise debts were then transferred to the newly created Consolidation Bank, a state-owned holding institution for the administration of bad debts.

The commercial banks also transferred matching liabilities, mostly "redistribution loans" provided by the central bank (Czech National Bank) at discount rates, as well as deposits from state-owned insurance companies and savings banks. Hence, the banks were able to improve their balance sheets, asset structures and capital-asset ratios, and at the same time became less dependent on the resources of other financial institutions, such as the savings banks and the central bank.

- At the end of 1991 the commercial banks were provided with bonds worth Kcs 50 billion, issued by the National Property Fund (the Government agency in charge of administering and monitoring the privatization of state-owned assets) for partial debt write-offs (Kcs 38 billion) and recapitalization (Kcs 12 billion). Debt write-offs were targeted at potentially viable enterprises with bad loans accumulated before 1990, under the old system. As a result, the "Big Four" (the commercial banks) and the savings banks reached capital adequacy ratios of 4.2 percent and 3.2 percent, respectively. (The capital adequacy ratio measures a bank's ability to cover bad loans, by comparing "adjusted capital" to "risk-weighted" assets. The internationally accepted ratio is 8 percent, set by the Bank for International Settlement in Basel.)

The commercial banks were also provided with a relatively small amount (Kcs 1 billion) to cover debt write-offs on inventory loans in the armaments industry.

- In late 1992 the Consolidation Bank again purchased nonperforming loans from the commercial banks; the loans, with a nominal worth of Kcs 15 billion, were purchased at a discount.

These measures set the stage for the most unorthodox element of the Czech transformation program: the coupon privatization of the major banks in 1993. Between 37 and 53 percent of the banks' shares were distributed through coupons (vouchers) during the first privatization wave. The huge demand revealed that the public was well aware of these banks' prospective worth, although bad loans still made up a significant share of the total portfolios (even under Czech accounting standards). The state—through the Czech National Property Fund—retained between 40 and 45

percent stakes in the Commercial Bank, the Investment Bank, and the Czech Savings Bank. The Zivnostenská Banka, a relatively small but well-established bank, was sold off 100 percent to private investors. (The International Finance Corporation took a 12 percent stake in that bank.)

Coupon privatization, however, could not solve the crucial problem of attracting strategic private investors. The privatized banks are still awaiting capital injections from strategic investors, although investment funds own significant portions of the shares of some banks. It is noteworthy that five of the six largest investment funds are owned by banks.

At present more than fifty banks, many fully or partly foreign owned, are competing for clients. The Big Four, however, still account for almost 70 percent of all outstanding loans, while the Czech Savings Bank holds about 50 percent of all deposits. Large margins have enabled most banks to make sufficient provisions in 1991 and 1992, and their financial positions have improved. At the end of 1992 their capital adequacy ratio stood, on average, at almost 7 percent, and the target level of 8 percent is expected to be reached in 1996.

Total bank credits to the private sector rose by 42 percent from January to October 1993, and by the end of 1993 the private sector held three-quarters of the medium-term credit extended by the banks. (In the first half of 1993 the banks reported a total of Kcs 10 billion in pretax profits, on revenues of Kcs 85 billion.) The shift to private sector lending—much of it now collateralized—should, over time, result in a significant drop in the share of bad loans in the banks' portfolios. However, some newly established private banks, with clients

exclusively from the private sector, are experiencing portfolio difficulties.

Contrary to widely held expectations, a wave of bankruptcies has not taken place in the wake of privatization. More than 1,000 bankruptcy procedures have been initiated, but only thirty bankruptcies have actually taken place, compared with thousands in Poland and Hungary. This may be explained by the fact that several banks, through their own investment funds, are not only lenders, but also owners of enterprises. Also, banks may reason that the costs associated with bankruptcy procedures outweigh the potential benefits.

[The London-based *The Economist* offers another argument: banks, encouraged by past bailouts, assume that they run little risk in piling up bad loans to companies that are (or were) state en-

terprises. Most banks do not push delinquent companies into bankruptcy; rather, they tend to roll over bad debts. So far, only one small bank had gone bankrupt; last October the Industrial Credit Bank was taken over by the Czech National Bank. More typically, in December the government agreed to pay Kcs 1 billion to Agrobanka to cover bad farm debts.]

It is too early to say whether this overly cautious approach to restructuring will squeeze the private sector out of much-needed bank credits. But it is safe to predict that once the European economies rebound, an export-led recovery in the Czech Republic could accelerate a shift into the high-productivity sectors, which, in turn, would significantly improve the across-the-board financial position of the Czech banking sector. Finally, it is important to point out that in reforming and restructuring the banking

sector, the Czech approach has been very similar to the one applied early on in Czechoslovakia's overall transformation process: namely, to proceed quickly with privatization; and to convince enterprise and bank managers early on that they are responsible for the consequences of their lending and restructuring decisions and cannot shift this responsibility to the government and the budget. The actors participating in the bank restructuring and debt work-outs have to accept that they jointly share the burden and costs of moving from the old banking system to the new one. In exceptional cases only, the government manage the process in an attempt to minimize the costs of friction.

*Ulrich Hewer*  
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## How to Make Bad Debts Good? The Banking Sector in Hungary and Poland

The banking sector in Hungary and Poland, for that matter in most CEE economies, is still struggling with the massive debt buildup of state-owned industrial giants over the years. (In Poland, however, pre-big-bang inflation has wiped out a large part of the debt.) In both countries the cleaning up of the portfolios of the large commercial banks has been accompanied by recapitalization and at least partial privatization. All these measures require extra budgetary expenditures at a time when fiscal policies are stretched to limit. Eventually, the taxpayers are the ones who will pick up the tab.

### **Hungary: Permanent Recapitalization**

In late 1993 the Hungarian government announced a two-stage operation to recapitalize major state-owned commercial banks and savings cooperatives for

HUF 140 billion (\$1.4 billion); and to increase their at-present negative capital adequacy ratio to at least 4 percent by the middle of 1994. The program's goal is to facilitate privatization. Starting in January 1997 the state is not to hold more than 25 percent of a bank's registered capital, either directly or indirectly, as stipulated in the Hungarian Bank Law of 1991.

To finance the program, government bonds with a twenty-year maturity have been issued. In the last days of 1993 the government increased the assets of eight leading commercial banks by HUF 110 billion (about \$1.1 billion): the Hungarian Credit Bank—the largest commercial bank—received HUF 56 billion, the Commercial and Credit Bank HUF 37 billion, and the Budapest Bank HUF 5 billion. The government is planning another injection of HUF 30 billion by mid-1994. Beginning in March the banks will

either write off bad debts, declare a moratorium on repayment, or make debt-for-equity swaps with their clients. Although the banks will have to deal with some 10,000 to 25,000 small and large private and state-owned enterprises, most experts agree that the bulk of bad debt is concentrated in 70 to 100 large state enterprises.

The bank consolidation program has as its long-term goal of reaching the internationally accepted 8 percent capital adequacy ratio. The short-term target is a more modest 0 percent—a vast improvement over the current -15 percent. At the end of 1992, bad assets totaled HUF 186.4 billion (11.5 percent of outstanding loans), while at the end of June 1993, they stood at HUF 229 billion (13.2 percent of the total). Nonperforming loans are primarily con-

centrated in the largest state-owned banks where they sometimes represent more than a third of all claims.

(A growing number of small commercial banks—not burdened by bad loans—are entering the market. Foreign banks are also rapidly increasing their market share. While the large state-owned banks lost HUF 16.21 billion after taxes in 1992, foreign-owned banks posted a HUF 3.22 billion profit. The latter also maintained extremely high—32.78 percent—capital-asset ratios.)

In support of the program, the state will temporarily increase its equity stake in the banks. Currently the state—through the State Holding Ltd.—holds 35 to 65 percent of the Hungarian Credit Bank, the Budapest Bank, the Hungarian Foreign Trade Bank, and the Commercial and Credit Bank, and wholly owns the National Savings Bank. In the National Savings Bank the state's share will be 50 percent, plus one vote.

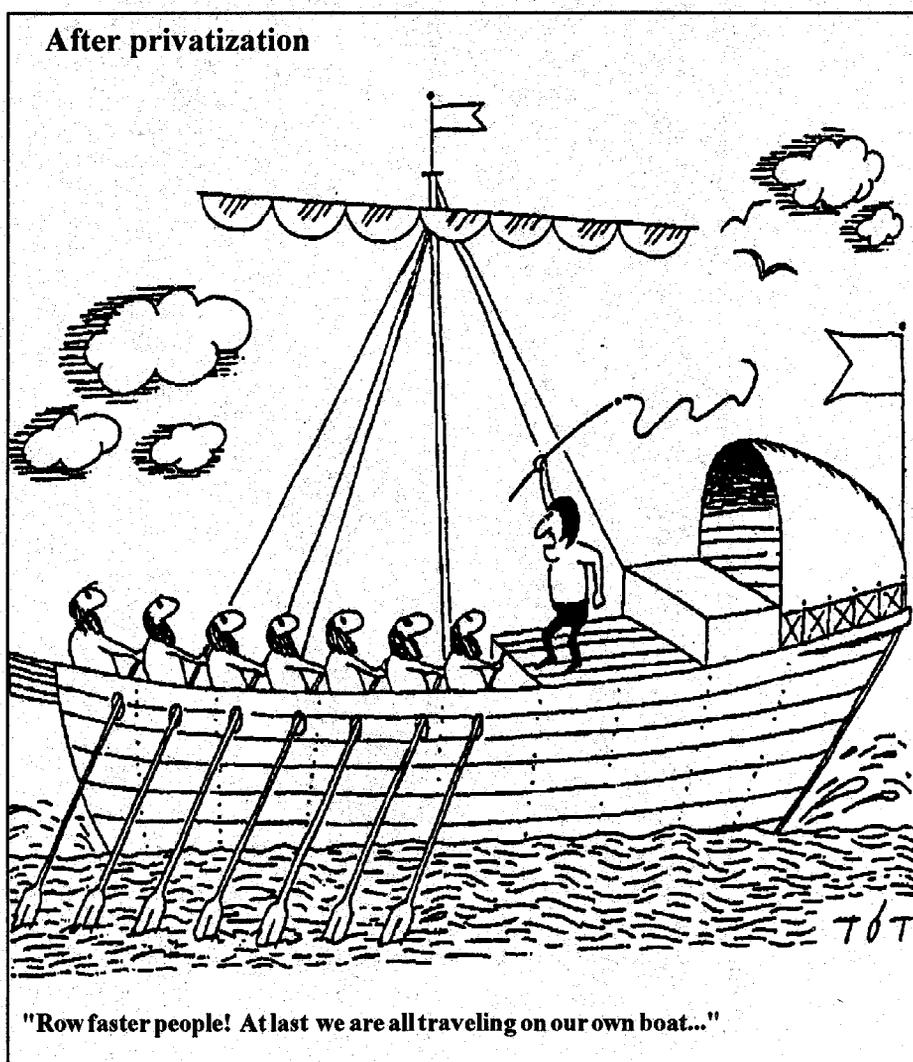
After January 1997 in accordance with law, the state will hold only 25 percent, plus one vote (to ensure a veto right), in the Hungarian Credit Bank, the Commercial and Credit Bank, the Budapest Bank, and the Hungarian Foreign Trade Bank. In the Postabank the government's stake will be reduced to 20 percent. As to private owners, according to the latest government plan, professional strategic investors (meaning foreign banks in most cases) could acquire a 30 to 50 percent stake and, exceptionally, a more than 50 percent stake; other investors, including Hungarian and foreign insurance companies, pension insurance funds, and investment companies would be permitted stakes between 2 and 10 percent. Stocks will be issued on the Budapest Stock Exchange for between 5 and 10 percent of the share capital. In late January the English-language *Budapest Sun* reported the first partial sell-off: the EBRD and the Munich-based Bayerische Landesbank are ready to buy a minority stake in the Hungarian Foreign Trade

Bank. The Budapest bank is also poised for privatization.

Since setting up the new two-tiered banking system in 1986, a total of 300 billion forints has been invested or pledged to improve the solvency of state-owned financial institutions. (In March 1993, for example, the Ministry of Finance, as part of a credit-consolidation scheme, initiated in 1992, handed over to the banks treasury bonds worth HUF 80 billion, in exchange for nonperforming bank loans with a nominal value of HUF 103 billion.) None of the recapitalization exercises, however, has sufficed to clean up the bank's balance sheets. A large part of the loan portfolio claimed against state enterprises, have been in default for protracted periods, a legacy of the

socialist mono-bank system. The Hungarian Bank Law of 1991 obliged commercial banks to obtain a minimum capital adequacy ratio of 7.25 percent and to increase it to 8 percent by end-1993. Many banks were unable to meet these requirements, however, and refinanced overdue interest and principal on nonperforming loans so as to avoid balance-sheet recognition of associated losses.

As a result of the cleanup operations, a large chunk of the nonperforming assets will be transferred to the Hungarian Investment and Development Corporation, which is jointly owned by the State Holding, Ltd., and the State Property Agency. These agencies are responsible for negotiating work-out solutions



From the Hungarian weekly *168 Ora*

with debtor enterprises (among them some of the "Dirty Dozen," that is, the twelve and later fourteen largest industrial dinosaurs). These flagships of socialist industry, including the busmanufacturer, Ikarus, have accumulated a total bank debt of HUF 37 billion and closed last year with a loss of HUF 8 billion. They employ more than 55,000 workers and represent a combined registered capital of HUF 100 billion. Their fate has not yet been decided.

Another fifty-five large, indebted industrial companies have been requested to submit by end-March comprehensive rescue programs, outlining their plans for restructuring and cash flow and market development; plans are to be filed with the lender banks, the relevant branch ministries, and all state creditors. This accelerated reorganization process is to be completed by May. A "jury" involving the Ministry of Finance will decide the companies' future. Those that fail to make the grade will sink; those that are considered viable will either remain clients of the relevant bank or will have their debt sold to the State Property Agency.

#### **Poland: Privatization Deadline 1996**

Nine Polish commercial banks, spinoffs from the National Bank of Poland, inherited substantial bad debts when they started operation as regional state commercial banks in 1989. (In order of their size of capital, they are: Bank Slaski, Wielkopolski Bank Kredytowy, Bank Przemyslowo-Handlowy, Pomorski Bank Kredytowy, Powszechny Bank Kredytowy, Bank Zachodni, Powszechny Bank Gospodarczy, Bank Gdanski, and Bank Depozytowo-Kredytowy). These banks account for about 65 percent of all the bank debt, accumulated so far by state-owned enterprises.

Wielkopolski Bank Kredytowy was privatized in September 1993, with the EBRD purchasing a 28.5 percent stake

in the bank for \$13 million. Bank Slaski (Silesian Bank) was privatized just recently with the Dutch Internationale Nederlanden Groep taking a 25.9 percent stake and gaining control over the bank's management and operations. The Polish treasury retained a 34 percent stake in Bank Slaski, while a 30.1 percent stake was sold to the public for 1.23 trillion zloty (\$57.3 million) and a 10 percent stake was set aside for bank employees. Bank Przemyslowo Handlowy could be the next to privatize. Crédit Suisse First Boston has won a tender bid and will advise on the bank's privatization.

(Several foreign banks already operate in Poland through wholly owned subsidiaries. The Chase Manhattan, Banque Nationale de Paris, and Dresdner Bank have recently applied for licenses. By 1993 about eighty new private banks were operating in Poland, including eight with at least partial foreign ownership. These new private banks are small and account for less than 15 percent of total credit.)

The remaining seven commercial banks, along with such large specialized banks as the Bank Handlowy (the former foreign trade bank), the Agricultural Bank, and the Savings Bank, are still state owned. Their loan portfolios had steadily deteriorated, leading up to the beginning of 1992, when the volume of substandard, doubtful, and bad loans amounted to \$1.5 billion, about a third of their total assets. Since early 1993, however, their portfolios have improved. The improvement is the result of the Enterprise and Bank Financial Restructuring Act, approved by the Parliament in March 1993, which authorized preprivatization injection of new capital into the seven spinoff commercial banks as well as the Agricultural Bank and the Savings Bank. The banks received long-term government bonds worth up to 21 trillion zlotys (about \$1 billion), half of which went to the seven commercial banks to increase their capital adequacy ratio to or above 12 percent. The government were able

to mobilize capital for this operation from \$1 billion in unused stabilization funds, (the stabilization fund was established in 1989, initially as a contingent pledge by twenty countries to support convertibility of the Polish currency).

Following the debt-cleansing and recapitalization, the large commercial banks are to be privatized by 1996. But the government intends to keep a 20 to 30 percent stake in the banks. A senior official in the Ministry of Finance recently explained that "while the government does not want to become a controlling shareholder in the privatized banks, it wants to safeguard the strategic interests of the state and to hold onto profit-making investments."

In 1992 the nine "target banks" set up special work-out departments to deal with some 3,000 enterprises whose loans had been declared substandard or nonperforming by the banks' auditors. Debtor enterprises have to present a proposal for restructuring, including debt rescheduling, partial write-offs, and loans-to-equity conversion. Should a company prove unable to conclude agreement with its creditors on restructuring by March 31, the bank has to initiate a forced liquidation or sell the assets. About 200 loss-making state-owned industrial giants were granted a reprieve of several years; gradually declining budget subsidies will be available for their restructuring efforts, provided they shed labor, upgrade management, and adopt other stringent measures.

*Compiled from reports of the EBRD (Economic Review, "Current Economic Issues", July 1993), the Oxford (U.K.)-based Oxford Analytica, the English-language weekly Budapest Sun, the World Economy Weekly (HVG), Budapest, Euromoney, London ("Central Europe: How to Rebuild a Banking System," December 1993), and various news agency reports.*

## Quotation of the Month: The government of a transforming country is the worst imaginable agent to take care of restructuring“

### Václav Klaus on the Czech Privatization Experience

Perestroika-style economic thinking suggests that the shift from soft to hard budget constraints can be achieved, and that economic behavior can be modified, by changing formal rules and introducing rational macroeconomic policies. Those measures, however, represent necessary but insufficient conditions for the transformation. It is privatization that moves an economy past perestroika to a real systemic change.

In some industrial and developing countries where privatization has taken place—the best known of which is the Thatcherian privatization of Great Britain in the late 1970s and early 1980s—privatization represented a partial change in an already existing, properly defined property rights structure, that is a shift of property rights between two (or more) well-defined economic agents. This kind of privatization has almost nothing in common with the task we are facing.

Privatization in [Central and Eastern Europe] means the establishment of a previously nonexistent property rights structure. Privatization in the West may be viewed as a “reform” process. In the East, however, privatization is the road to the most fundamental objectives of a systemic transformation. It is the process within which the nonowner or quasi-owner (the government) transfers nonassets to their first (initial) proprietor, and in doing so “creates” the assets. In organizing the privatization program of a transforming economy it is always important to understand that peculiarities of that economy. The special characteristics of transforming economies in Central and Eastern Europe call for special, nonstandard privatization methods:

**Revenues.** The government’s objective should be to accomplish economic transformation rather than to maximize the proceeds coming from the sale of government’s assets. To understand that paradox is absolutely crucial.

**Speed.** Meager proceeds are usually believed to be the price paid for the speedy privatization. We have found, however, that in the Czech Republic and elsewhere the correlation between proceeds and time, if any, is the reverse of what has been hypothesized for standard privatization. In other words, the slower the privatization, the smaller the proceeds. For one thing, the true value of the privatized enterprise rapidly decreases due to its unavoidable preprivatization agony and to the absence of a real owner during such a process.

We looked for privatization techniques that were faster than the standard ones. Our nonstandard voucher privatization scheme proved to be rapid and efficient. It is based on selling vouchers (quasi-money applicable only in the privatization process) to every adult citizen at a symbolic price. The vouchers are redeemable for shares of privatized firms. Voucher privatization turned more than 75 percent of Czech adults into shareholders, with shares either in the 1,500 privatized companies or in the investment privatization funds. The voucher scheme has also facilitated application of standard privatization techniques in the rest of the economy and, indirectly, speeded their implementation. The overall privatization program also includes transfers of state property to municipalities, restitutions to original owners, transformation of “Soviet-type” cooperatives into cooperatives of real owners, privatization of small-scale busi-

ness through public auctions, and privatization of medium- and large-scale enterprises through direct sales, joint ventures, tenders, and so on.

**Organization.** The effectiveness and speed of privatization depends greatly on the organization and administration of the process. It makes sense to concentrate privatization initiatives at the microlevel, not at the government level. Planning, organizing, restructuring, dividing, and demonopolizing functions for the enterprises should not be imposed from above. (This approach is thus entirely opposite to what has been done by the Treuhandanstalt in the former GDR.)

**Foreign Involvement.** The presence of foreign investors in the Czech Republic has always been considered beneficial and, therefore, most welcome. We are quite content with the continuous inflow of foreign capital and now want to accelerate it artificially. It is one of our fundamental theses that foreign capital will enter the country on a massive scale after privatization have been carried out since the decisions that will promote the inflow will arise from the private initiative of real owners rather than the irresponsible decisionmaking of government bureaucrats (irresponsible in the sense of a failure of logic). In keeping with this philosophy, we resisted strong temptations to introduce a special foreign investment law that would have accorded better treatment to foreign investors than to domestic ones.

**Restructuring.** Privatization is usually initiated with the goal of bringing efficiency and prosperity to individual privatized enterprises. It is a common myth, shared by many, that privatization in a postcommunist country could, and should, have the same objective. But

what that really matters in our case is the effect of privatization on the economy as a whole. The question is not "Is the enterprise restructured?" but "Is the economy restructured?"

Individual restructuring must follow privatization. We have no doubt that it will be the new owner, not the government, who is motivated to find the ideas, time, and resources for the necessary restructuring. The Czech government has never listened to the advice that state ministries and agencies should attempt to increase the efficiency of state-owned enterprises before they are privatized. Furthermore, we consider it unnecessary to design legislation and

techniques and develop perfect owners. Such an objective is beyond the capacity of postcommunist governments. Besides, the first (initial) owners of privatized firms may not be the final ones.

In the early weeks and months of 1990 the Czech approach [to privatization] provoked harsh criticism from all imaginable sources. By now, however, even the most prominent international financial organizations have realized that government of a transforming country is the worst imaginable agent to take care of restructuring tasks. Moreover, it has been recognized that internationally renowned consulting firms, which are very expensive, lack the necessary coun-

try-specific and system-specific knowledge.

It has been observed—at least in the Czech Republic—that the meaning of privatization may differ substantially in different sociopolitical environments. I am convinced our approach is correct—the results speak for themselves. Margaret Thatcher privatized three or four firms a year; we have been privatizing twice that many each day.

*Excerpts of the Czech prime minister's presentation at the fourth CEEP Annual Conference on Privatization in Central and Eastern Europe, held in early December in Ljubljana, Slovenia*

## Letters to the Editor

### **CEE Trade Access to EU Markets: An Exercise in Trade Management?**

Most economic commentators have argued whether the Association Agreements between the countries of Central and Eastern Europe (CEE) and the European Union (EU)—as the European Community is called since January 1 1994—represent a glass that is half full or a glass that is half empty. According to Bartłomiej Kaminsky ("Central European Access to EC Markets: Hard or Easy?", *Transition*, September 1993, p. 6) it is clearly at least three-quarters full.

The problem is not so much the tariff levels discussed by Mr. Kaminsky as the tariff quota arrangements, the plethora of safeguard clauses, the potential for anti-dumping actions and, as rightly argued by Alan Winters, (*Transition*, October-November 1993, p. 11) the rules of origin. The EU now has a powerful set of contingent protection mechanisms in place, which can effectively limit the export growth of virtually any products that CEE countries might conceivably

sell in quantity to the EU over the next 5-10 years.

The EU countries and the Commission may or may not choose to apply these safeguards aggressively. However, their existence and the uncertainties over how they might be used must increase private sector investment risks, particularly from potential non-EU foreign investors. It is very revealing that the words "contingent protection", "safeguards" and "anti-dumping" never appear in Mr. Kaminski's article.

In a major study carried out by the National Economic Research Associates (NERA), for the European Commission, (titled "Trade and Foreign Investment in the Community's Regions: The Impact of Economic Reform in Central and Eastern Europe") we have shown that the EU can expect to have sizeable gains both in export volumes and in economic welfare from free trade with CEE countries. Given the Geographical location, they are natural trade partners. CEE countries could be expected to account for around 6 percent of EU manufactured imports by 2010 com-

pared to 2.3 percent in 1987. Of course, we project corresponding increases in EU exports to CEE countries. We project a moderate EU surplus in total trade with the CEE countries and a substantial EU surplus in manufacturing trade which could be around \$40 billion by 2010 (in 1991 prices). CEE countries could, if EU countries are prepared to hold off on the contingent protection, represent an addition to the EU export market the size of its current level of exports to the U.S.

The potential for a mutual expansion of trade and the resulting gains could provide a sizeable boost to EU export growth and welfare as well as greatly assist the chances of successful reform in CEE countries. The NERA study shows that much of the increase in trade could be expected to be growth in intra-industry trade rather than inter-industry trade. This is true of many of the sensitive products like chemicals and textiles. The corollary is that, to achieve these potential gains, EU countries must be prepared to accept greatly increased imports of agricultural goods from the CEE. All of these changes will inevitably im-

pose short term adjustment costs and present political difficulties, considering the unemployment situation in western Europe. However, the prospective gains are large, while the likely cutback in the production of sensitive products is small, even in the short term.

Much of the reluctance to open up EU markets to CEE exports comes from the poorer EU Regions--Portugal, Spain and Southern Italy. But these regions can be the main gainers from open access. CEE demand for EU goods, particularly capital goods, is much more likely to be supplied from these areas than from the richer EU countries. The NERA study shows that the CEE economies, if successful, could generate extra exports from the poorer EU regions, increasing their manufacturing output relative to earlier expectations, by around 2 percent in the next 15 years. This contrasts with a gain of around 1 percent for the EU as a whole.

The key point is that international trade is not a zero-sum game. Some EU coun-

tries appear to act as if opening access to CEE producers inevitably meant export losses to their producers. Hence, there is a tilt towards managed trade even though the EU's own interests as well as those of CEE countries are best served by freer trade. The growth in CEE imports will be largely determined by their export growth. Every extra unit of CEE exports, particularly over the next few years will increase their imports by an equivalent amount.

EU countries and the Commission face a choice. They can limit the use of the contingent protection mechanisms and fulfil the expectations of Mr. Kaminski and the hopes of many more. Or, they can use these mechanisms to such a way that impede the necessary industrial restructuring in transition economies, and limit the growth in CEE-EU trade. That is the easier option, particularly in a period of recession. The NERA study and much other research suggests it is the wrong option. A generous interpretation of the Association Agreements is needed both to assist the trans-

formation in CEE countries and to meet the best interests of EU citizens.

*Jon Stern*

*Senior Consultant*

*National Economic Research Associates (NERA), London, U.K.*

### On China's Growth Rate

I would like to warn our friends and ourselves not to overestimate China's economic growth which is robust at any rate. The State Statistical Bureau of China calculates GNP in current prices and uses some unpublished price deflator or deflators to make it comparable with the GNP of last year. Hence the growth rates are very sensitive to the numerical value of price indices.

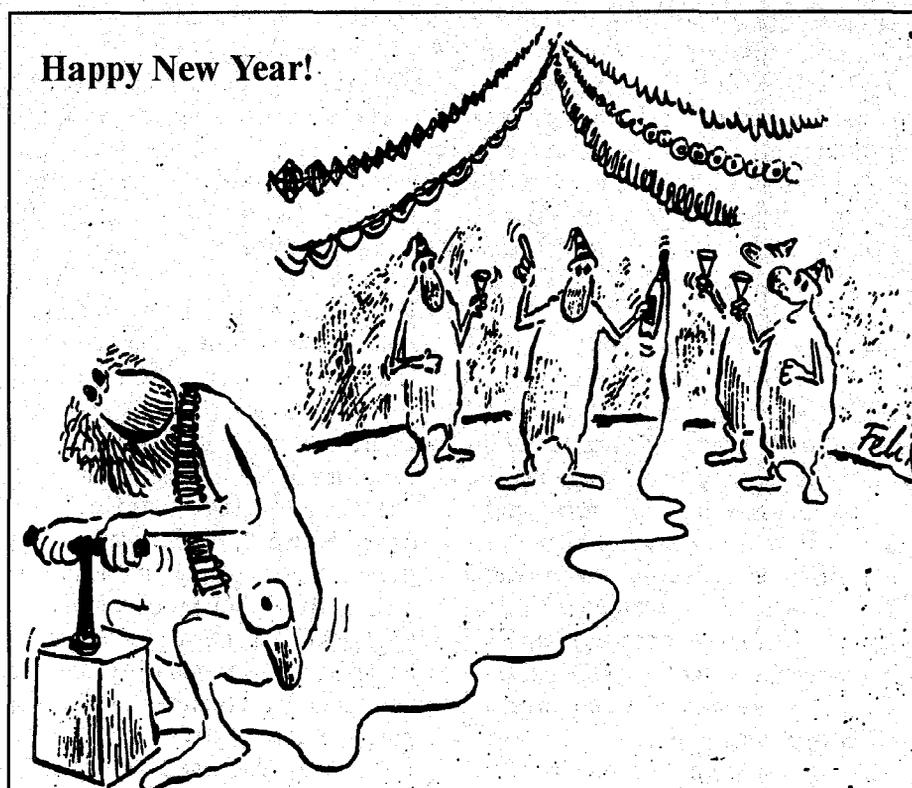
The *published* growth rates between 1979 and 1992 averaged to an annual rate of 9.0 percent (see column I). Calculating the growth rates with the *retail price indices*, the average rate will be less; 8.1 percent (Column II). Using the urban cost of living indices, the average rate will slow to an annual 7.2 percent. (Column III) For comparison, see the following table:

### China's annual GNP growth, using different deflators (percent):

	I	II	III
1979	7.6	9.2	9.3
1980	7.9	5.5	4.0
1981	4.4	4.3	4.2
1982	8.8	6.8	6.7
1983	10.4	10.3	9.7
1984	14.7	16.5	16.7
1985	12.8	13.0	9.8
1986	8.1	6.9	5.9
1987	10.9	8.6	7.1
1988	11.3	5.1	3.1
1989	4.4	-3.5	-2.2
1990	4.1	8.3	9.2
1991	8.2	11.2	8.8
1992	13.0	12.7	9.4
Geometric Average	9.0	8.1	7.2

*Wang Mongchang*

*Institute of Quantitative and Technological Economics, CASS*



From the Croatian cartoonist Felix

# Vietnam's Economic Options--Coping with Mounting Resources

In 1993, Vietnam has recorded an economic growth rate of 7.8 percent and an inflation rate of 5.2 percent. Recently, there has been a turnaround in the country's access to international finance, including IDA credits from the World Bank (see box). The first Donor Conference for Vietnam, held in the World Bank's Paris office, resulted in aid commitments of \$1.86 billion from multilateral and bilateral donors.

Vietnam has grown surprisingly well in the absence of aid. The resumption of financing creates the potential to do even better. The resources being offered to Vietnam represent both an opportunity and a challenge. Between 1989 and 1991 the government had to reduce its fiscal and external deficits to virtually zero owing to the lack of financing. With the resumption of aid both fiscal and external deficits have widened; this is appropriate given the strong revival of both public investment to infrastructure, and private investment to productive activities. The challenge for the government now is to manage these deficits in a sustainable way.

## Managing Fiscal Expenditures

The turnaround in Vietnam's fiscal balance between 1989 and 1991 was remarkable. During that two-year period, total government spending was reduced from 27.9 percent to 18.9 percent of the GDP. With revenue roughly stable, the fiscal deficit declined from 11.9 percent to 4.1 percent of the GDP. The fiscal discipline was at the heart of Vietnam's disinflation program. Obviously, the government displayed a firm commitment to fight inflation and reduce a range of expenditures. Subsidies to state enterprises were eliminated; real public sector wages declined sharply; and the

government's investment program basically came to a halt. It would not have been feasible or desirable to maintain this kind of austerity for long. By 1991 investment in infrastructure and provision of social services had fallen to levels that threatened long-term growth.

Beginning in 1992, increased resources from taxes, oil revenue, and aid have been available to the government, which has been faced with the new challenge of increasing expenditure in a rational and sustainable manner. This may be a more difficult task than simply cutting everything in order to stop inflation.

In the area of the civil service, for example, Vietnam has a large and poorly paid bureaucracy. To get better public services while maintaining stability, it needs to focus its activities more sharply, reduce the number of workers, and raise salaries. This strategy requires making choices about priorities for public services.

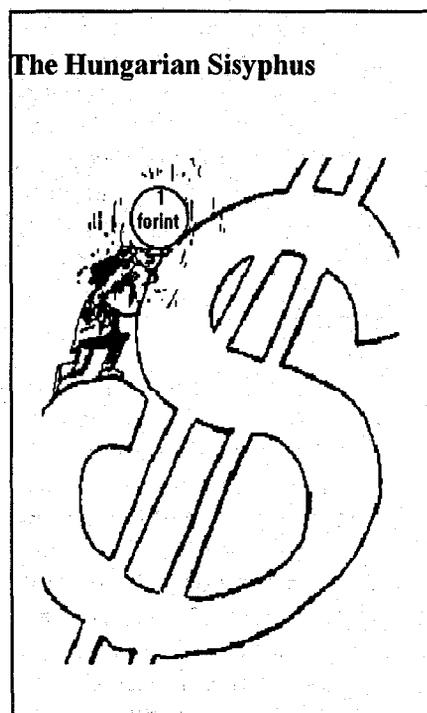
During the adjustment period, on the other hand, costs were held down by letting real salaries erode in the face of inflation, with relatively little change in the number of workers. The number of civil service workers declined by only 8 percent. As more revenue has become available in 1992 and 1993, the government has restored real public sector wages, with the predictable result that expenditure has risen rapidly.

There is a comparable concern on the capital side of the budget. Virtually everything was cut during 1990-91. Since then the government has expanded its investment, with an appropriate focus on infrastructure. There has been a tendency, however, to start too many different projects, with the danger that there will not be the financial and admin-

istrative resources to complete all of them in a timely fashion. A large portfolio of slowly implemented projects will have little positive impact on the economy. There is yet time for Vietnam to correct these incipient problems in its fiscal policy. While the fiscal deficit has increased sharply over the past two years, inflation is still low and it would be premature to fault the government for its macroeconomic management.

## Managing Capital Inflow

Concerning Vietnam's external policies, there is an analogous shift in the tasks facing its policymakers. Between 1989 and 1991 the government had to manage a rapid decrease in its external deficit resulting from the collapse of the Soviet Union (previously the main supplier of aid) and the lack of financing from the west. Beginning in late 1992,



From the *Hungarian Economy*

increasing external finance has been available to the country—both aid and commercial credits—and the challenge for the government now is to manage this capital inflow.

Just like the fiscal deficit, the current account deficit quickly dissipated: from more than 9 percent of GDP in 1989 to less than 1 percent in 1992. The falloff in foreign financing—in conjunction with liberalization of the trade and exchange regimes—resulted in a large devaluation (73 percent) of the real exchange rate in 1989. This helped to spur a surge in exports and to restrain imports during the next few years, leading to a steady decline in the external deficit.

The growth of imports picked up sharply in 1993. The increased demand for imports was the result of the more rapid growth of the economy and the increase in investment, including foreign investment. As a consequence, a current account deficit has emerged that may be difficult to finance. The public sector has had recourse to borrowing on commercial terms that it can ill afford.

The prudent macroeconomic policy would be to utilize highly concessional aid resources and direct foreign investment to finance the balance of payments. Most of the aid money pledged in Paris, however, is for projects and will disburse gradually; the same is true for direct foreign investment, where large commitments are slowly turning into disbursements.

After several years of austerity Vietnam has shown a desire to get on with growth and has been willing to borrow at fairly high cost to start the process. While understandable, this strategy entails the risk of undermining macroeconomic stability. The task for the government now is to get this external borrowing under control and to shift to low-cost sources of financing as aid and direct foreign investment disbursements pick up.

## Managing Reform

To sum up, Vietnam's macroeconomic management was inaccurate during an era of declining resources. The country has now entered a new phase in which the government has a growing volume of resources at its command—from expanded tax revenue, aid, and foreign commercial borrowing. These resources can potentially make the process of adjustment smoother. It is easier, for example, to lay off civil service workers or to privatize state firms in a rapidly

expanding economy. There is also the danger, however, that financing will become a substitute for reform. Vietnam is at a critical juncture in its reform program at which the central government needs to assert control over public expenditure and borrowing. Otherwise, borrowing and spending by government at different levels and by public firms could take off in an uncontrolled manner and undermine macroeconomic control.

David Dollar  
East Asia and Pacific,  
Country Department I

## Focusing On Rubber and Rice—IDA Credits to Viet Nam

*On January 25, 1994 the International Development Association (IDA)—concessionary credit arm of the World Bank—approved a credit of \$96 million in support of a new, three-year, \$106 million agriculture project aimed at improving the lives of Viet Nam's farm families. Farmers should more than double their incomes, from \$40 to \$96 per person or \$480 per family. (The new credit was preceded by two IDA credits for primary education and highway repair approved in October 1993; totaling about \$228 million, three credits were the first IDA loans to Viet Nam since 1978.)*

*The agriculture project will make it easier for Vietnamese rice farmers in forty provinces to obtain credit and agricultural extension services. (Some 4,300 villages with 4 million farm households will be targeted under the plan.) Even though the Vietnamese Bank of Agriculture (VBA), formed in 1990, had raised available credit from \$33 million in 1991 to \$236 million in 1993 funds still fell short. Only 10 percent of Viet Nam's 10 million farmers have been able to obtain the credit they need. With \$52 million from the IDA-supported project, the VBA will make short-term loans averaging \$100 to finance farmers' purchases of fer-*

*tilizer, seeds, and insecticides. Longer-term loans averaging \$1,000 will be made available to farmers to buy agricultural machinery, including small tractors, fishing equipment, and motor tillers.*

*Viet Nam's one-hundred-year-old rubber industry will be also revitalized with the help of the IDA-supported project: the Rubber production of nine state companies covering some 160,000 hectares in the country's southeast region should double by 1996, and bringing in an extra \$60 million in export earnings. Also, 1,000 staff at Viet Nam's agricultural ministry will receive training to assist them in carrying out agricultural reforms.*

*Viet Nam's agricultural reform was launched back in March 1989, when the communes were dismantled and family farming was restored. Rice production soared, transforming Viet Nam from a rice importer in the mid-1980s, to one of the world's top three rice exporters in 1991. In recent years, however, military demobilization and cuts in the state work force have brought about one million people to the fields and put pressure on agriculture to generate more jobs, according to a report on January 28 in the World Bank News.*

## Conference Diary

Forthcoming

### **Doing Business in Russia: New Opportunities and Recent Developments**

February 24-25, 1994, New York

The conference is sponsored by the American Conference Institute. Experts will present current views on the legal, accounting, and economic regimes and the investment climate in Russia. Participants include business persons and government officials with hands-on experience in projects. Discussions will focus on case studies involving health care, technology transfers, oil and gas investments, and various manufacturing initiatives. Specific topics include: investment and trade laws and regulations; current projects with practical lessons learned; tax issues; financing investment and trade; the role of multilateral agencies in financing projects; U.S. government loan, equity, insurance and feasibility programs, currency regulation and convertibility; trade regulation by the Russian federation; intellectual property protection; accounting; the \$2 billion oil and gas framework agreement; regional perspectives; and countertrade as an innovative marketing tool.

*Information: American Conference Institute, 175 Fifth Avenue, Suite 2182, New York, N.Y. 10010, tel. (416) 927-7936 or fax (416) 927-1563.*

### **U.S.-Newly Independent States Chamber of Commerce and Industry Series:**

#### **Technology on the Volga**

February 24, 1994, City University of New York Graduate Center

#### **Ukraine: Planting Now for Future Harvest**

March 24, 1994, City University of New York Graduate Center (tentative)

#### **Russia in the Year 2000: Watershed**

### **or Drought for American Investment?**

April 21, 1994, Russian Federation Mission Hall (tentative)

*Information: US-NIS Chamber of Commerce and Industry, P.O. Box 1178, Central Islip, New York 11722, tel. (516) 582-9102, fax (516) 582-2159.*

### **Credit Guarantee Schemes for Small and Medium-size Enterprises in Poland**

March 21-22, Warsaw

This meeting coorganized by the OECDILE Program and the PHARE PIL will focus on the organizational, legal, and conceptual dilemmas encountered in the first Polish Guarantee Scheme and ways to solve them. Participants include Polish practitioners and small and medium-size enterprise (SME) financial specialists working in the OECD and developing countries.

*Information: Martin Frost, OECD at the Initiatives for Local Employment Creation Program, tel. (331) 4524-9170, fax (331) 4524-9098.*

### **Sixth World Bank Conference on Development Economics**

April 28-29, 1994, Washington D.C.

Organized by the World Bank, inauguration by President Lewis T. Preston, with keynote address by Vice President Michael Bruno on Development Issues in a Changing World: New Lessons, Old Debates, Open Questions. One major theme "Transition in Socialist Economies" includes Macropolicies in the Transition to a Market Economy: A Three Year Perspective (Leszek Balcerowicz and Alan Gelb, Anders Aslund, Janos Kornai) Russia's Struggle with Stabilization (Jeffrey Sachs, John Williams, Maxim Boycko); Establishing Property Rights (Andrei Shleifer, Oliver Blanchard, Roman Frydman); Chinese Reform Experience with State and Col-

lective Enterprises (Thomas Rawski and Gary H. Jefferson, Nicholas Stern, Shahid Burki).

*Information: Boris Pleskovic, the World Bank, Research Advisory Staff, Room N 9037, 1818 H Street, N.W., Washington, D.C. 20433, tel. (202) 473-1062, fax (202) 477-0955.*

### **Global Countertrade: Strategy and Implementation**

May 8-11, 1994, Philadelphia

This conference sponsored by the American Countertrade Association will be the third biannual meeting of the countertrade organizations of the world. *Information: ACA, 121 S. Meramec Avenue, #1102, St. Louis, Missouri, 63105-1725, tel. (314) 727-5522, fax (314) 727-8171.*

### **1994 Conference on Economic Reform: Latin America and PCPEs**

May 12-13, 1994, Washington, D.C.

This conference, hosted in May 1994 by Georgetown University, will deal with the critical issues facing transitional economies, drawing from the Latin American experience, but focusing on lessons that are relevant to previously centrally planned economies, PCPEs. Academicians and policymakers of national and international renown will be selected for debate and discussion. The conference will be organized around three issues: privatization; monetary control and financial institutions; and safety nets and labor markets.

*Information: Pew Economic Freedom Fellows Program, 1304-36th Street, N.W., Washington, D.C. 20007, tel. (202) 687-5277, fax (202) 687-5288.*

### **Ukraine in Transition: Reforms, International Relations, Ecology**

May 23-27, 1994, Odessa, Ukraine

Second Congress of the International Ukrainian Economic Association. Calls for papers (to be delivered in Ukrainian, English, or Russian).

*Information: V. N. Bandera, Economics Department, Temple University, Philadelphia, PA 19122, tel. (215) 204-5039, fax (215) 204-8173.*

### **Contemporary East European, Russian, and Eurasian Education: Common Legacies and the Struggle for Reform**

June 15-18, 1994, New York

This conference is organized by the Association for Slavic and Eurasian Educational Research (ASEER), in cooperation with the Institute on East Central Europe of Columbia University and the education section of the Deutsche Gesellschaft für

Osteuropakunde. ASEER, a new, international professional working group based in the U.S., is dedicated to fostering comparative and collaborative research and policy analysis on East European, Russian, and Eurasian education. Conference themes include: new information technologies for educational research and exchange; new approaches to the history of East European, Russian, and Eurasian education; the effects of Sovietization on national education systems; attempted education reforms since 1989 (or 1991); the revival and uses of comparative and international education studies in the former Soviet bloc; and the role and prospects for Western technical assistance and cooperation in fostering education reform.

*Information: Mark S. Johnson, ASEER, 246 Hawthorne Street, Memphis, Tennessee 38112, tel. (901) 272-*

*0083, fax (901) 726-3718.*

### **The Economy of Defining Economic Democracy after the Cold War**

June 16-18, 1994, Portoroz, Slovenia

Seventh Conference of the International Association for the Economics of Self-Management (IAFESM). Papers dealing with workers participation, self-management, and economic and industrial democracy are welcome, (from the perspectives of economic theory, institutional and historical studies, experience in Central and Eastern Europe, and experience in developed and developing economies.)

*Information: Vice President Milica Uvalic, IAFESM, Borgo Santa Croce 17, 50122 Florence, Italy, tel. and*

## **World Bank/IMF Agenda**

### **The World Bank Fosters Latvia's Agriculture ...**

A \$25 million World Bank loan approved on January 11 aims to speed up the recovery of Latvian agriculture; the loan, which is part of a \$45.1 million agricultural development project, is targeted at the country's emerging private farmers and entrepreneurs. Most of the loan will help make it easier for Latvia's 52,000 private farmers to borrow money—or average \$5,000 each—to invest in their farms. (Declining demand and crumbling trade links with the former Soviet Union have cut food output by one-third every year since the Baltic country declared its independence in 1991.) The new loan—which is for seventeen years, including a four-years grace period, and carries a variable interest rate, currently 7.27 percent (down from the 7.43 percent charged in the previous six months)—marks the first Bank-supported investment project in the Baltic.

### **...and the IMF its Economic Program**

The IMF approved credits of \$64 million to Latvia, to support the government's 1993/94 economic program. Of the total \$32 million may be drawn under a fifteen-month standby, and a further \$32 million is available under the systemic transformation facility (STF). The economic program aims at holding the monthly inflation rate at between 0.5 and 1 percent and at accelerating privatization.

### **Kazakhstan To Receive Massive Aid**

Representatives from sixteen countries and eleven international organizations met in Paris on January 14 and committed a total of \$1 billion for Kazakhstan's development needs in 1994. New commitments, together with disbursements from last year's pledges could reach \$1.5 billion. On January 26 the IMF approved \$255 million in financing for

Kazakhstan. About \$170 million is available over the next twelve months under a standby credit, and about \$85 million immediately, as the second drawing under the systemic transformation facility. Japan has announced that it will provide Kazakhstan with financing that matches the support of the IMF, the first time they have done so in conjunction with a standby. Kazakhstan's austerity program, which is awaiting parliamentary approval, proposes to tighten credit and money, and slow the decline in industrial output to between 3 and 5 percent in 1994, down from the 13 percent experienced in 1993.

### **Blocking the Locust Invasion in Algeria**

The World Bank approved a \$30 million emergency loan to help fight a locust invasion in the food-growing regions of Algeria. The emergency loan, to be supplemented by a \$20 million contribution by the Algerian government, would bolster surveillance and warning sys-

tems. The project would also help strengthen regional cooperation between Algeria and other countries in North Africa and the Sahel Region, which faced similar threats. (In another development, Algeria set a 1994 budget deficit ceiling of 125.3 billion dinars, or 9.6 percent of GDP, on spending of 535.3 billion dinars. The 1993 deficit is 192 billion dinars, or 12 percent of GDP. The narrower deficit will be achieved by improving revenues and imposing greater budgetary rigor, head of state Ali Kafi said.)

### Supporting FYR Macedonia

With help from a \$40 million World Bank loan and a credit of \$40 million from the International Development Association (IDA), both approved on February 8 FYR Macedonia is embarking on an ambitious economic reform program. The assistance marks the first Bank operation in FYR Macedonia since the country joined the institution on December 30, 1993. The IDA and World Bank funds will pay for badly needed imports. The funding will also help open the way to international assistance by giving new weight to a multi-donor effort assisting FYR Macedonia in clearing its share of the former Yugoslavia's debts. The IMF is providing a \$17 million credit under the Systemic Transformation Facility.

### Easing China's Telephone Shortage

A \$250 million World Bank loan, approved in late December 1993, will help finance China's \$623 million telecommunications project aimed at increasing long distance and local telephone capacity in several provinces of the country. Telephone demand has climbed 20 percent annually in the 1990s, and about 1.6 million people are now waiting for telephones. A 2,084-kilometer (km) fibre optic cable in the north will link Beijing, Inner Mongolia, Ningxia, and Gansu. In the south a second cable of 4,461 km will link the provinces of Zhejiang, Fujian, Jiangxi, Unan, Guizhou, and Sichuan. The project is also de-

signed to help make the telecommunications sector more competitive through accounting and pricing reform and the establishment of a legal and regulatory framework.

### Helping Armenia's Earthquake Victims

On February 1, the International Development Association (IDA) approved a credit of \$28 million to Armenia in support of efforts to reconstruct housing, factories and municipal infrastructure in the northwestern corner of the country that was affected by the 1988 earthquake. (IDA is the World Bank affiliate that lends to the poorest countries on

concessional terms). Japan is cofinancing the project with \$400,000. The earthquake took the lives of an estimated 25,000 to 30,000 people and left more than a half-million people homeless. The quake also took an economic toll by destroying about 40 percent of Armenia's manufacturing base. Industrial output fell by half in 1992 and the country's average income now amounts to about one-third of its 1989 level. This new project marks the second loan to Armenia since the Bank made its first loan to the country in March, 1993. The first loan aimed to improve Armenia's ability to carry out economic reforms, manage a private market economy, and build up a private sector.

### EDI Training Programs in the FSU

*In late 1991 the World Bank's Economic Development Institute (EDI) initiated an educational program in countries of the former Soviet Union (FSU) to assist in the transition process. In addition to the target audience of trainers, enterprise managers, government officials, bankers, and agriculture and energy specialists participate in the programs. Topics include "Banking and Finance," "Market Economics," "Privatization and Restructuring," "Project Analysis", and "Orientation to the World Bank." By the end of the first year, EDI had organized twenty-five courses reaching over 2,500 participants, with a budget of \$2.25 million. By the end of 1993, the total number of participants had reached almost 4,000. This year, the seminars will receive more participants from the Central Asian republics, and both the project analysis and project management programs will be extended. The first EDI trained Russian trainers have already run their first training courses.*

*As part of the program, EDI has produced a variety of written and visual training materials in Russian*

*that can be used as aids by local participants in their future teaching. Studies on economics, banking and finance, and enterprise restructuring are available in Russian, as are training handbooks on financial risk management, bank regulation, and supervision and bank analysis. A series of papers and case studies were published on enterprise management for restructuring and privatization based on local experience. The updated version of "Glossary on Banking and Finance," in both English and Russian, has just been published. Sixteen instruction videos complement courses on banking and finance.*

*[Videos can be made available for Russian trainers. Contact Mary Elizabeth Ward, the World Bank, Room M-5011, 1818 H Street, NW, Washington, DC 20433, tel. (202) 473-6372. Written materials are available from the World Bank, EDI Training Materials Center, Room M-P1-010, 1818 H Street, NW, Washington, D.C. 20433, tel. (202) 473-6351.]*

Lisa Griffin, EDI, the World Bank

## Milestones of Transition

**Poland's** parliament has sent the government's proposed budget for 1994 to commissions. A final vote is expected in February; in the meantime, the government's draft budget has legal force. The government plans revenues of 610 trillion zloty (\$28 billion), expenditures of 693 trillion (\$32 billion), and a deficit of 83 trillion (\$4 billion), or 4.1 percent of GDP. The economy is expected to grow 4.5 percent in 1994, with investment rising 6 percent; exports, 6 percent; and imports, 2.5 percent. Inflation is expected to drop to an average of 27 percent. A monthly devaluation rate for the zloty of 1.6 percent will continue. Real wages are to rise 2 percent. Domestic debt servicing will cost 82 trillion zloty (\$3.9 billion), while servicing Poland's foreign debt will consume a further 30 trillion zloty (\$1.4 billion).

The **Czech** koruna is the most stable currency in postcommunist Europe, asserts a report of the Dresdner Bank. Real inflation in the Czech Republic dropped from 60 percent in 1991 to 10 percent in 1993 and the koruna's exchange rate against all major Western currencies has remained stable for a relatively long time.

**Bulgaria** may seek to resolve its debt problems by purchasing liabilities directly from the country's major creditors, Finance Minister Stoyan Aleksandrov announced in mid-January after a two-day meeting in Frankfurt with representatives of commercial creditors. Bulgaria owes more than \$9 billion to its commercial creditors and the debt is currently sold on the open market for slightly more than 35 cents per dollar owed.

In **Hungary** the number of registered unemployed fell to 635,000 in November 1993, 70,000 less than the peak figure in February 1993. November's unemployment rate of 12.2 percent was 0.4 percent lower than in October. Only 330,000 people received unemployment

benefits, however. The rest were either ineligible for compensation or their period of entitlement had expired. Some 130,000 people received financial support from local government authorities.

**Hungary's** nuclear waste problem is intensifying. Russia is no longer accepting radioactive waste produced by Hungary's Soviet-designed atomic plant at Paks; and Ukraine objects to transportation of the waste through its territory. Storage facilities at Paks, which produces 56 yons of nuclear waste yearly will be filled by early 1995. Hungarian officials are talking with French and British firms about solutions to the problem.

In the first nine months of 1993 **Estonia's** industrial production amounted to 10.36 billion kroons (\$762 million), representing a 32.4 percent decline compared with the same period in 1992, and a 60 percent decline compared with 1989, according to the 1993-94 economic survey of the Estonian economics ministry. As of October 15 of 1993 the Estonian enterprise register listed 7,434 manufacturing companies and 72 mining enterprises of which only about 4,000 were operating. Investments in new and existing enterprises amounted to 5.59 billion kroons, of which less than 900 million kroons came from abroad.

In **Lithuania** industrial output fell by 25 percent in 1993, with only 49 percent of industrial capacity utilized throughout the year. Agricultural production was satisfactory, but severe drops in purchasing power decreased demand for meat and dairy products, and lowered procurement prices. The 1994 budget envisages a deficit of 163 million litai (\$40 million) with expenditures of 2,945 million litai exceeding revenues of 2,782 million litai—both about 60 percent higher than in 1993.

Inflation in **Latvia** slowed to 5.1 percent in December 1993 from the No-

vember rate of 8.8 percent. (Food prices increased by 7.8 percent, and the rate was only 2.4 percent for clothing and footwear.) In 1993 the inflation rate amounted to 34.7 percent.

**Russia** exported much more oil in 1993 than in 1992, but slumping world markets took their toll on revenues. A study by the Center for Economic Analysis said that crude oil exports outside the former Soviet Union rose 30 percent in the ten months January through October over the same period in 1992 but that the average contract price (\$105.10 a ton) was 18.9 percent lower. Prices for crude oil, Russia's main export earner, have fallen to their lowest levels in five years due to oversupply.

Some 15 percent of **Russia's** territory is an "ecological disaster zone," and only half the country's 222 million hectares of arable land is suitable for farming according to ecology minister Viktor Danilov-Danilyan who explained that around 100,000 people in Russia live in areas with "an unfavorable radioactive situation" and that only about one-fifth of the toxic industrial waste produced in the country is purified. According to Danilov-Danilyan the "very serious" ecological situation is unlikely to improve any earlier than 1995.

**Russian** President Boris Yeltsin published a decree yesterday aiming to conclude a voucher privatization program by July. Yeltsin's decree provides new benefits for the investment funds, exempting them from paying tax on dividend income.

**Russia's** ministry of labor says that official data that put the number of people out of work in Russia at around one million seriously underestimate the number of unemployed. Vladimir Varov, deputy minister of labor, said on January 12 that the true number is between 4 and 5 million people, or 5 to 6 percent of the work force. Of these, one million are

officially registered as unemployed, while the rest are "working for bankrupt enterprises, living on state subsidies disguised as wages, and producing nothing that anyone needs."

In the first nine months of 1993 **Romania's** foreign debt grew 26 percent to the equivalent of more than \$3 billion, the Romanian news agency, Rompres, reported. In another development, some 244 Romanian state companies were shifted into private hands last year, compared with a target of 550, according to the State Ownership Fund.

Unemployment is continuing to rise in the transition economies of Eastern Europe and the CIS, although the increases in 1993 were in general somewhat smaller than in 1992, according to the latest report of the Economic Commission for Europe. In mid-1993 there were about 6.5 million persons unemployed in Eastern Europe, 6 percent more than in December 1992. Unemployment rates ranged from an exceptionally low 3 percent in the Czech Republic to nearly 30 percent in FYR Macedonia. In the CIS countries registered unemployment rose 27 percent between December 1992 and June 1993, but the unemployment rate was less than 1 percent in all of the CIS countries except Armenia (5 percent). Although these low figures reflect in part technical deficiencies in the statistics they also point to a general reluctance to accept open unemployment.

**China** has established its first minimum wage rules to protect workers' living standards, the official *China Daily* reports. The minimum wage level, set by individual cities and provinces, must be at least half the local average wage. Shanghai has set its minimum at \$24 a month, while the special economic zone of Shenzhen has set a level of \$32 a month.

Liu Jiang, **China's** farm minister, warned of a widening gap between the urban rich and the rural poor and called for more investment in agriculture, amid

estimates of 300 million jobless peasants by the year 2000. He told a national conference on rural work that the average farmer's annual income in 1993 was 880 yuan (\$101), an increase of only 2 percent over 1992 after inflation; in contrast, urban incomes rose 10 percent. Latest official estimates show that the average urban resident earned about 2,300 yuan (\$264) in 1993.

Explosive urbanization in **China** over the past decade has left many experts convinced that Chinese cities are at the saturation point, writes the *China Daily*. In twelve years' time the number of cities in China has more than doubled from 223 to 517, with their populations increasing by a similar amount, from 90 to 231 million people. China now has thirty-two cities with at least 1 million people—more than the France, Japan, Russia and the United States combined. China expects a population of 1.22 billion by 2000 despite a strict birth control program, meaning the country's population is increasing by 11 million annually. The country's large and medium-size cities do not currently have the financial resources to cope with the growing infrastructure demands imposed by ever-larger populations. The article recommends that urban growth be concentrated in key cities such as Shanghai, Beijing, Tianjin, Shenyang, Guangzhou, Chongqing, and Wuhan and that new cities be built along the Yangtze River.

**China's** economy grew at record speed in 1993. Official data show that industrial output in 1993 was \$403 billion, an increase of 23.6 percent over 1992, when output rose 20.8 percent over the previous year. The growth rate in 1993 was the highest since China began its open-door and reform policies in 1978.

**Germany's** Economic Research Institute reports that German recovery is not in sight, although a gradual upward movement might be apparent in the west by summer. The institute has forecast that western German GDP will decline by 0.5 percent in 1994, while that of the east will grow by 6 percent. Germany's

1993 GDP contracted by 1.3 percent, with the Western part of the country showing a decline of 1.9 percent, and the east an increase of 6.3 percent.

**Cambodia's** new budget and economic legislation, have brought government accounting procedures into line with international standards for the first time since the 1960s. Finance minister Sam Rainsy reports that Cambodia's parliament has approved a 1994 budget of 890 billion riels. Gross domestic product for 1994 has been forecast at 6 trillion riel (\$2.4 billion), 8 percent over 1993, (compared with 7.5 percent growth this year over 1992). An estimated \$300 million in investment is needed for energy development in Cambodia to ensure sufficient supply by 1997, according to the country's minister for industry, mines and energy.

The Europe Agreements associating **Poland and Hungary** with the **European Union** entered into force on February 1. (Europe Agreements has been signed also with the Czech Republic, the Slovak Republic, Romania and Bulgaria, but implementation in their cases takes more time, owing to the separation of Czechoslovakia, and some unresolved trade issues). Poland's and Hungary's legislation will be harmonised with that of the European Union. This applies especially to customs law, partnership law, banking law, company accounting and taxation, intellectual services, competition regulations, the protection of human, plant and animal life and health, legislation on foodstuffs, consumer law, indirect taxation, technical standards and regulations, transportation and environmental protection. The Europe Agreements were signed in December 1991. In the meantime, interim agreements implemented the accords' trade measures. (The Community's interim accord with Bulgaria entered into force on February 1). The June, 1993 meeting of the Copenhagen European Council held out the prospect of full membership for the six countries once they satisfy economic and democratic requirements, but set no target date for that to happen.

## New Books and Working Papers

The PRDTE unit of the World Bank regrets that it is unable to supply the publications listed.

### World Bank Publications

Andrés Solimano and David Yuravlivker, **Price Formation, Nominal Anchors, and Stabilization Policies in Hungary: An Empirical Analysis**, WP no. 1234, December 1993, 36 p.  
To order: Ms. Susana Florez, PRDTE, Rm. N11-017, tel. (202) 473-9075.

Authors, using monthly data, provide econometric estimates of the determinants of inflation for 1990-92. Empirical estimates of price equations--both consumer price index and producer price index--show the quantitative importance and statistical significance of the exchange rate in Hungary's price formation during the period of intensified reform, as the economy became more open to international trade. Money supply affects consumer and producer prices with several lags; its impact on prices is small in the short run. Nominal wages have a more significant effect on the consumer price index than on producer price index.

The study presents policy simulations of alternative rules for the exchange rate and the money supply, and their effect on the rate of inflation and the level of the real exchange rate. They find that a rule of fixing the exchange rate entails 5 percent less inflation a year--measured by the consumer price index--than if the rule is based only on reducing the rate of money growth (to 1 percent a month).

A fixed exchange rate policy, nevertheless, is associated with greater appreciation of the real exchange rate than is the policy of money-based disinflation--nearly 4 percentage points more real appreciation a year. A Purchasing power parity-based exchange rate rule stabilizes the real exchange rate at the cost of a substantial acceleration in inflation. These exercises illustrate the nature and magnitude of the trade-offs between

faster disinflation and the level of external competitiveness in an open economy such as Hungary that uses the exchange rate as a nominal anchor in disinflation.

Alfredo Thorne, **Eastern Europe's Experience with Banking Reform: Is There a Role for Banks in the Transition?**, WP no. 1235, December 1993, 38 p.  
To order: Noni Jose, Rm. 18-168, tel. (202) 473-3688.

Leila M. Webster and Dan Swanson, **The Emergence of Private Sector Manufacturing in the Former Czech and Slovak Federal Republic: A Survey of Firms**, World Bank Technical Paper no. 230, November 1993, 93 p.

Leila M. Webster, **The Emergence of Private Sector Manufacturing in Hungary: A Survey of Firms**, World Bank Technical Paper no. 229, November 1993, 99 p.

Leila M. Webster, **The Emergence of Private Sector Manufacturing in Poland: A Survey of Firms**, World Bank Technical Paper no. 237, November 1993, 94 p.

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

### IMF Publications

To order: IMF Publication Services tel. (202) 623-7430 or fax (202) 623-7201.

J. Blommestein and Michael G. Spencer, **The Role of Financial Institutions in the Transition to a Market Economy**, IMF WP no. 93/75, Washington, D.C., October 1993, 45 p.

Financial institutions intermediate between savers and investors and contribute to corporate governance. Equity and bond markets in the former centrally planned economies are not yet in a position adequately to provide these services. It is not yet clear that investment funds will provide the necessary financing and corporate management. The first priority for financial sector reforms must be to establish a healthy commercial banking sector. Banks are the most promising source of financing, provide payment services which are crucial to both the real and financial sectors and, by monitoring the use of loaned funds, will be the primary source of corporate governance during the transformation to a market economy.

Financial sector reform has, at times, been portrayed as a question of adopting either a bank-based or a (securities) market-based model. In the bank-based model, commercial banks, often licensed as "universal" banks, take the lead in financing enterprise restructuring and investment. Proponents of the market-based model argue that the structural problems in the banking sector cannot be overcome easily; so firms will have to look to equity and bond markets for sources of new capital. Equity and bond markets in the post-socialist economies are not sufficiently well developed to support significant issues of new securities or to provide a mechanisms for corporate control. They lack adequate liquidity, regulatory oversight, information disclosure, and clearing and payment systems. The important role of banks in maintaining the payment system and in providing credit to market participants to support trading and settle-

ment means that until banks are restructured and recapitalized, securities market development will be constrained.

Investment funds emerging from mass privatization schemes may create concentrations of equity ownership that would allow them to play an important role in corporate control and perhaps, too, in finding sources of investment capital. They are a relatively recent innovation, however, and it remains to be seen how active they will be in financing and managing privatized enterprises.

The authorities should first establish a healthy banking sector, because it is the banks that are the most promising source of working capital and corporate control. This does not mean that securities market development should be ignored, only that it should not be a priority use of scarce government resources at the present time. Many observers recommend that banks be given the power to act as universal banks, combining lending with securities market operations and equity investment. However, commercial banking and investment banking activities should be separated, at least until banks have demonstrated competence in their commercial lending operations.

Paul Hilbers, **Monetary Instruments and Their Use During the Transition from a Centrally Planned to a Market Economy**, IMF WP no. 93/87, Washington, D.C., November 1993, 29 p.

#### CEPR Working Papers

L. Karp and S. Stefanou, **Domestic and Trade Policy for Central and East European Agriculture**, CEPR no. 814, November 1993.

E. Várhegyi, **Key Elements of the Reform of the Hungarian Banking System: Privatization and Portfolio Cleaning**, CEPR no. 826, September 1993.

*To order CEPR Discussion Papers: 25-28 Old Burlington Street, London W1X 1LB, tel. (44 71) 734-9190, fax (44 71) 734-8760.*

#### WEFA Working Papers

Michael Alexeev, Jim Leitzel and William Pyle, **Essays on Second Economy Markets**, Berkeley-Duke Occasional Papers on the Second Economy in the USSR, no. 37, December 1993, 53 p.

Kimberly C. Neuhauser, **Two Channels of Consumer Credit in the USSR**, Berkeley-Duke Occasional Papers on the Second Economy in the USSR, no. 38, December 1993, 67 p.

Vladimir G. Tremel and Michael V. Alexeev, **The Second Economy and the Destabilizing Effect of Its Growth on the State Economy in the Soviet Union: 1965-1989**, Berkeley-Duke Occasional Papers on the Second Economy in the USSR, no. 36, December 1993, 76 p.

*To order: The WEFA Group, Special Projects/Ginny Jones, 401 City Avenue, Suite 300, Bala Cynwyd, Philadelphia, 19004, tel. (215) 660-6387 or (919) 660-1841.*

#### WIIW Papers:

**Die Industrien Tschechiens und der Slowakei: Profile, Trends und Bezug zu Osterreichs Industrie**, no. 201, 1993, 69 p.

Raimund Dietz, **Eigentum und Privatisierung aus systemtheoretischer Sicht. Ein Beitrag zur Theorie der Transformation**, no. 150, 1993, 182 p.

Peter Havlik, **Osteuropa zwischen Plan und Markt: Die Wirtschaftsentwicklung in der Region von 1989 bis Anfang 1993**, no. 149, 1993, 77 p.

András Inotai and Jan Stankovský, **Transformation in Progress: The External Economic Factor**, no. 200, 1993, 77 p.

Zdenek Lukas, **Die Landwirtschaft in den Oststaaten 1992**, no. 148, 1993, 96 p.

*To order: Vienna Institute for Comparative Economic Studies, P.O. Box 87, A-1103 Vienna, tel. (431) 782-567, fax (431) 787-120.*

#### Other Working Papers

László Csaba, **Economic Transformation in the Visegrad Countries: A Comparison**, University of Helsinki, WP no. 353, 1993, 18 p.

Danuta Gotz-Kozierkiewicz and Witold Malecki, **Exchange Rate and Foreign Debt in the Monetary Stabilization**, Institute of Finance (Warsaw), no. 37, 1993, 43 p.

Elzbieta Skrzyszewska-Paczek, **Stabilization in Mexico: Lessons for Poland**, Institute of Finance (Warsaw), WP no. 36, 1993, 39 p.

*To order: Institute of Finance, information and Publication Section, Warsaw, Swietokrzyska 12, Poland.*

Eugenio F. Lari, **Has The World Bank a Role to Play in Central and Eastern Europe?**, [Original title **Quale Ruolo Può Ricoprire La Banca Mondiale Nell' Europa Centrale ed Orientale?**], Quarterly Review of Banca Toscana, 2/1992, 30 p.

#### New Books

Mike Dennis, **Social and Economic Modernization in Eastern Germany: From Honecker to Kohl**, Pinter Publishers, London, 1993, 252 p.

**Launching, Financing, and Protecting Business Ventures in Russia: A Regional Strategy**, Geonomics Institute, Vermont, September 23-26, 1993, 79 p.

To order: *Geonomics Institute*, 14 Hillcrest Ave., Middlebury, Vermont 05753, tel. (802) 388-9619, fax (802) 388-9627.

Malcolm R. Hill and Caroline M. Hay, **Trade, Industrial Cooperation and Technology Transfer Continuity and Change in a New Era of East-West Relations**, Avebury, Vermont, 1993, 123 p.

Walter LaFeber, **America, Russia, and the Cold War, 1945-1992**, 7th edition, McGraw Hill, New York, 1993, 394 p.

Jeffrey Miller, **The Bulgarian Banking System**, Bulgarian National Bank, 1993, 63 p.

Maciej Nowicki, **Environment in Poland: Issues and Solutions**, Kluwer Academic, Boston, 1993, 191 p.

Perry Patterson, **Capitalist Goals, Socialist Past: The Rise of the Private Sector in Command Economies**, Westview Press, Boulder, 1993, 225 p.

George Soros, **Toward a New World Order: The Future of Nato**, The Soros Foundations, New York, November 1993, 18 p.

Providing economic assistance to the former Soviet Union has been an unmitigated failure. The history of Western assistance [could be divided] into three phases: first, when Western assistance should have been promised but was not; second, when it was promised but it was not delivered; and third, when it is delivered but it does not work. We are now entering the third phase.

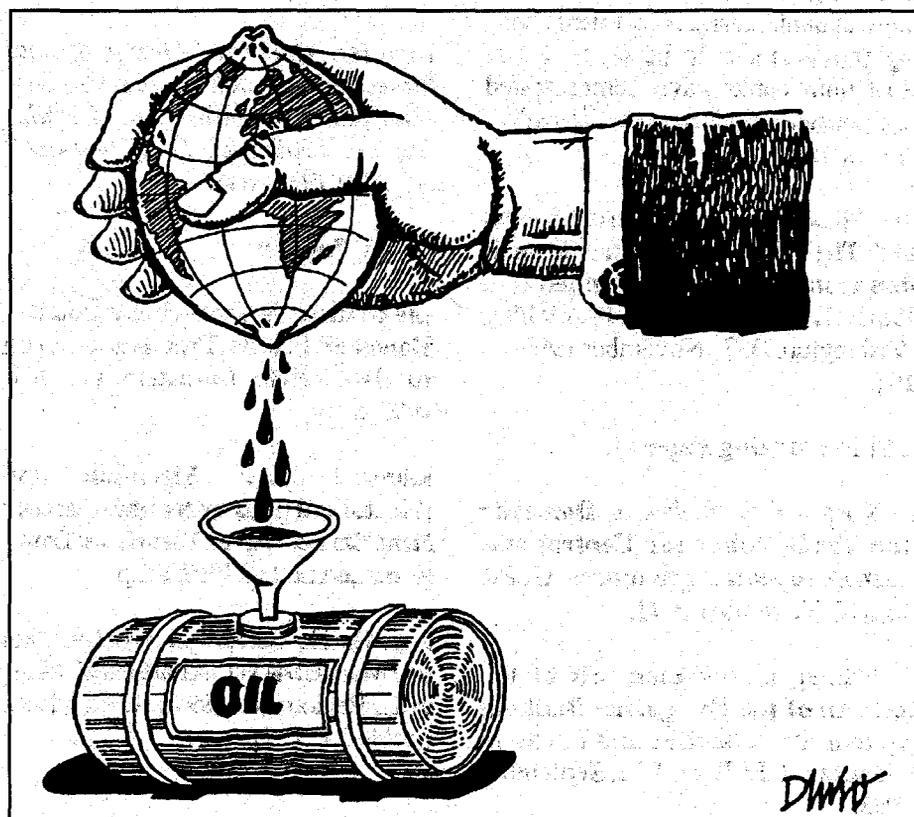
One of the reasons for the failure is that each donor country is acting on its own and is guided by its own interests and not that of the recipients. In my foundation, we describe Western assistance to the formerly communist countries as the "last bastion of the command economy." That may be unavoidable, but at least

there ought to be a unified command. In this respect, NATO offers a better culture than the European Commission which has been put in charge of coordinating economic assistance. The G-7 ought to have developed a command structure for dealing with economic aid to the former Soviet Union, but did not.

There is much to be gained from giving the task to the NATO's Partnership For Peace. For one thing, it would put the emphasis on conflict prevention rather than intervention; for another, it would put the economic cost in the context of the gain in security. Incidentally, it would focus attention on the constituency in the former Soviet Union which is the most important from a security point of view, namely the military. In current economic conditions, even very small expenditures benefitting the military would have a major effect in their attitude and behavior.

Perhaps the greatest accomplishment of the Marshall Plan was that it fostered European cooperation. The need for cooperation among the formerly communist countries is even greater than it was in post-war Europe and it is in this field that the Partnership For Peace could make its greatest contribution to security. But the reform and reconstruction of economic ties among the formerly communist countries should not be pursued at the expense of their integration into the European economy. Countries like Hungary have almost completely broken their dependence on the Soviet market; they need better access to European markets more than any other form of economic assistance. By allowing differentiated treatment, including membership in the European Union and NATO, the Partnership For Peace should help fulfill their aspirations.

To order: *The Soros Foundations*, 888 Seventh Avenue, New York, NY 10106, tel. (212) 757-2323, fax (212) 974-0367.



From the *Hungarian Economy*

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