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THE NEWSLETTER ABOUT REFORMING ECONOMIES

TRANSITION NEWSLETTER

The World Bank Group
Our Dream is a World Free of Poverty

THE WILLIAM DAVIDSON INSTITUTE
AT THE UNIVERSITY OF MICHIGAN BUSINESS SCHOOL

Vol. 12, No. 4 October-November-December 2001

"Just Like Combating Terror, Fighting Poverty Is a Common Responsibility"

Interview with Nick Stern, Senior Vice President and Chief Economist of the World Bank

By Richard Hirschler

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According to Nick Stern, while the World Bank's long-term strategy is not changing as a consequence of September 11, certain adjustments are taking place. The Bank will apply a more inclusive approach to ensure that developing and transition countries share the benefits of globalization more equitably, and recognizing that no "one size fits all" solution is available, the Bank will increasingly encourage countries to choose their own approach to development.

Public Disclosure Authorized

Q: Many scholars have argued that the September 11 terrorist attacks and the frustration of the impoverished Muslim masses are connected. Do you see such a connection?

A: First, let us be clear about one point: no sense of injustice can ever justify what happened in the United States on September 11. In analyzing the connection between poverty and terrorism, there is great temptation to simplify. Most of the terrorists involved in this crime appear to have come from rich families, from relatively well-to-do countries. At the same time, we have to study and understand the role of failed states that often provide or condone safe havens for organized terrorism. These safe havens are frequently outside governments' control, and they are often afflicted by conflicts, mostly internal conflicts that are, at least in part, provoked by poverty. Recent research on conflict and violence by Research Director Paul Collier clearly points in this direction. Thus some connections between poverty and the attacks are apparent, but we should avoid simplistic explanations.

Q: Still, as Martin Wolf wrote recently in the *Financial Times*, the terrorist attack of September 11 killed the post-Cold War delusion of effortless international harmony. He highlights the income gap between poor and rich. The high-income countries, with a combined population of 900 million, have an average per capita annual income of $26,000 and are generating four-fifths of the world's gross national income at market prices. In the developing world, 5.1 billion people have an average annual per capita income of $3,500. Half of them, about 2.4 billion people, live in low-income countries with average annual per capita incomes of $1,900. At the same time, Wolf notes, 99 percent of the 3 billion growth in world population foreseen in the next 50 years is expected to be in the developing world. He also predicts that more fragile countries will continue to stagnate; that there is a possibility of wars over resources, particularly water; and that nuclear weapons may proliferate, some perhaps falling into terrorist hands. As he puts it, "The position enjoyed by the rich countries may be more fragile and less easy to defend than many have, until recently, assumed." Have we entered a period of escalating confrontation between rich and poor countries, and will this require a change in the World Bank's long-term strategy?

A: The fallout of September 11 is profound. However, we also have to consider the pre-September 11 situation more realistically. From 1980 to 2000

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the number of people living in poverty—defined as $1 or less income a day in purchasing power parity—declined by about 200 million, despite the global population increase of about 1.6 billion. A new World Bank study, "Globalization, Growth, and Poverty," written by Paul Collier and David Dollar, divides developing countries into two groups. The first group of 24 countries, which includes Bangladesh, China, and India, has doubled its ratio of trade to GNP in the last two decades, while the second, less "globalized" group on average trades less than it did 20 years ago. In the "more globalized club," where about 3 billion people live, income per person grew by 5 percent a year during the 1990s, faster than in the industrial countries. Life expectancy is much longer than it was 30 or 40 years ago, and the literacy rate is far higher. In China, for example, during the last two decades illiteracy dropped from 35 to 16 percent. In the less globalized group, however, average incomes fell by nearly 1 percent a year during the same period, and the development gap between these and the rich countries, as measured by per capita income, widened significantly. Thus billions of people—even many in the more successful countries—were left behind, excluded from a better life.

Thus we must look to a much more inclusive approach toward reaping the benefits of globalization. Developing countries should participate more actively in the technological progress of our age, share more equitably in the benefits of international trade, and enjoy the social and economic advantages of living in open societies. We must also recognize that integration can take many different forms; there is no "one size fits all solution." Countries that have succeeded in their development efforts have all encouraged entrepreneurship, reduced government harassment and obstacles to private enterprise, and opened up to trade—but they did this in their own ways.

So I wouldn't simplify the present situation as an escalating confrontation between rich and poor, but certainly we need to recognize that we have to build an integrated world with much stronger inclusion and with more leeway for diversity. If we can integrate a diverse world while avoiding any traps of standardization, development efforts will be more successful and the world we live in will be a more harmonious place. But I don't think that a radical change in the Bank's longer-term approach to development will be necessary. Indeed, I think it underlines the importance of the message of inclusion that is at the center of our approach.

Q: But as the black clouds of a worldwide recession hang over us, will the Bank's approach need to change in the short term? Argentina is practically bankrupt, and we cannot exclude the possibility of another terrorist attack. These and other dangers could cause havoc to the world economy.

A: The World Bank anticipates that the worldwide economic slowdown will reverse in six to nine months, and that the world economy will begin to return to higher growth in mid-2002. We are predicting 1.3 percent global GDP growth for 2001 and 1.6 percent for next year. The United States, with a combination of fiscal and monetary measures, is doing a lot to revitalize its economy. Europe could do a little more, but Japan is

the one that really needs to boost its economy, probably with a combination of structural reform and moderate inflation. And the world's trading system has to be strengthened. The international community made an excellent start at Doha, and we have been working throughout the last year to support this outcome. In general, the Bank will play an even more central role in the future, because of its improved understanding of the importance of multilateral efforts.

As I indicated a moment ago, the broad thrust of the Bank's strategy has not changed in response to September 11. We believe that our emphasis on poverty reduction already had us on the right long-term course, and we were also taking steps before September 11 to respond to the short-term problems caused by the cyclical global slowdown. But we have, of course, made some additional adjustments in response to the changed conditions since the attacks. We have put support mechanisms in place for countries that suddenly find themselves hosting large numbers of new refugees. We are providing financial and other support to maintain the momentum of reform in the nations most affected by the shock to international capital markets, such as Turkey. We have gone through our portfolio of activities, country by country, and in cooperation with the countries' authorities have worked through the implications of the attack and have adjusted our programs accordingly. We will deliver on our existing programs—which, as I have said, are directed at the long-term challenge of promoting development—while doing our best to respond to new needs. As it becomes necessary and feasible, we will actively participate in the rebuilding of Afghanistan. We must also recognize that the slowdown will further depress some commodity prices, which will inflict serious losses on some countries, particularly in Africa.

Q: How will the new approach apply to the transition economies of Central and Eastern Europe and Central Asia as well as to the reforming economies of China and Vietnam? In the European Union (EU) many aid officials have started to reevaluate their aid policy, admitting that the policies put in place 10 years ago to help the newly independent countries of the former Soviet Union, trying to prop up democratic institutions and jump-start free markets in places where these institutions were scarcely understood, were "misguided at best, and downright unhelpful at worst." With poverty growing in Central Asia and health care and education levels declining, a new EU policy will be based on alleviating poverty and raising educational standards, as the EU's Javier Solana has pointed out. Is this also the thinking inside the World Bank?

A: The big challenge is to get growth going. The large output declines in much of Europe and Central Asia in the 1990s have put many into poverty and severely damaged social sectors. The Bank will focus more intensively on helping improve the investment climate in transition economies, particularly for small and medium enterprises and farmers. This is also closely related to the efforts to include the poor in the development process. Investing in and empowering poor people will be fundamental.

Q: In one of your speeches given recently in Beijing you compared reform strategies in China and Russia and underlined the importance of building on existing institutions. Many scholars argue that creative destruction, as a major notion of Western development policy, has backfired severely in Russia.

A: In China, life for the new small and medium private companies has been much easier than in Russia, despite the more radical political changes in the latter. In the early 1980s the Chinese authorities removed entry barriers and gave the green light to the development of small and medium businesses. As Deng Xiaoping himself admitted, the authorities couldn't foresee the full consequences and were surprised by the intensity of the response. However, they were ready to follow the course of adaptive learning, and as their successful accession to the World Trade Organization has illustrated, were also ready to undertake courageous steps. In Russia, attempts to legislate almost instantaneously a large array of institutions for a market economy, of which the population had no memory, may well have been counterproductive, particularly in an environment where governance was weak and deteriorating. The result was a slow emergence of the sound institutions necessary to support the markets. In agriculture,

for example, and in contrast to China, the knowledge of how to be a peasant farmer and of who owned what land were simply gone, and bringing it back is hard.

We also have to remember that Stalin's strategy was for an incredibly overintegrated, rigid production system, motivated by politics and ideology, that held everybody hostage to the state and to party apparatchiks. In contrast, China was much more decentralized, so that people's mutual dependence was much more local. There, if a new opportunity came along and somebody wanted to start a business, inputs were locally available. And liberalization, instead of knocking down a rigid system as it did in Russia, produced gains from internal as well as external trade. So the message is not that one country should exactly follow the model of another country, but that one should build on existing institutions. I may add that recently the Russian economy is also showing more hopeful signs. The government is making serious efforts to stabilize the economy, move ahead with structural reforms, and reduce poverty.

Q: Realizing the pivotal role that it will play in the future to uplift the poor, what can the Bank do to improve the negative views about it so as to neutralize the demagogy of the antiglobalist movement and other critics of the Bank?

A. As a former university teacher I believe in the importance of ideas, and thus of exposition, persuasion, clarity, argument, and evidence. I believe that we have to show people evidence of the role that integration into the world economy has played and the success stories of development. And we can demonstrate the failures when countries have turned inward. So we have to set those facts out, and our new study on globalization, which I mentioned earlier, is doing just that. However, we have to recognize that people worry about exclusion. They also worry about cultural and economic domination and about standardization. The development community has to act to address those concerns. For example, we have to make sure that trade rules recognize the interests of the developing countries much more strongly than they do now. The industrial countries spend a total of up to $1 billion a day on agricultural subsidies, which is more than six times the amount they provide in development assistance. Better market access for developing countries is essential. We also have to make sure that intellectual property rights, rules, and regulations are not implemented in a rigid or inflexible way, and that the industrial countries open up their markets more to imports of agricultural goods from developing countries.

Trade alone, of course, is not enough. Sound policies and institutions are crucial, and here the Bank has a central role to play. With good policies, governance, and institutions in place, overseas assistance can be a powerful force for growth and poverty reduction.

Q: Despite its original motto of "the smaller the government the better," to wage a war against terrorism on a wide front and ensure public safety, the U.S. leadership has had to increase the state's role and introduce a range of new government regulations. Does this mean that the pendulum will swing again for the Bank's policy? At the beginning the Bank emphasized the beneficial role of government and of central planning in managing the economy, then praised the invisible hand of the market, especially in the late 1980s and the 1990s. Are we now going back to the age of big government that can protect citizens from the dangers of weapons of mass destruction?

A: I don't think we are seeing a massive switch back to big government; rather, in the last three months we have seen a recognition that the government is responsible for providing security. This may mean that some civil rights we have come to see as natural will now come into question, and as citizens, we have to look at certain things very carefully. But I don't think that is the same as big government. The arguments for government providing good governance, sound institutions, and appropriate regulation, and for government involvement in large parts of the education, health, and social protection systems, are as strong as ever. In these respects the government's role should never have been regarded as minimal. What I would really emphasize at this point is that the world now has a real opportunity to learn from adversity and pull people together. We saw the world do this after World War II, with the creation of the United Nations and the World Bank, and with the start of what has become the EU. Just as combating terror is the responsibility of us all, so too is fighting poverty. And many of the steps that we need to take—such as cutting off financing for terrorists and strengthening states at risk of failure—will succeed only if we do them collectively.

Petty Corruption in the Wild, Wild East

By Scott Thomas

In the early and unsophisticated stages of the transition, people who wanted to gain monetarily from their position in government or their access to public sector officials would target their tender efforts on public expenditures. This meant they either gained access to direct budgetary allocations or to soft loans from public sources that they had no intention of repaying. However, when opening the vein of domestic credit creation through these more conventional means proved hyper-inflationary in so many countries, the hemorrhage was eventually stanched under pressure from the international financial institutions. This led to the more sophisticated rent-seekers we have become familiar with today. These fall into two general types:

Corruption with clout. Those rent-seekers with real clout have utilized it to influence privatization processes, gain control of state-owned companies, strip them of anything of value, default on their liabilities and contingent liabilities, and end up with fortunes. Although much of the cost of this ownership "transfer" was one-off, to the extent that the oligarchs ended up owning or controlling natural or state-sanctioned monopolies, they continue to represent a major deadweight loss to society. The solution is proactive government policy to increase competition, coupled with the enforcement of laws against anticompetitive behavior and, where some form of natural monopoly exists, government regulation.

Petty corruption. Small-timers, on the other hand, have to rely on income from the ubiquitous bribes that are necessary to conduct business in an exceedingly hostile enabling environment. Although not as politically polarizing as the large-scale theft described above, the deadweight loss of small-time official crookery is likely to be just as serious economically in terms of lost sales, jobs, income, and growth, because it preys on the main growth sector: small- and medium-scale enterprises.

The fact is, in many, if not most of the economies in transition, without petty corruption, economic activity would grind to a screeching halt. Why? The complex overlay of economic laws, regulations, inspections, reporting requirements, fees, and taxes, if actually implemented as written, would bankrupt anybody so foolhardy as to follow them to the letter. In many cases following them to the letter is not even possible because they are contradictory and overlapping.

Most countries in transition implemented the maze of economic legislation and regulation without any advance public consultation, or re-

In Country Y Agency Inspectors Have Going (Away) Rate

Each month Country Y (which shall go nameless) requires all enterprises to file four separate payroll declaration forms, containing essentially the same information. Companies are subject to payroll inspections by six separate agencies. Payroll forms and inspection results are not shared among the agencies. The forms must be filed in hard copy, and usually must be delivered in person to each of the four agencies. Forty percent of the companies that had been inspected said they had received visits from representatives of two or more agencies during a short period, a procedure described as extremely onerous by every enterprise manager surveyed.

The social fund agencies, for their part, are inundated with the monthly reports, which burden their staff with so much paperwork they have no time to review and analyze them. One agency representative said, "Monthly reporting is hell for us."

Why all this effort? Because payroll contributions to social funds, health, pension, unemployment, disability, education, and so on are not being paid. On closer inspection, however, it turns out they aren't being paid mainly by the long-bankrupt state-owned or formerly state-owned large enterprises. But as these companies are bankrupt, agency inspectors hardly ever visit them. Instead, they focus on small and medium enterprises. Although these companies are rarely in arrears, the inspectors have broad discretion: they will always find something wrong. The real reason for all this seems to be to benefit the army of inspectors: When last checked, the going rate to make an inspector go away was about $40. Not bad in a society where the average monthly salary was around $120.

ally without much prior analysis at all, and it is rarely subject to any feedback from the citizenry being regulated, or to expost performance review by the agencies supposedly in charge. To be blunt, without a relatively easy way around the incoherent, duplicative, intrusive, and maddeningly time-consuming and costly public sector interference in the economy, no economic activity could survive. And that way is—the bribe.

At a conference held at a major U.S. university some time ago, representatives of public sector institutions of Country Y were almost uniformly blasé about the impact of this kind of petty corruption on their economic prospects. Corruption was universal, the question was only one of degree. It was a form of "networking." Italy was corrupt—and look how successful its economy was. Corruption was embedded in their culture. It was a small cost of doing business. No real harm done.

But that's not the reaction of foreign investors when they're asked about barriers to risking their money in the economies in transition. Here's a sampling of what they tend to say when interviewed about sources of corruption in the wild, wild East:

Currency controls. Currency controls and licensing procedures are often extremely time-consuming, and can harm ventures with foreign partners.

Tax rates. Tax rates, including payroll taxes, are high, and the tax code is an intricate maze, creating disincentives and distortions.

Tariff and nontariff barriers. Tariff and nontariff barriers are often incoherent and distortionary.

Tax and customs collection. Uneven and nontransparent collection of taxes and customs levies creates enormous opportunities for corruption. Import delays are frequently used as an incentive to pay bribes.

Product and building standards. Product and building standards are often significant barriers to investment, are based on outdated methodologies with no reference to cost, and through the threat of significant delays offer significant opportunities for corruption.

Licensing and registration. Regional and local licensing and registration procedures are often fragmented, duplicative, time-consuming and arbitrary, and are sources of frequent corruption.

Redress of grievances. Investors have little recourse for redress of grievances stemming from the arbitrary enforcement of laws, regulations, standards, taxes, and customs levie, or failure to implement contracts with local partners.

The list could go on and on. The point foreign investors are making is that they have other opportunities, with similar potential payoffs, and much less risk of losing the whole venture to a death by a thousand paper cuts. And in fact, Country Y's record is not good: Despite being accepted for entry into the European Union, foreign investors have pretty much given it a miss. With all the lost sales, jobs, income, and growth that has entailed. The deadweight loss of petty corruption, by this measure, may be the difference between growth and no growth.

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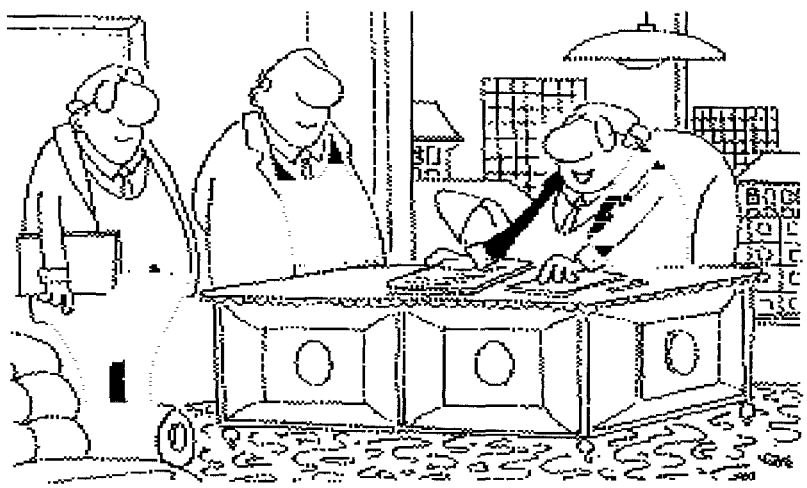
Fortune is Blind—Or Maybe Not?



"My brother-in-law is a really lucky guy. If he wasn't already a millionaire, he might as well play the lottery; he is once again the winner of our open tender."

From the Hungarian magazine *Hócipõ*

Anticorruption Campaigns: How to Get Rid of Paradoxes and Inconsistencies

By Arista-Maria Cirtanutas

International organizations will have to go well beyond their current anticorruption efforts if they want to succeed. They will have to rely more on grassroots organizations and drop their unrealistic zero tolerance demands, and instead, tap into local customs and traditions. The author also suggests that economic and political elites should be held accountable to their own citizens.

Consistent with the recent recognition by international organizations such as the International Monetary Fund and the World Bank that markets will not function properly in the absence of states, they are now paying increasing attention to substantive questions of good governance. As an overarching concept, good governance focuses not only on the appropriate parameters for liberal, capitalist institution building, but also on the standards for appropriate conduct within these institutions. Accordingly, the international development community is devoting ever more rhetoric and resources to the problem of corruption, given the extent to which corrupt practices can subvert the formal institution building process by undermining professionalism, administrative efficacy, and, ultimately, democratic legitimacy.

Converting Hearts and Minds

Even though the local costs of corruption were presumably just as or more burdensome in the days of the Duvaliers and the Idi Amins, the violence of such regimes, the end of the Cold War, and the dynamics of globalization have created new conditions. Under these conditions the corrosive effects of corruption are even less acceptable to international organizations because they are less containable. Consequently, "the fight against bribery and corruption," as the Organisation for Economic Co-operation and Development (OECD) puts it, has assumed global proportions that extend beyond the organization's own *1999 Convention on Combating Bribery of Foreign Public Officials in International Business Transactions* to include efforts being undertaken by the European Union (EU), the Council of Europe, the Organization of American States, the International Monetary Fund, the World Bank, the World Trade Organization, the United Nations, the International Labour Organisation, and even the Open Society Institute. Extensive monitoring and training programs have been established under the auspices of these organizations to promote public administration reforms; strengthen control mechanisms; and perhaps most important, educate both elites and publics in affected countries that the "cancer of corruption," as described by World Bank President Wolfensohn in his 1996 annual meeting address, is a serious matter.

An impressive, almost missionary effort in the form of anticorruption campaigns and international conventions is under way to convert the hearts and minds of people around the world to a universal set of norms and principles defining ethical and professional conduct. While the international organizations promoting this new "climate of civic responsibility and ethics" ("Corruption in Poland: Review of Priority Areas and Proposals for Action," World Bank, Warsaw, October 1999; and "Assumptions of Poland's Anticorruption Strategy," 2001, http://www.worldbank.org.pl/html) are often supported locally by concerned citizens and public officials, the heavily promoted, supposedly universal standards are clearly derived mainly from idealized Western standards and are meant to supersede local customs and practices. The OECD convention, for example, states that bribery is an offense regardless of "the value of the advantage, its results, perceptions of local custom, the tolerance of such payments by local authorities, or the alleged necessity of the payment." Even seemingly harmless "common practices, such as gift-giving to employers, superiors, et al, in positions of influence, are inherently inimical to procedures such as formal tendering."

Perhaps nowhere is this internationally orchestrated "clean-hands" campaign more evident than in the efforts to combat corruption in Eastern Europe and the former Soviet Union. Because of their geographic proximity and growing economic interdependence, not to mention pending EU membership for at least four or five countries in the region (the Czech Republic, Estonia, Hungary, Poland, and Slovenia), the dangers posed by

the "contagion of corruption" have spurred Western efforts to promote anticorruption measures throughout the region. As these measures have not yet met with overwhelming success, the EU, as the most concerned Western organization, continues to voice its reservations, most recently in its 2001 "Enlargement Strategy Paper" (http://europa.eu.int/comm/enlargement), the annual progress report for candidate countries. The paper points out that "previous reports identified corruption as a serious problem exacerbated by low salaries in the public sector and extensive use of bureaucratic controls in the economy. This assessment remains largely valid, although several positive developments have taken place. In most countries anti-corruption bodies have been strengthened, and progress has been made in legislation, in such areas as public procurement and public access to information. Encouraging developments in several countries as regards the reform of public administration also contribute to the fight against corruption. Notwithstanding these efforts, corruption, fraud and economic crime remain widespread in many candidate countries, where they contribute to a lack of confidence by the citizens and discredit reforms. Continued, vigorous measures are required to tackle this problem."

Factors behind the Failures

Given the attention focused on this fight against corruption, especially in Eastern Europe, and the orchestrated international effort behind it, how can the ongoing failures be explained?

Most obviously, one can blame **the vested interests** that local politicians and civil servants have in resisting anticorruption measures that would reduce their opportunities for graft and rent-seeking. This is clearly the answer favored by many Western experts and advisers who bemoan the lack of political will in the transition countries.

One could also point to the resiliency of **customary practices of local communities** where corruption functions not just as an instrument of exclusion and privilege, but also as a mechanism for individual survival and resistance to externally imposed rules of conduct. Just as the U.S. war against drugs has run aground, in part because of the intransigence of drug-producing communities whose livelihoods depend on the drug trade, so too ordinary people, not just corrupt elites, will resist the fight against corruption. The former might understand the problematic nature of their conduct, but may still depend on corrupt practices simply to get by.

While both explanations are doubtless relevant, a third factor may also provide some insight into why Western anticorruption campaigns have not been as effective as hoped in Eastern Europe and elsewhere. Along with the vested interests and the practices of the targeted populations, the **paradoxes and inconsistencies of the anticorruption efforts** themselves may also have diminished their impact.

At first glance the current campaign appears quite comprehensive and well laid out. For example, having learned from past mistakes, international organizations are now quite cognizant of the need to involve civil society in the campaign against corruption rather than relying solely on elites who can too readily bend anticorruption campaigns to their own purposes. Accordingly, organizations from the World Bank to the OECD and the EU all agree that "as stakeholders in the quality of governance and as intermediaries for communication between the populace and the institutions of the state, the organizations that comprise civil society can be essential in constraining corruption" (*Anticorruption in Transition: A Contribution to the Policy Debate*, World Bank, Washington, D.C., 2000). On a similar note, the World Bank's 1999 report on Poland cited earlier concludes that the assistance of civil society is essential to establish "priorities and modes of operation. And it will also be important to tackle public apathy if anticorruption efforts are to have any credibility and command the support they need to be successful." In building anticorruption coalitions, international advisers are energetically pursuing—as necessary and desirable—partnerships with civil society organizations. They view these relationships as crucial, not just for the constructive synergy that can result from state-society interactions, but because the widely recognized public apathy regarding these matters, especially in Eastern Europe, represents a formidable stumbling block.

In addition to engaging the social dimension, international anticorruption strategies have also become more multifaceted, going beyond legal and technical enforcement mechanisms in the attempt to create a culture of decency and integrity-based ethics management. Remarkably, nothing less than a fundamental human transformation appears to be at stake in which cultures of hypocrisy are to be transformed into cultures of virtue and professionalism. Perhaps realizing that markets require not just states, but also civilized conduct, the international community is now intent on promoting such apparently indispensable "protecting principles" as public duty and professional commitment.

Inconsistencies in Design and Implementation

While more encompassing and ambitious than past anticorruption efforts, the current campaign is flawed in both design and implementation for a number of reasons.

Whereas Western states are simply invited to overhaul their fundamentally sound systems of governance, by contrast, East European states are told that they must engage in substantive reforms as a condition of membership in the Western club as represented, for example, by the EU. While qualitative differences in governance between Eastern and Western Europe certainly exist, given the recent, very public problems of corruption in France, Germany, Italy, and the EU itself, not to mention the atmosphere of electoral fraud and disenfrancisement surrounding the last U.S. presidential election, greater attention could be devoted to the shared problems of political corruption and weakened democratic legitimacy.

Disjunction between the stated intention of involving society at large in the effort and the continued emphasis on the role of elites is a less obvious, but critical, inconsistency in the design of the international anticorruption undertaking. For example in the transition from the vicious circle of monopolistic rent-seeking to the virtuous circle of diminished control rights and limited discretion, transparency, and accountability is assumed to rest almost entirely on the shoulders of "decisive political leadership" capable of pushing through the necessary reforms. As these same political leaders remain located within the unreformed structures highly conducive to corruption, the fact that the required anticorruption leadership has not been forthcoming in Eastern Europe is hardly surprising. Even in a country like Poland, where the media and the public are quite well informed about the existing levels of corruption and where every effort is being made to pass all the right laws mandated by the international community, the World Bank is still waiting for decisive leadership to move beyond formal compliance to a substantive transformation of the system of governance.

Zero Tolerance?

Rather than waiting for a *deus ex machina* committed to battling corruption from the top down, a more profitable approach might be to focus on bottom-up, socially integrated solutions capable of altering the overall public environment in which elites operate and to which they are accountable. This type of engagement with social actors would, however, have to be sensitive to prevailing public opinion in Eastern Europe regarding politicians and state administration in general. For the most part, people appear to agree that public officials will always steal, but that they should also keep such activities within certain rules or boundaries. Under these conditions, the zero tolerance anticorruption campaign international organizations favor is likely to be deemed unrealistic, if not hopelessly naïve and needlessly rigid. Even if "low pay is no excuse for illegal or unethical behavior," as the OECD's elaboration of an "ethical infrastructure" asserts, populations struggling to survive are unlikely to be sympathetic to such puritan pronouncements. Thus the focus should shift to provoking public discussion of what exactly the self-limiting rules and boundaries in any given institutional setting should consist of.

From a sociological perspective, corruption can be analyzed not just in terms of the unethical or criminal use of public office for private gain, but also in terms of the bonds of reciprocity and interdependence that structure the interactions between elites and the public. If significant groups in a given society believe that a breakdown in these bonds has occurred and that restoring relationships of respect and trust is vital to the government's stability, then international efforts could usefully be directed toward helping to reestablish such bonds. International organizations must accept that these will vary from case to case and, more to the point, will no doubt deviate from idealized Western standards. If, however, communities see local social networks as adequate or necessary guarantors of their survival, such networks are unlikely to be amenable to reform, no matter how corrupt outside observers deem them to be. Anticorruption campaigns must therefore genuinely resonate with local community concerns regarding the extent to which the norms and practices of reciprocity have eroded, thereby posing a threat to the community's very endurance. By tapping into the values of the local "moral economy," anticorruption campaigns could well succeed in diminishing truly harmful corrupt practices over time. This might not occur in the revolutionary led-from-above sense envisioned by today's advisers, but amelioration as an evolutionary development predicated on social—as opposed to purely political or sweeping cultural—transformations might well come about.

Accountability to Own Citizens

Because the EU's Phare programs for civil society development in Eastern Europe had previously come under critical scrutiny and been subjected to budget cuts, the EU's

capacity and will to develop state-society partnerships have been curtailed, especially in the most ostensibly developed East European countries. Instead, as the date of enlargement draws nearer, concern has shifted toward establishing the proper "control environment" in the leading candidate countries to promote sound financial management via internal supervisory and auditing procedures.

- The narrowing of the EU's focus to civil service reform may pose additional dangers if the outcome is the creation of closed mandarin-like elites with greater accountability to the EU than to their own citizens. We have already seen the extent to which nongovernmental organizations in the region can become more accountable to international donors and supporters than to their own communities. Teaching professionalism to East European elites in Brussels and elsewhere in Western Europe or training them in the twinning procedures established to provide Eastern European administrators with Western European advisers and partners will, no doubt, enhance efficiency and promote merit-based appointments. However, whether this type of training will result in administrators responsive to the needs of their citizens is doubtful in the absence of parallel funds and attention paid to the development of social actors who can demand responsiveness.

In remaking local elites in their own idealized image, Western organizations may well be forging bonds of respect and trust between international and national elites, which will help to contain the contagion of corruption. But if this protective firewall for the West comes at the expense of reinforcing the moat that already divides postcommunist politicians and civil servants from their own populations, the social cost in Eastern Europe will be immeasurable.

The author is assistant professor of government and foreign affairs at the University of Virginia. This article is an abridged and updated version of her article "Corruption and the New Ethical Infrastructure of Capitalism," published in the spring/summer issue of the East European Constitutional Review, a joint publication of the New York University School of Law and the Central European University in Budapest.

Writing an Effective Anticorruption Law

By Richard E. Messick and Rachel Kleinfeld

As growing numbers of citizens in developing and transition countries have suffered at the hands of corrupt officials, they have started to demand government action. An obvious first step is ensuring that laws to deter corruption are in place. Deterrence is not the first, or necessarily the preferred, method of defense. An informed and vigilant citizenry, government employees endowed with a service ethic, and other measures can be more effective in combating corruption. However, achieving those objectives takes time, while enacting an anticorruption law is a relatively speedy, inexpensive way to start addressing the problem. As a result, laws that punish bribery and other forms of corruption have proliferated throughout the developing world.

The problem with these laws is that often they do not reflect the limitations of the institutions that enforce them, be they the police force and public prosecution service or a noncriminal administrative agency. Many recent anticorruption initiatives have also overlooked complementary legal reforms that can prevent or expose corrupt acts.

Law Enforcement Capabilities

Anticorruption and ethics laws generally encompass a variety of statutes that prohibit bribery, nepotism, conflicts of interest, and favoritism in awarding contracts or providing government benefits. Such laws often also require public servants to disclose their incomes and assets. When drafting such acts, the instinct is to list every activity that could conceivably be considered corrupt and then write language making each illegal. The result is often a broadly drawn provision setting out a general standard, such as the provision found in several nations' laws that make the "abuse of public office for private gain" a crime.

Such sweeping language does address bribery, nepotism, and conflicts of interest, but bureaucratic and political rivals can also invoke it to question perfectly innocent actions by those holding public office. Accordingly, those who draft anticorruption legislation should ask several questions: What is the capacity of the institutions that will enforce the law? Are the police, prosecutors, courts, and other enforcement agencies staffed by honest, technically competent professionals? Are they independent of the executive? To whom, and in what ways, are they accountable?

The answers to these questions will often not be reassuring. In many countries enforcement institutions lack skilled professionals. Moreover,

the employees of such institutions are often easily manipulated for political purposes. World Bank surveys have found that the poor rate the police and other enforcement agencies as some of the most corrupt and least trusted government agencies. Reformers may believe that anticorruption work cannot proceed until enforcement agencies are strengthened. But while capacity building is essential for the long-term sustainability of an anticorruption program, it takes time.

Adopting "Bright-Line" Rules

Those writing anticorruption statutes must take into account the weaknesses of the agencies that will enforce the law they are drafting. In most cases that means writing a law that is easy to understand, simple to apply, and demands little or no judgment in determining its applicability. Laws written this way are said to contain "bright-line rules" as opposed to those containing standards that are open to interpretation by enforcement agencies.

If hiring a relative were against the law and an official's nephew suddenly appeared on the payroll, the ethical breach would be obvious. By contrast, if the law contained an exception for "qualified" individuals, endless arguments about the nephew's qualifications could ensue, muddying the question. With bright-line rules citizens, the media, and watchdog groups can readily determine whether the government is serious about enforcing anticorruption laws.

Countries with weak enforcement institutions should consider including the following bright-line rules in their anticorruption laws:

- No government employee may receive any gift, payment, or anything of value in excess of a small sum from anyone who is not a member of that person's immediate family.
- No employee may hold, directly or indirectly (that is, through family or other agents), an interest in a corporation or other entity affected by that employee's decisions.
- Every year all employees above a certain pay level must publicly disclose all the assets they hold directly or indirectly.
- No employee may hire a relative (with a precise specification on how distant relatives must be before they are not considered relatives).
- All employees must disclose any relationship with people hired and with firms or entities to whom they award a contract or concession.

No statute can avoid some open-ended provisions. If a section in an anticorruption law must leave something open to question, one way to reduce enforcers' discretion is to establish a procedure for obtaining advance rulings. Employees concerned about doubtful cases can then ask representatives of the enforcement unit for an advance ruling on the legality of a proposed action. Gradually, the accumulated opinions will develop into a body of law to guide both the courts and those subject to ethics guidelines.

Complementary Laws

Statutes outlawing bribery, nepotism, and other corrupt acts should be complemented by laws that help bring corruption to light. **Freedom of information laws** are one example. Such laws require the government to disclose information about its activities at the request of any citizen and watchdog groups can use them to monitor government behavior.

Similarly, in recent years several countries have adopted **whistleblower protection laws**, which encourage government employees to reveal corrupt acts they have uncovered in the course of their work without fear of retaliation.

Libel law reform can also be an important part of anticorruption legislation. Some countries' laws make it a crime to publish anything that brings the government into disrepute or insults a government official. Under such laws a journalist who accuses an officeholder of accepting bribes or otherwise acting corruptly can be fined and jailed regardless of whether the allegation is true or false. To ensure that fear of prosecution does not deter the press from exposing corruption, many industrial nations make it difficult for government officials to obtain compensation if they are libeled by the press.

National legislation alone is not a panacea; **international cooperation** is also required. In cases involving large sums of money, recouping stolen funds is often problematic because corrupt officials can stash assets abroad. Treaties should be considered that would permit a requesting country to overcome bank secrecy laws and other obstacles to recovery. Transparency International's *Source Book* (2000) lists dozens of other systemic reforms needed to root out corruption.

This is a shortened version of the authors' article, published as a PREM Note, in October 2001, and available on http://www-wbweb.worldbank.org/prem/pas/premnotes/PREM note58.pdf. Richard E. Messick is a senior public sector specialist, and Rachel Kleinfeld is a consultant in the Public Sector Division, PREM Network, World Bank.

Slovak Republic's Fight Against Corruption—Excerpts from a Government Report

The Slovak Republic adopted a national program to fight corruption in June 2000. The program has the following objectives:

- **Eliminating opportunities for corruption.** The principal remedy in this area is access to information. The Free Access to Information Act, in effect since January 1, 2001, is one of the main pillars of the program. In principle, this act allows access to any information other than classified data. It also mandates increasing the transparency of public administration as a whole; minimizing subjective elements in decisionmaking; removing unnecessary administrative barriers; enhancing the transparency of public procurement; and eliminating corruption in state enterprises, mainly by reducing the government's influence.

- **Increasing the risks of engaging in corrupt practices.** In addition to prevention, corrupt practices must carry a greater risk. Thus public officials must be required to submit declarations of their assets. Moreover, investigation methods need to be considerably strengthened, including the deployment of special agents to combat corruption. The risk associated with corruption can be increased through harsher punishment.

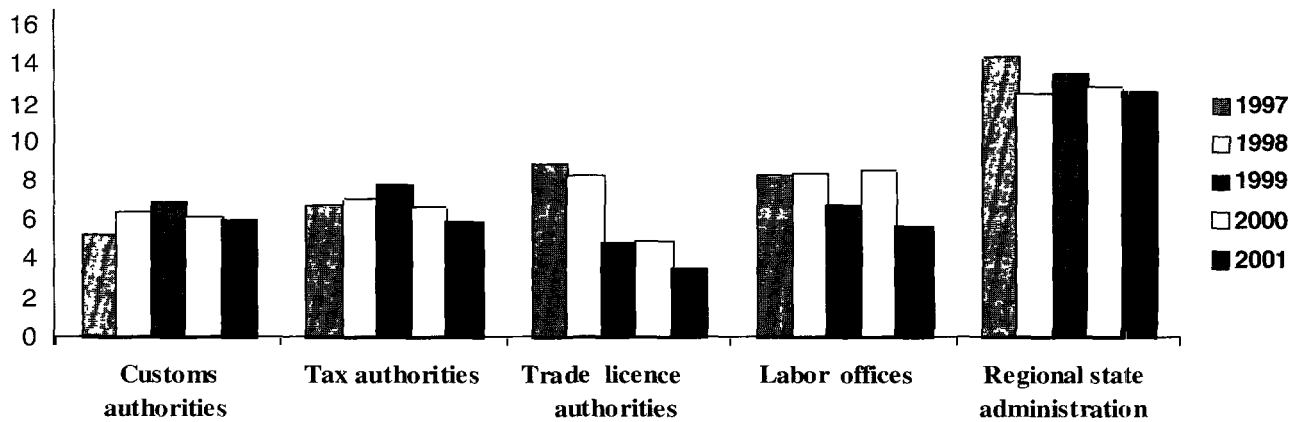
- **Enhancing public sensitivity to corruption.** The first barrier to corruption, which must be as strong as possible, is high personal and moral standards. To this end, the public must incessantly be informed of the harm corruption causes. Detected corruption cases should be brought to the attention of the public, together with a computation of the estimated damage. Education should be aimed at lowering the public's tolerance of corruption. Enhancing public sensitivity should start at school in the context of ethics classes. Nongovernmental organizations and the media should be enlisted to cooperate in enhancing public awareness.

Some early results of the fight against corruption include the following:

- **Criminalization of corruption.** Corruption was criminalized under the Criminal Code on April 11, 2001, and the government approved the imposition of harsher sentences for corruption. The upper limit of a jail sentence for bribery was increased from one to two years and for the abuse of office from two to three years.

- **Case distribution.** A computer-based system for randomly distributing cases to judges was introduced at the Banská Bystrica District Court in cooperation with the Swiss Ministry of Justice. This system speeds up court procedures and guarantees the observation of the constitutional right to a lawful judge by preventing the arbitrary assignment of cases. This model will be implemented at all district courts throughout the Slovak Republic.

Perception of the need to give a bribe, 1997-2001
(percentage of those surveyed in a sample conducted in 2001)



Source: Slovak government's report 2001

- **Company register.** Regular operation of the company register started on January 1, 2001, and has helped create a more transparent business environment. Accelerated procedures, such as those for processing applications for entering a company in the company register, are also expected to help curb corruption.

- **Ombudsman.** A law that is currently under preparation will regulate the status of the human rights ombudsman, whose aim is to help people exercise their constitutionally guaranteed rights and freedoms.

- **Act on free access to information.** The right to be informed helps prevent situations likely to give rise to corruption from developing, increases the risk of detection, and allows the public to scrutinize the exercise of public power and the use of public funds. As mentioned earlier, access to information is open to everybody. Applicants are not required to give reasons for or to justify why they are requesting access to information.

- **Register of licenses, concessions, and permits.** The aim of this register is to list licenses and permits issued by central government agencies to increase transparency and identify potential problem areas.

- **Law on lobbying.** A working group has been set up to prepare this law.

- **Cadastral authorities.** Work is under way to improve the cadastral authorities, which according to diagnostic surveys are affected by corruption.

Excerpted from the government's report on the Fight Against Corruption in Slovakia, published in October 2001, www.government.gov.sk

Corruption: The Enemy of Progress

By Jennifer Munroe

"Corruption and social inequality make people cynical about democracy," noted Bulgarian President Petar Stoyanov, opening the Partners in Transition conference held in Sofia, Bulgaria, in September 2001. One major topic of the conference—organized by the Center for Institutional Reform and the Informal Sector (IRIS), together with USAID and KPMG Consulting—addressed the obstacles posed by corruption. In the months preceding the conference, IRIS organized working groups in six countries (Albania, Bulgaria, Georgia, Hungary, Russia, and FR Yugoslavia) to address the theme of corruption.

Corruption is reversing some of the gains achieved by transition countries over the last ten years, and continues to pose several threats. It can hold back economic reform by distorting government policies and by diverting private sector effort from value-added investment to lobbying and rent-seeking. It tends to drive new firms underground, siphon resources offshore, and dampen incentives for foreign investment. Worse, when corruption seriously compromises the legal system, predation can reach catastrophic dimensions, essentially shutting down the economy.

While corruption clearly has damaging effects, it is fundamentally important for reformers to bear in mind that corruption is a symptom of underlying institutional imbalances. These include subordinate judiciaries and audit systems, perverse incentives in the civil service, weak civic institutions, and skewed relationships between government and the private sector.

Recent literature suggests that there are two main categories of corruption in transition countries: state capture and administrative corruption:

- **State capture:** if individuals, groups or enterprises seek to influence the formulation of laws, regulations, and policies, so as to secure special advantages. In some transition countries, this activity has diverted significant attention away from market-oriented restructuring of the economy and toward the entrenchment of oligarchical power through state intervention in banking and industry.
- **Administrative corruption:** if individuals or groups provide illicit gains to public officials in exchange for advantages created intentionally distorting the implementation of existing laws, rules, and regulations. Administrative corruption takes such forms as the exchange of bribes for the unlawful granting of licenses, state bank loans, privatization awards, court judgments, and infrastructure contracts; "grease payments" to secure permits, customs clearance, and government services to which the payer is entitled; and the misdirection of public funds by state officials for their own, families,' or friends' benefit.

In many transition countries, corruption is "path dependent"; that is, it represents the continued mingling of state and enterprise interests and decision-making through non-transparent channels of personal influence, both of

which were prevalent under the Communist system. That system also left a legacy of state dominance and feeble civic organization. Moreover, the economic, administrative, and political changes associated with the transition of the past 12 years have created additional incentives for corruption, including falling wages and morale of public servants and weak administrative taxation systems.

Various Strategies

What is to be done? Speakers at the Sofia conference reported the strategies they have developed to address corruption, and their attempts to implement reforms.

H. E. Mikheil Saakashvili, then the Georgian minister of justice, listed three core components of the transition that facilitate corruption: the wholesale revision of legal and regulatory systems, the massive redistribution of assets, and the absence of countervailing institutions. Under these conditions, corruption tends to build and sustain the rule of oligarch groups, especially through their undue influence on state policy processes and control of the media.

This suggests that fighting corruption must be an integral part of building an accountable government. In general, corruption in industrial countries can be reduced by an effective and transparent state administration coupled with an active civil society. Georgia has made some progress on this front, with its reform of the judiciary to require qualifying exams, and establishment of an open public register of income declarations by government officials (see box).

Other speakers gave additional examples of policy changes that help combat corruption, such as improving financial audits (Hungary), abolishing compulsory foreign trade permits (Yugoslavia), and reforming customs valuation (Bulgaria). Many speakers also stressed the importance of external forces, such as ratification of the OECD convention and the run-up to EU accession—including the adoption of harmonized legislation—as providing helpful incentives for countries in the region to address corruption seriously.

Speakers from Albania and Bulgaria each referred to the financial crises in their countries during the 1990s,

Rule of Law Project Brings Quiet Reform to Georgia

Georgia's new Freedom of Information chapter of the General Administrative Code affects the life of almost every Georgian. For example, the city government of Tbilisi is required to give information, if asked, about the money it spent on new cars for city officials. Since the media will also have access to this information, the local government is likely to be more careful about how it spends the taxpayers' money.

It used to be very difficult to get in touch with most government officials, or even to learn who they were. Today, if you walk in to the State Chancellery building, you find a list posted with the names of the government officials that work there, their title or position, and their telephone numbers and room numbers. If you are denied information about your pension by the government, there is a set process now that you can follow to have this decision reviewed.

These are not big, exciting changes that get everyone's attention. But multiply the effect of these examples throughout the country, and at every level of government, and you begin to see how changes in the law can make Georgia a better place to live and work.

Administrative law comprises those rules that affect the way government does its business. With the assistance of USAID and its contractors, Georgia adopted a important new General Administrative Code in 1999. This code included the freedom of information rules, which were the most progressive ever passed in the former Soviet Union and have become a model for other states.

This fall marked the award of a $10.8 million, four-year contract to the IRIS for the USAID Rule of Law project in Georgia. IRIS has been working in Georgia for several years, and was instrumental in the adoption of the administrative law reforms.

"The kind of transparency and accountability that these reforms can provide will not only make the government work better, but make it increasingly difficult for corruption to flourish," Howard Fenton, local director of IRIS's Georgia project, pointed out.

IRIS will be working with several Georgian NGOs. in conjunction with the Georgian Young Lawyers Association and the Liberty Institute, the project will help raise people's awareness of their legal rights and help the government administer laws in a better and more open fashion by working with individual ministries.

and stressed the linkage of those crises to corruption. They also suggested that the weakness of the media played a significant role in perpetuating systemic corruption in both countries. Boiko Todorov, coordinator, Southeast European Legal Development Initiative Coalition 2000, Bulgaria, suggested that organized crime and trafficking, key factors generating corruption in the Balkans, arise from that region's instability and underdevelopment. A regional approach is therefore needed to address corruption effectively.

Business Capture

Gyorgy Satarov chairman, Indem Foundation, Russia, presented a brief analysis of data from the World Bank's study *Aggregating Governance Indicators*. The data suggest a non-linear relationship between the progress of transition, on the one hand, and of state capture on the other. The two advance in linear fashion until a midpoint of instability, where, in the successful countries, state capture declines as the transition advances, but in the unsuccessful cases, state capture continues to increase while the transition's progress is reversed. The latter trajectory seems to involve another form of capture, "business capture," in which officials gain control over private firms to extract rents.

Boris Begovic, chief economic advisor to the deputy prime minister, Federal Republic of Yugoslavia presented a survey from Serbia that found that multiple bribing of officials by respondents was prevalent, that bribers normally receive the services they have "paid for," and that both the share of turnover and of senior officials' work time devoted to corruption are substantial. The core anticorruption strategy in Serbia should be deregulation, and therefore elaborate strategies and anticorruption commissions would be unnecessary, Boris Begovic suggested.

To sum up, corruption has clearly became a high priority item on the reform agenda of both governments and civic organizations. Understanding of the causes, mechanisms, and consequences of corruption is advancing as studies proceed across the region.

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How Hungary Escaped Transition Failure and Runaway Corruption

The early 1990s in Hungary were marked by rapid institutional change and severe economic downturn. Credit relations and the financial system generally suffered from widespread corruption, including the exchange of loans for bribe, self-enrichment schemes and manipulation of such procedures as bankruptcy, state-initiated debt restructuring programs, and banking supervision processes. The cost of this early rash of corruption and later episodes through the 1990s easily runs into hundreds of millions of dollars.

Many countries in similar circumstances have failed to come to grips with these problems, with disastrous results—the paradigm example being Russia's experience leading up to the crisis of 1998. There, rapid privatization (in the absence of functioning safeguards and market institutions) opened the door to massive self-enrichment by enterprise insiders, and the recycling of funds through a loosely supervised banking system. This led to the rise of oligarchs who bent the system to their will, creating public giveaways and a culture in which lobbying and self-dealing trumped the profit motive.

Hungary saw the beginnings of this in the early 1990s. Its experiments with market socialism had ushered in a complex and murky business environment. Hybrid (state-private) corporate groups, in many cases run by (former) state managers, linked enterprises, banks, and the state in an often collusive mutual embrace. Studies elsewhere have shown the governance failures that arise (with resulting underperformance and vulnerability to crises) where financial institutions are predominantly conglomerate- or state-owned, especially in emerging markets. In these situations, financial flows often depend far more on politics and personal networks than on transparent accounts and legal arrangements.

What could be done about this? Focusing on a direct assault against corruption would likely prove wasteful at best, if not disastrous, in a context

where market institutions and the rule of law have only just begun to emerge. This suggests that establishing effective governance in the economy must be among the first priorities for a number of reasons, including the reversal of the wrong incentives. Thus the choices confronting Hungary in the early 1990s were tough, and the stakes high. Should privatization be rapid or gradual? Should market institutional reform be strict and sudden, or slow and accommodating? Should banking reform center on existing institutions or rapid influx of new ones? Hungary escaped the trap of failed transition that would have meant a spiral of distortion, stagnation, and corruption. The main steps in the reform were the implementation and adjustment of a legal reform package known as "legislative shock therapy," a (highly flawed), debt restructuring process, and robust privatization—especially of state holdings in the banking sector. These changes helped create one of the strongest financial sectors in the region along with a competitive and reasonably well-governed market.

These reforms revolutionized ownership incentives and imposed transparency on the system. The influx of foreign owners, together with the growing strength of markets and public sector institutions, brought banks and enterprises under the effective discipline of corporate governance and regulation. This helped create one of the strongest financial sectors in the region, a vibrant economy, and a reasonably well-governed and competitive marketplace. Corruption in the financial system, nearly a way of life in 1991, has become far more episodic and manageable. Having significantly improved both corporate governance and state oversight institutions, and having substantially divested its holdings in the real and financial sectors, Hungary is poised to emerge from its market transition. The disciplines imposed by the applicable international regimes, especially the EU, have played an important role.

The lessons learned from this experience include:

- Binding outside constraints (in Hungary's case, huge foreign debt) can effectively motivate restructuring.
- Intelligent incrementalism can succeed (Hungary averted the temptation of a large-scale mass privatization, instead sold the state-owned companies for cash—which proved to be more time-consuming, but also more rewarding).
- State ownership can be made accountable if it is sufficiently small, in a context of meaningful political and market competition.
- High levels of foreign direct investment—especially by strategic investors—are fundamental to timely emergence of sound banking and corporate governance in transition environments (In the period 1990-2000 foreign direct investment flows to Hungary reached almost $20 billion, compared with its population of 10 million).

This case study and the others in the series—on infrastructure projects in Nepal, customs reform in Bolivia, and electoral campaign finance in Argentina—are available on the IRIS web site at http://www.iris.umd.edu.

World Bank\IMF\EBRD Agenda

World Bank Is Drafting New Assistance Strategy for Russia

The new, two-year World Bank strategy for Russia is currently being prepared and is scheduled to be discussed by the Bank's Board of Directors in April 2002, Julian Schweitzer, director of the World Bank's Moscow Office, announced during a recent press conference in Moscow. The Bank has started releasing $600 million in loans to Russia for six previously approved programs. The six projects include a $85 million loan for municipal heating, $122.5 million for municipal water supply and sanitation, $50 million for education reform, $80 million for promoting relocation of far north residents, $60 million for a forestry pilot project, and $200 million for a coal and forestry coguarantee. In 2002 the Bank may lend Russia another $600 million.

IMF Backs Bankruptcy Plan to Protect Indebted Countries

The International Monetary Fund's (IMF's) management has thrown its weight behind a radical plan for an international bankruptcy procedure that will allow indebted governments to seek legal protection from private sector creditors. Describing the plan as "the missing element we must provide" in the global financial system, on November 26 IMF Deputy Managing Director Anne Krueger said the Fund should have the power to impose temporary standstills on debt payments while countries worked out restructuring deals with their creditors. "At the moment, too many countries with insurmountable debt problems leave it too long, imposing unnecessarily heavy economic costs on themselves and on

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China's Own Path toward a Market Economy: Interview with a Prominent Reformer

By Pál Réti

Pal Réti, editor of the World Economy Weekly, Hungary's leading economic magazine, recently interviewed Chi Fulin, executive director of the Haikou (Hainan)-based China Institute for Reform and Development and a regular contributor to this newsletter, during a visit to Hungary. The interview touched upon a wide range of topics currently hotly debated in China. This article is an edited translation of the original interview.

In the first half of the 1980s, Chi Fulin taught political science at the University of Defense in Beijing. In 1986 he moved to the Central Office of Political Reforms headed by Prime Minister Zhao Ziyang. He has held his current position since 1991.

Q: China's membership in the World Trade Organization is now official, which means that government officials can no longer interfere in and control the state-owned enterprises. Are they willing to refrain from doing so?

A: Yes, they are. About 220 Chinese laws that are incompatible with World Trade Organization rules have to be changed. Our objective is clear: companies should be independent and the government should not interfere in their affairs. Chinese courts are also playing a greater role, for example, when state-owned enterprises sue the government. Just recently a small, partly state-owned, but majority privately-owned, company based in Hainan sued the state-controlled securities commission for not allowing the company to issue shares on the stock exchange. Initially the court rejected the complaint against the state, but following an appeal, the company won the case.

Q: Hungarian experience shows that the main instrument whereby the Communist Party exercises control over companies and other institutions is the policy of cadre management. Is the Chinese Communist Party ready to give up that privilege?

A: This is an especially important issue in China. The previous policy of cadre management was certainly faulty in many ways, for example, it was a breeding ground for corruption. We have already progressed in four areas. First, senior officials, that is, ministers and regional secretaries, are chosen by the competent party, or more often by state agencies, after the opinions of some 100 to 200 department heads, directors, and other senior officials have been taken into account. If these opinions are negative, then candidates find it difficult to obtain the positions they are seeking. Second, lower-level positions, that is, directors and department heads, are officially advertised and all affected are asked to give their opinions on the applicants, which could number in the dozens or hundreds. Candidates are chosen on the basis of these opinions. Currently, individuals with university degrees can obtain such positions without being party members, which is a relatively new development. Third, company manager positions are also advertised and notices about vacant positions indicate the salary that goes with the position. Fourth, at an even lower level, that is, in villages and small towns, residents freely elect local leaders.

Q: Two decades ago the Chinese reform process started in the countryside with the reorganization of the production of goods. However, observers have recently said that the agricultural reform is loosing momentum. What do you think should be done about this?

A: The lack of up-to-date agricultural technologies and the low quality of Chinese agricultural products is due mainly to the unclear legal status of land leasing. The law currently allows peasants to cultivate a certain area of land based on a 30-year lease. However, as land is collective property, if they wish to, local authorities can assign such parcels to different lessees every year. This keeps the peasants in a state of perpetual uncertainty. We would like the People's Congress to pass a law on land leasing next year that would prevent interference in the use of land. That would allow peasants to cultivate the same piece of land for many years. They would be able to invest in it, to mortgage it, even to sell the lease if they moved elsewhere. This would be an enormous positive change for China's 800 million peasants.

Q: Market forces are already influencing the agriculture and industry sectors, but what will happen to such state monopolies as telecommunications, air and rail transport, or the energy sector?

A: We should pass laws that would create a legal framework for market competition in such sectors, including allowing foreign ownership of companies. Such reforms have started, and these companies have already been transformed into shareholding companies. For example, the local government owns only 10 percent of the shares of Hainan Airlines, while private companies and individuals own the other 90 percent.

Q: Did you also buy some of these shares?

A: Many of my friends have bought some, but my position as director of the provincial reform commission precludes me from doing so.

Q: In one of your papers you wrote that during the process of transforming the state-owned banks into shareholding companies, an enormous amount of irrecoverable debt came to light. How is China addressing this problem?

A: About 20 percent of the state-owned banks' debts are bad and may not be paid back, and another 5 to 8 percent of loans are definitely irrecoverable. The banks transformed some of these loans into shares. Larger banks created their own debt management departments or affiliate companies to reorganize their bad debts and sell them if possible. Those small or medium state-owned enterprises that accumulated too much debt should go bankrupt. I believe that radical solutions should be applied in such cases, and that related companies should be relieved of their bad debts and those that operate under market conditions should start out with a clean slate.

Q: In your writing you emphasize the need for China to adopt a classical market economy, but at the same time you often mention that China should develop a socialist market economy. Why?

A: I use the term people's market economy—which is also the title of my book to be published next year—in which the main role in the economy is assigned to workers. We have to take into consideration that China's workers created an enormous amount of property. János Kornai, the famous Hungarian economist, wrote a book about the shortage economy in socialist countries. I would address this same problem as one of a shortage of ownership rights. This theory was tested when Hainan's state-owned company that produces drinks from coconuts was transformed into a shareholding company. The company's employees all received a small portion of the shares for free and more shares for a third of their market price. We must also bear in mind that more highly qualified employees contribute more to a company's capital accumulation, and thus deserve a bigger share. In the case of the coconut drink company, the management received 25 percent of the shares and other employees got 75 percent.

Q: China has several models of economic transformation to choose from, ranging from that applied in the Czech Republic to that used in Tajikistan. Which model will China choose?

A: My institute has been carrying out research on the various transformation models and practices for years. We think that China is too big a country to follow any one particular model. However, the Hungarian reforms—which assured the stability of the transformation—have some valuable lessons for us, especially those introduced in the 1980s. When we visited Russia recently, we were quite surprised to learn that the Russians are extremely interested in the Chinese reforms, and generally believe that their own shock therapy has been a failure.

Q: China is the only large region where economic growth did not slow down significantly and is running at well over 5 percent per year. How long can China sustain this growth rate during the current slowdown of the world economy?

A: In the first half of 2001 China's GDP grew by 7.8 percent, and economic growth for this year will not be less than 7 percent. However, while the worldwide slowdown, especially that of the United States, will certainly influence China's economy, we have some advantages that can balance these influences. The domestic market is reviving and market forces have started to boom in the countryside. Private enterprises have gathered strength and progress has been enormous. In the next five years, investments in infrastructure alone will reach $100 billion, and China will spend an additional $30 billion in investments related to the 2008 Olympics. These developments will significantly influence China's economic growth.

Q: Two years ago I interviewed Fang Gang, economic advisor to the Chinese government. His radical reform ideas were similar to yours, but one year later he quit

his job as head of a government research institute. Are you not afraid that your views might cause you some problems?

A: Fang Gang is currently a vice chairman of the Chinese Research Society for Economic System Reform. He can propagate his views more freely now than as the head of a government research institute. Reformers have been often criticized for their views and fierce debates about the direction of reform continue, but we don't have to be afraid of reprisals. Chinese leaders are more than willing and ready to learn from the ideas of academic experts. One can even gain a certain fame if criticized by high-level officials.

Accounting Standards in China

By Ray Ball, Ashok Robin, and Joanna Shuang Wu

Since China adopted its open-door policy and embarked on a path to economic reform more than two decades ago, the world has witnessed a stunning transformation. GDP growth has averaged 8 percent per year, exports have grown 15 percent per year, the state's share of industrial output has shrunk from 78 to 28 percent, China has attracted $300 billion of foreign direct investment, and individual and foreign portfolio investment have become considerably more significant. China is now an active participant in the increasingly integrated world markets.

Prior to the reforms, China's accounting rules were adapted to a Soviet-era planning system. Like their counterparts in many countries, China's regulatory authorities have concluded that international transactions would stand to gain if the accounting standards Chinese companies used conformed more closely to international practice. Higher-quality financial statements also increases their utility in evaluating managers' performance, a significant problem during China's transition from state control to a market economy.

China has made a great deal of progress in reforming its accounting standards. Most notably, in 1992 the Ministry of Finance promulgated a completely new set of standards for domestic companies known as the Accounting Standards for Business Enterprises (ASBE). The ASBE were based on International Accounting Standards (IAS) and adapted to local conditions.

Despite these reforms, the quality of domestic financial statements was thought to be insufficient for international users for the following reasons:

- While the ASBE are based on IAS, they are different in several aspects. They overlook the rule that inventories are valued at cost or at market price, whichever is lower, and do not report if the value of land, buildings, and equipment becomes nonrecoverable.
- Under the ASBE international users do not receive a certification that the financial statements conform to internationally acceptable standards or an indication of the extent of any divergence.
- The financial statements of domestic companies reporting under the ASBE are audited by domestic audit firms, whose independence has been questioned. Staff in many of these firms were formerly internal accountants in the companies they now are required to audit, and in the Chinese context their relationships with and obligations to former colleagues who now are managers in their client companies are likely to persist.

Managers have few incentives to incorporate losses in reported income on a timely basis. (Economic losses arise from reduced present values of expected future cash flows from an individual asset or group of assets, for example, a portfolio, a business unit, a subsidiary company, or a strategy. Timeliness implies that soon after managers are aware of an economic loss, an asset write-down is charged against income.) Information asymmetry is resolved at least in part by private communication rather than through published financial statements. The pressure for transparent, publicly-disclosed accounting information is reduced by the following:

- **The prevalence of *guanxi* (connections) networks**, as well as by extensive share ownership by the state and by institutional investors.
- **The strong role the government plays** in the accounting system and the resulting close link between tax reporting and financial reporting, which create demands such as ensuring a stable source of tax revenue for the state and avoiding reporting embarrassingly large profits or losses.
- **The stock exchange listing rules** that require companies to be

profitable, providing a further incentive to hide losses.

- **The many institutional features** that limit the quality of accounting information. Transactions among organizations with historically close relationships under state ownership are widespread, and when the state remains as a major shareholder, this provides enhanced opportunities for income manipulation to hide losses. Off balance sheet liabilities of uncertain quantities (for example, to provide housing, schooling, or health care) further reduce the transparency of financial statements.
- **The shortage of qualified accounting professionals and the lack of auditor independence**, which hinder the application and enforcement of accounting standards.
- **The rudimentary legal framework** and the essential absence of shareholder litigation provide issuers (managers and auditors) with little incentive to incorporate economic realities, including losses, in published financial statements in a timely fashion.

Thus government regulation by itself will not induce the provision of high-quality accounting information. Managers and audit firms must face market-based incentives to ensure that such information is provided. Accounting standards interact closely with the institutional environment, including the development of an independent judicial system, the reform of the management and governance of state-owned enterprises, the implementation of bankruptcy law, and the reform of the financial and tax systems.

The real challenge facing accounting in China today involves the domestic uses of accounting information, for example, in resource allocation, corporate governance, stewardship, and performance evaluation, and the development of auditor training and independence. This implies that the most fruitful area for Chinese accounting reform lies not in simply adopting or imitating IAS, but in reforming domestic institutions.

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Purchase Versus Pooling Method of Accounting: What a Difference!

Under the current **purchase method** of accounting, the acquiring company must write off as goodwill a portion of the purchase price of a target company that has not been accounted for by the target company's tangible assets. This poses a particular problem for high-tech companies, which often have significant intangible assets (such as intellectual property and highly trained personnel) and few solid physical ones. In many high-tech transactions where few tangible assets are involved, much of the purchase price can consist of goodwill. Under current rules such goodwill must be written off periodically against a company's future earnings, according to a defined schedule, over a specific amortization period of up to 40 years. This naturally decreases a company's net earnings.

Many firms therefore use the alternative **pooling of interests** standard in mergers and acquisitions. Firms choosing this option have to meet specific criteria, including the requirements that acquisitions must be financed by common stock rather than by cash and that assets of the acquired company must not be sold for two years after the transaction. Under the pooling standard companies are not required to amortize goodwill generated in such transactions against future earnings. In practice, therefore, merging companies can ignore goodwill for accounting purposes. This allows the financial statements of merged companies to show larger returns on assets and equity than if the companies were required to amortize goodwill.

In early 2001 the Financial Accounting Standards Board—the designated U.S. organization in the private sector for establishing and improving standards of financial accounting—decided to eliminate the pooling of interests method of accounting for business mergers and acquisitions and require a single method: the purchase method. The board argues that this will greatly improve transparency and that the current values of assets and liabilities that have changed hands will be reported to investors, who will be able to learn the real cost of one company buying another, and as a result be able to track future returns on the investment.

Accounting and Auditing Reform Advances in Moldova

By Adolf Enthoven and Mike Neider

The countries of the former Soviet Union (FSU), of which Moldova is one, have made radical structural changes to their political and economic conditions since 1991. As a result, their accounting and auditing systems have also been subject to restructuring. Moldova was recently elected as the first associate member of the International Federation of Accountants, the world's leading body of professional accountants. The changes in Moldova present some interesting lessons for other transition economies. While lagging behind in many areas of transition, Moldova has become a leader in accounting and auditing reform among the newly independent states of the FSU.

Moldova's government and institutions were well aware that to accomplish the transition to a more market-oriented system, their accounting and auditing systems had to be reformed. The various steps called for included:

- Adopting international accounting and auditing standards
- Setting up a professional organization of accountants
- Supplying technical assistance to enterprises.
- Restructuring the educational and training process

While accomplishing all this is not easy—indeed, it requires nothing less than a full-scale reorganization of the way companies and individuals do business—its success is critical to the Moldovan economy. A major implementation and assistance vehicle has been the Moldovan Accounting Reform Project (MARP), funded by the U.S. Agency for International Development and managed under the auspices of the East-West Management Institute, a Soros Foundation affiliate. MARP is providing assistance to Moldova's transition to international accounting and auditing practices using the following three-pronged approach:

- Helping the government draft and implement new accounting and auditing standards based on international practices, and promoting these new standards through coordinated public education activities
- Building a self-sustaining association to promote accounting and auditing principles and to train and support professionals
- Ensuring long-term professional capacity by developing new accounting and auditing curricula at institutions of higher learning.

The government estimates that 22,000 enterprises have converted to the national accounting standards, representing 95 percent of those mandated to do so. The enterprises using the national accounting standards require trained professional accountants, and MARP recognizes that this need can be met most effectively by local institutions. To this end MARP has helped develop the Association of Professional Accountants and Auditors, a self-regulating accounting and auditing association responsible for professional development, training, certification, and other programs. The association's membership is growing steadily, and today it has more than 1,600 registered members. This association was the first accounting association in the FSU to be inducted as an associate member into the International Federation of Accountants.

Aided by MARP, the association offers comprehensive training programs for accountants, auditors, and enterprise managers, including a continuing professional education program for certified public accountants, and has developed a professional testing and certification program, a code of professional ethics, and other professional guidelines. It has published three training manuals on the new accounting system, on managerial accounting techniques, and on tax accounting. These manuals describe the conversion to the new national accounting standards, the maintenance of an accounting system, and the preparation of financial statements and address tax accounting and reporting and disclosure issues in relation to annual financial statements.

The accounting and auditing profession, and the economy as a whole, depend heavily on students in the field receiving a high-quality education. MARP is working with the Moldovan Ministry of Education, the Academy of Economic Studies,

and a number of universities to assess and improve their accounting and auditing curricula to bring their standards to international levels.

MARP clearly shows that all parties involved in this kind of transformation process, including the government and its institutions, professional and academic bodies, and international development agencies, need to work closely together to accomplish the desired objectives. The circumstances under which all these parties had to operate, especially initially, was difficult, but commitment by all those involved has led to success. MARP's sound management and activities are a potential model for other transition economies, although each country may require somewhat different approaches and vehicles.

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Moldova's Economy Has Far to Go

Moldova, with a population of 4.3 million, is one of the poorest countries in Europe, with per capita GNP of $328. This ethnically diverse country is wedged between Ukraine and Romania. It was the second smallest country in the FSU and has the highest population density. Moldova's rich soil and temperate climate made the country a major supplier of agricultural products to the FSU.

Moldova's boundaries have been redrawn many times. Once part of the Ottoman Empire, the country was absorbed into the Russian Empire in 1812. After a brief period of independence in 1918, it became part of Romania. During World War II, the FSU annexed the territory on the right bank of the Dniestr River. At the same time Moldova lost part of its territory to Ukraine, while being combined with the Moldavian Autonomous republic of Ukraine to form Moldova as it is constituted today. The majority of the population consists of ethnic Romanians (65 percent), but Moldova also has sizable minorities of Ukrainians and Russians (13 percent each), together with Bulgarians (2 percent), a Christian Turkish people known as the Gagauz (3.5 percent), and other ethnic minorities.

Under the command economy of the FSU, Moldova's economic role was as a producer of raw and processed foodstuffs, primarily grapes, grains, wines, vegetables, and livestock. Agriculture accounted for more than 40 percent of the net material product, while agroindustry contributed approximately half of the almost 40 percent of net material product accounted for by the industrial sector.

Moldovan industrial enterprises registered 14 percent growth in the first 11 months of 2001 compared with the same period of 2000, and the food processing industry accounted for 70 percent of overall industrial output. Moldova's economy depends on trade, with the shares of imports and exports averaging 50 percent of GDP. Its principal exports are agricultural, including wine, processed foods, and tobacco products. The country is almost totally dependent on imported energy, and most other inputs are also imported, mostly from Russia and Ukraine. Given Moldova's small domestic consumer base, future growth is likely to be export led, and the country will need to switch its resources into products that have profitable export markets.

The country's external debt has grown enormously in the past eight years and now stands at $1.5 billion, or 120 percent of GDP. Western financial assistance and help with economic reforms and mass privatization did not result in economic growth until this year, when economic growth is expected to reach 4 to 5 percent.

In 2001 Moldova was due to pay $110 million in external debt service, equivalent to one-third of its budget revenues. Next year marks the peak of liabilities, with $200 million due for repayment. International Monetary Fund officials have identified several aspects of the government's economic program that they regard as controversial, namely: the price controls on public goods, the trade restrictions to protect local producers, the reestablishment of a monopoly in the alcohol and tobacco industries, the preferential energy prices for agricultural producers, and the stalled privatization of telecommunications operator Moldtelecom and the wine and tobacco industries.

How to Avoid Derailing Russia's Railways Reform

by Russell Pittman

Given both the vast dimensions of the Russian Federation and the poor state of its road system, the railways are much more important than in most other countries. Currently the railway system, historically a vertically integrated, state-owned monopoly, is facing tremendous pressures to reform.

In many ways the railway system remains as it was 10 and more years ago. Seventeen separate railway enterprises, divided into geographic monopolies, have a large degree of autonomy over technical operations in their territories. Nevertheless, the central Ministry of Railways in Moscow sets all tariffs and schedules and regularly reallocates revenues so as to more or less equalize the enterprises' profitability. Almost 50 percent of rail traffic is interlined, that is, it moves on the tracks of more than one of the regional railroads, and with each change to a different railway enterprise, the train must stop and a different locomotive must be attached. Most of the large mining and manufacturing enterprises have their own private "industrial" railways, which also require a change of locomotive upon shipment delivery.

Freight tariffs have long subsidized intercity, suburban, and commuter passenger operations, as well as light-density freight lines that the railroads have not been permitted to abandon. No separate rail regulator exists, and the ministry both oversees and regulates the operations of the regional railroads.

As the Russian economy begins to recover and the demand for freight services grows, so does the demand for improvements in railway services. The ministry's dual role as both operator and regulator has given rise to widespread complaints about tariff increases. While the Ministry for Antimonopoly Policy has restrained increases in some cases, it has not stopped them.

Reform Plans

Serious discussions about reform began in 1998 with a government resolution calling for a broad restructuring, focusing on sloughing off auxiliary activities that competitive markets could supply, such as locomotive and car repair, and including the now standard reform proposal to allow some competition among different train operating companies on a monopoly track system. The Ministry of Railways circulated a similar, but more detailed, proposal in late 2000. At this point the Ministry for Antimonopoly Policy formally objected, focusing in particular on two aspects of the reform plan, namely:

- The new railway enterprise, Russian Railways (Rossiyskiye Zhelezniye Dorogi or RZD), would continue to be state owned for the foreseeable future. As the Ministry of Railways would continue to set tariffs, the lack of independence between the regulated enterprise and the regulator would persist.
- Although the reform plan envisions the creation of competing companies operating trains, it envisages that RZD will own at least 50 percent of these companies in the near term and at least 25 percent in the longer term. Thus how much competition would actually be created is not clear.

How might the system be restructured in a competition-friendly manner? Most experts would agree on the bare minimum requirements for a liberalized Russian railway system to operate in a more efficient and productive manner, namely: permitting flexible local or regional tariff setting; allowing flexible local or regional train scheduling; ending systemwide revenue redistribution; separating the ownership and regulatory functions; and implementing direct, transparent government subsidization of passenger operations rather than subsidizing them from freight revenues.

In Russia, both the road freight transport and river freight transport industries tend to be structured so they are reasonably competitive, therefore where economically feasible, they provide shippers with competitive transport alternatives and obviate the need for regulation. Thus the government should encourage competition between various modes of transportation by providing private operators with the necessary road and water infrastructure; protecting competition in the state's procurement policies at all levels to ensure that infrastructure investments achieve the best results possible; and ensuring that tax policies, including taxes on fuel use, do not discriminate against particular transport modes.

However, regardless of any such policies, in this vast country huge volumes of commodities travel most economically by rail. Railroad competition is an important part of any liberalization program.

International Models

A number of possibilities for competition exist, as illustrated by various international models.

- **Private railroad companies control both the tracks and the trains that run along them.** This was the case in the United Kingdom for the first 100 years of rail operations. In the United States, Canada, and Mexico, most traffic moves on nonregulated tariffs using nonregulated shipping arrangements, though there is some regulatory protection available for "captive" shippers (shippers who rely on a single railroad for freight transportation, without effective choices, who must accept the rates and service levels offered). Competition is not perfect, but it is workable. The result has been a much reduced presence for the rail regulators in these countries.
- **One or many railroad companies may serve a particular location.** This is the case in the United States, where pairs of major cities often have two, or even three— "parallel" railroad companies operating between them and competing for customers. Most tariffs have been deregulated, and are set in contracts between railroad companies and shippers. At particular locations with multiple shippers, such as cities, railroad companies may agree to form a switching area, whereby they use each other's railroad track. (Note that the switching area track may be owned by the local government or jointly by the railroads that use it.) Most such arrangements are voluntary and mutually agreed upon.
- **One or more railroad companies may serve a particular location, but captive shippers have more choice.** Two privately-owned carriers, the Canadian National Railway and the Canadian Pacific Railway, handle most rail traffic in Canada. They run their own trains over their own track. The main difference between the Canadian and the U.S. system is that in Canada, captive shippers located on one of the railroads but within 30 kilometers of the other can insist upon using either service.
- **Source competition is introduced.** In 1997–99 the Mexican railway system, a government-owned monopoly, was divided into three major privately-owned regional railroads, each with a monopoly in its own region, and seven smaller companies were also established. Each of the three main rail enterprises runs its own trains over track that it controls through a long-term concession. Instead of much parallel competition between different railroads competing as origin to destination services, Mexico relies on source competition, that is, shippers from a particular source, for example, Mexico City, can forward goods to several Gulf ports for further delivery using competing railroad companies based on the best freight prices.
- **Different train-operating enterprises compete using a single monopoly-owned track.** This is identical to unbundling the natural monopoly bottleneck from competitive markets in the electricity and telecommunications sectors. Unbundling, however, raises a difficult question: is the owner or operator of the natural monopoly bottleneck, the track, to be permitted to operate in the competitive sector of the market, the trains? If the answer is yes, a serious problem of favoritism and discriminatory access may arise. If the track owner or operator is not permitted to run trains, economies of scale are lost, chances of competition among railroad companies are further eroded, and complex contracts have to be worked out between the track owner or operator and the train operators.
- **The countries of the European Union (EU) have traditionally had unitary, monopoly, state-owned railroads.** However, as a result of EU directives, each member country will be obligated to separate the cost accounting records of the track and other infrastructure from that of train service and to allow international groups to use the rails. (The hope is to further unify the market by providing seamless transborder rail shipments within the EU). For the foreseeable future, train operators and track companies will remain vertically integrated; however, under certain circumstances they must permit other train operators to operate over their track, presumably under regulated rates and conditions.
- **The United Kingdom has separated the ownership and control of the track and the operation of trains into two completely independent enterprises to encourage competitive train operators to enter the market**. The track company, Railtrack, provides track access to both freight and passenger trains at a regulated tariff level. Thus far the rail regulator has permitted only one freight operator on the track (see page 27).

Russia's Choice

Currently the EU system is popular in policy debates around the world, and for good reason: it provides transparency as well as competition between the various transport modes

(rail, road, and water). Like the EU, Russia should also require the railways to keep separate accounts for their track and train operations. It should also require them to charge themselves a reasonable, regulated tariff for track access, so that in the future, shippers of large volumes—who typically run their own internal railroads anyway—may be able to continue to supply their own long-distance rail transport or threaten to do so.

The EU system, however, is extremely regulator-intensive. It seems very unlikely that the Russian regulator will have the knowledge or enforcement capability necessary to ensure that this access tariff is set at the correct, efficient, nondiscriminatory level in hundreds of different situations around the country, even if economists can ever agree on how to do that conceptually.

This is even more true of the U.K. system, which requires complete enterprise separation between the track owner or operator and all train operators. Such a system may require less regulation of access terms than the EU system given that the track owner has no reason to discriminate among different train operators, but it more than offsets this advantage by the additional contract negotiation and enforcement that it requires, a burden for which the Russian legal system is unprepared, and the loss of economies of scale between train and track operators. The EU system is at this point essentially untested. The experience of the U.K. system to date is one of controversy, confusion, and failed hopes. At this point, neither seems to be a solid foundation upon which to base competition in the Russian railway sector.

As concerns the three North American systems, parallel rail service between origin and destination points provides the best economic alternatives for shippers who depend on rail and requires a minimum of close regulatory supervision and intrusion. Certain rail routes in Russia—such as the Pacific coast to Europe and some areas in European Russia—could provide sufficient parallel track, and policymakers should consider introducing this option in those areas. Shippers who remain captive to a single rail carrier in these territories could be protected in the same way the Canadian system protects captive shippers, whereby the railroad serving the shipper must provide access or connecting service to the nearest alternative railroad.

Thus options include parallel rail competition for some shippers located in the right places, regulatory protection for shippers in such areas who remain captive to a single carrier, and perhaps potential entry into long-distance haulage of their own commodities by some of the largest shippers. However, other alternatives are possible. For more than a century experience in Canada, the United Kingdom, and the United States has shown that the central idea behind the Mexican system—source competition—is an effective constraint on railroads that would otherwise have monopoly power.

More Competition, Less Regulation

The Mexican system deserves a serious look as a possible solution for Russia. In those areas where parallel railroad competition is not feasible, the most important locations for rail origins and/or deliveries would be determined. This list would probably include a few large cities, for example, Moscow and Yekaterinburg, and a few large, single-industry production areas, for example, the Kuzbass. Some of these cities may already be served by more than one railroad enterprise, with track heading in different directions from the city. The single-industry production areas are typically located in the interior of a region covered by a single railroad enterprise.

The railway enterprises would be reorganized and restructured so that each of these cities and production areas would be served by at least two independent rail enterprises, perhaps one going east and one going west, or one going north and one going south. The overall number of independent rail enterprises might be fairly small, but shippers at each of these rail termini would have at least two choices of rail service. The competition would require much less day-to-day regulation, and rely much more on day-to-day, rail-to-rail competition than alternative plans.

In such a huge and difficult to govern country like Russia, relying on source competition among vertically integrated regional railroads may well be more straightforward and lead to a superior outcome than relying on close regulation of vertically separated monopolists from the center.

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Gazprom on Rails?—Russia's New Railway Company

Railways Minister Nikolai Aksenenko, under investigation for misuse of office, left his office at the end of October and took what might be an open-ended vacation. Before his "leave of absence," federal prosecutors formally charged him with misuse of office under article 286 (3) of the Russian Federation Criminal Code, which carries a possible sentence of 3 to 10 years' imprisonment.

The current charges focus on the alleged misallocation of around 70 million rubles ($2.35 million) and unpaid taxes of 11 billion rubles. However, investigators have indicated that much larger sums are involved, including funds linked to the annual shipments of fuel and other necessities to remote northern regions before the winter. Investigators claim that the central apparatus of the ministry was financed from a "black cashbox," from which funds were allocated to purchase apartments for senior ministry officials and to pay them unauthorized bonuses.

In recent years, Aksenenko and his colleagues have been the focus of numerous investigations and allegations concerning commercial relationships between the ministry and various shipping companies allegedly controlled by ministry insiders or people close to them, including companies linked to both the minister's son and his nephew. In 1999 the Duma became concerned about the relationship between the ministry and the Swiss-based company Transrail, and asked Aksenenko to explain it. He refused.

Aksenenko claims that the case against him has been initiated by opponents of rail reform, and that the investigators do not understand the specific character of his ministry's work. The Ministry of Railways is one of two ministries—the other being the Ministry of Atomic Energy—authorized to undertake commercial activities as well as government functions. Whether Aksenenko is guilty or innocent, the mixing of commercial and governmental functions in these ministries makes policing corruption more difficult.

At any rate, Aksenenko and the ministry have tended to take an extremely conservative approach to restructuring the ministry. Critics argue that Aksenenko and his team are less interested in radical reform than in creating a Gazprom on rails. The more liberal elements of the government fiercely criticize the ministry's proposal. Two major issues are in contention, first, the restructuring of the railways to boost efficiency, investment, and so on; and second, the allocation of control over the enormous financial flows that the ministry currently controls.

The government is scheduled to finalize and submit to the Duma soon the first package of legislation governing rail restructuring. In the first phase of the planned restructuring, the new state-owned monopoly, Russian Railways (RZD), will take over all ministry enterprises, including the country's 17 regional railways. With an annual turnover of $10 billion to $15 billion, RZD is likely to be even larger than Gazprom or the electricity monopoly EES Rossii. The ministry's regulatory functions will be separated from its business activities, and activities that are natural monopolies will be separated from those that are not. The cross-subsidization of passenger services by rail freight will gradually be phased out. The government will preserve intact the single state-owned network infrastructure and the unified management of regulators. Competition is to be developed in the sector where possible, especially by providing independent companies engaged in freight and passenger services, maintenance activities, and other services equal access to this federal infrastructure.

The government and the ministry believe that these measures, together with steps to increase the sector's financial transparency, will make investment in rail transport more attractive, not least for foreign investors. However, how restructuring along these lines would attract investors, one of the key aims of the reform, is not clear. Aksenenko estimates that the sector requires around 600 billion ruble ($21.5 billion) in investment over the coming five years.

The ministry's proposals would mean that RZD would exercise just as much control over rail finances as the ministry currently does. The more radical reformers would rather organize RZD as a holding company and transform the 17 regional branches into independent companies initially, but not permanently, owned by the holding company. Opponents argue that such demonopolization would reduce the efficiency of the rail network and undermine the country's economic unity. They also argue that the costs of reform could easily exceed its projected benefits.

The battles over rail reform are thus set to continue for some time.

Excerpted from reports of Oxford Analytica, an international research group based in Oxford, U.K.

The Dismal Record of Britain's Railtrack

By Luigi Marcon

On October 8, 2001, Railtrack, a private U.K. company that owned and still operates the railway infrastructure, officially went bankrupt. It is the latest episode in the sad privatization saga of the national rail network. Was this a privatization that was too far-fetched?

In October the government refused to provide further subsidies to the ailing Railtrack and put it in receivership, thereby appearing to justify those who had criticized the hasty British Rail sell-off by a Conservative government in the mid-1990s. Railtrack's demise has shattered the underlying belief that if it is performing an essential public service, a subsidized, regulated private company is too important for the government to let it fail. How could this happen in a country that in the last decade has privatized with inventiveness and flair all the essential public utilities and infrastructure, such as water, electricity, gas, and telephone networks?

Some History

The restructuring and sell-off was meant to shake out British Rail, the U.K.'s subsidized, vertically integrated, state-owned railway monopoly, which was losing its competitiveness and was costing the government and taxpayers more and more. By mid-1990 demand for rail transport had contracted significantly. Between 1953 and 1993, the share of rail within transportation modes decreased from 17 to 5 percent in terms of passenger-kilometers, and freight tonnage was halved, with a market share reduction from 42 to 6.5 percent. At the same time, maintenance and operating costs were rising together with the need for new capital investments. That required ever greater subsidies to the rail industry, even though these were already high at almost £2 billion ($3.3 billion) per year.

During 1994–97 British Rail was unbundled, restructured, and divided into more than 100 private companies, including rail passenger and freight operators, companies that maintained the track and equipment, and companies that leased rolling stock. Both public offerings and management buyouts were used as privatization techniques. Some British Rail managers who knew the correct internal costs of the rail industry bought some rolling stock companies and sold them soon after, reaping huge profits. Railtrack was put at the center of this new system to manage the network, that is, the tracks, stations, yards, and signaling and other equipment, and under a strict regulatory regime was authorized to charge the train operating companies that used this infrastructure. The privatization of the railway infrastructure, in addition to the train operations was, and still is, unique in Europe.

In 1998, the second year after privatization, total profits in the industry as a whole were some £1.1 billion ($1.8 billion), while total subsidies still exceeded £1.8 billion ($3 billion). The pursuit of profits from all sides gave rise to adversarial relationships and a lack of coordination among too many private players, with recurrent disagreements between the rail regulator, Railtrack, and the train operators. Perhaps the most critical issue was that Railtrack had no evident incentive to invest in the rail network it owned. In this situation of a growing backlog of capital maintenance, railway passengers started to feel the heat as the crumbling rail infrastructure led to poor service; drastic speed restrictions; and expensive, urgent repairs. Many angry commentators argue that these chaotic conditions were responsible for two major recent railway accidents in Paddington and Hartfield.

Capital Needed

In mid-November it became clear that Railtrack needed a massive influx of capital, £3.5 billion, to keep going over the next few months to pay creditors and replenish its working capital, that is, money needed to run the business over and above its income from access charges. Most of the money is needed by the end of March 2002. Railtrack expects to have £5 billion of debt by March 31, the end of the company's fiscal year, up from £3.9 billion at the end of its last fiscal year.

Who will eventually inherit Railtrack's operations? For the time being there are only two publicly confirmed bidders: the government's nonprofit distribution company with a stakeholder board representing the wider industry, and the German WestLB Panmure investment bank, which has proposed a collaborative effort whereby private bidders and the government jointly buy the rail network.

Some Lessons

Privatization clearly helped make financial flows transparent in the previously state-owned railway sector and has changed the traditional organization and culture of the U.K.'s railways. Nevertheless, private involvement in the transport sector should not be seen as an end in itself, but as a potentially useful way to achieve the real objective of increased efficiency and better services for users. In the case of Railtrack, the private sector was not a magic bullet that could make the government's costs disappear, as in the end all costs must always be met, either directly by charging users, or indirectly by taxpayers when direct revenues do not suffice. In addition, as is often the case in the railway industry, restructuring is complex, and when coupled with private sector involvement has some painful social consequences that can spill over into the political arena. Eventually, it was the political irritation about a company that relied on taxpayers for most of its funding, mainly via the regulated access charges paid by the subsidized train operators, and yet paid dividends to its shareholders, that weighed heavily in the government's decision to pull the plug on Railtrack.

The company's sad track record provides many lessons for railway companies in other countries that must restructure in search of increased efficiency and better service, while at the same time facing contracting markets, rising operating costs, and ever greater needs for government subsidies.

Luigi Marcon is an adviser on transport projects at the European Investment Bank in Luxembourg. The views expressed here are those of the author and should not be attributed to the bank.

Mortgage Finance in Transition Countries

Learning from Common Mistakes

By Raymond J. Struyk

Hungary, Poland, and Russia addressed the development of mortgage finance comparatively early during their transition. They have generally succeeded in putting in place the necessary legal base for mortgage lending and in launching responsible lending operations. They were also able to remove the vast majority of home ownership subsidies from the banking system. High marks go to Russia's support of home purchases through its down payment subsidy scheme. Nevertheless, some policies were not optimal, and countries that are just now developing their mortgage finance system may be able to learn from these experiences.

Poland and Russia have chosen completely different approaches for developing mortgage finance and promoting homeownership:

- **Poland now has elements of the German mortgage system.** The *bausparkassen* system is a closed system in which mortgage loans from specialized housing banks are funded exclusively from the savings of future would-be borrowers. Because it is a closed circuit—only the funds saved are lent—interest rates on both savings and deposits can be substantially below market levels, with borrowers subsidizing themselves by accepting low interest rates when first saving. Mortgage banks are components of the rapidly developing mortgage loan market. The government supports home ownership through deep tax subsidies to those households purchasing new units.
- **Russia's financing model is one of commercial banks working with a nascent refinancing facility.** Here too home purchasers receive costly tax benefits, but in addition, down payments by moderate-income families are subsidized. Commercial banks act as loan originators together with a liquidity facility, the Agency for Housing Mortgage Lending. The agency is an open joint stock company, initially fully owned by the government, that purchases mortgages in much the way Fannie Mae operates in the United States. However, because credit and liquidity risks have made banks reluctant to originate loans, a number of builder-financed operations have also emerged, along with some bank-operated contract savings schemes. These schemes are numerous and probably assist with the purchase of more units each year than formal mortgage lending. Moreover, a number of *oblasts* (regional governments) and municipalities have initiated interest rate buy-down subsidy schemes with their own budget funds. These schemes undermine the demand for market rate mortgages from banks.

Most of these policies are inefficient. In both countries the tax subsidies accrue to richer families, are poorly targeted for influencing the home ownership decision, and are extremely expensive. In addition, the evolving structure of mortgage lending in Poland, with its specialized institutions, is less efficient than the universal bank model.

The lessons of these early reformers are critically important to other countries in the region that have thus far done little other than create nations of homeowners through mass privatization of former state housing. The countries of southeastern Europe and the Commonwealth of Independent States will soon be starting to develop their first real policies in this area. Because they tend to adopt policies similar to those in place in the leading countries of Central Europe and Russia, their policymakers and bankers should understand the pitfalls as well as the strengths of these countries' accomplishments to date, as follows:

- **Macroeconomic stability**. As illustrated starkly by the Russian case, and to a lesser degree by conditions in Hungary and Poland, even with a good legal and institutional framework in place for housing finance, little borrowing for home purchases will occur when the economy is characterized by substantial turbulence. High interest rates and uncertain future incomes discourage borrowers from taking long-term loans, and instability increases banks' exposure to the credit, interest rate, and liquidity risks inherent in mortgage lending. Economic stability strongly promotes housing investment by making mortgage loans attractive to both sides of the market.
- **Government action**. More important than subsidies in inducing banks to make mortgage loans with at least a five-year term is a strong mortgage law that minimizes the credit risk associated with lending. While this sounds obvious, some Commonwealth of Independent States countries still prohibit eviction in the case of foreclosure when a home purchase mortgage loan is in default. Beyond this, judges need training in any new mortgage-related law and senior judges need to review early rulings to be certain that they are in line with this law and that judges are not still invoking Soviet legal principles. Reliable, accurate, and prompt title registration systems are also a necessity. Finally, the government, working with local bankers' associations, must develop training programs to ensure proper loan underwriting and servicing, which will help minimize credit risk.
- **Specialized instruments, not special institutions.** The development of housing finance in the Visegrád countries has been dominated by the creation of institutions to execute special tasks: *bausparkassen* for housing-linked contract savings schemes and mortgage banks to attract funds from capital markets to housing lending. The disadvantages of this approach are clear. New institutions are costly to develop, take time to become operational, and make the whole housing finance system inflexible. While specialization has its advantages, countries initiating the development of their housing finance systems would be well advised to rely first and foremost on universal banks.
- **Best home ownership subsidies.** If a government determines that assisting with home purchases is a priority for the nation, then experience shows that three attributes are most desirable. First, it should make subsidies demand-side subsidies. The best among these are down payment subsidies of the type implemented in Russia. Second, it should target subsidies to lower- and moderate-income households, with larger grants going to lower-income families. Third, it should avoid long-term budgetary commitments, such as multiyear subsidies to lower interest rates on mortgage loans. Such commitments limit a government's ability to shift programs in response to changing conditions in the country. Incremental funding also often causes legislators to underestimate the total cost of the commitments they are making.
- **Wrong home ownership subsidies**. The list of subsidy mechanisms with undesirable features is long. Prominent entries include the following:

  --Allowing the costs of home purchase, home ownership, or mortgage interest payments to be deducted from taxable income.

  --Forcing banks to devote a certain share of their assets to mortgage lending or to cross-subsidize mortgage loans to make them affordable.

  --Using the *bausparkassen* system. This an expensive form of governmentsubsidy. The system targets subsidies poorly; they result in limited home purchasing power for participants; and they seem to result in little, if any, net household savings. Unlike German borrowers, Eastern Europeans can only afford to take a single loan. With the *bausparkassen* system in the dominant position, these loans will be low loan-to-value, highly subsidized transactions.
- Permitting interest rate write-downs.
- **Capital markets.** Obtaining funds from capital markets is a way of obtaining funds for financing mortgages, particularly in countries where the banking system is characterized by low liquidity and banks' liabilities are concentrated in short-term instruments. Despite its putative attractiveness, no country in the region has yet succeeded in systematically channeling funds from general capital markets into housing loans. Neither mortgage banks nor liquidity facilities have proven themselves.
- **Rental sector: the essential complement.** Some governments in

the region used mass privatization as a way of trying to wash their hands of the enormous rental housing responsibilities they formerly held. In other countries either the national government or local governments have used the municipal (former state) housing stock as an economic shock absorber, keeping rents low to cushion the impact of adverse economic developments. A few, such as Poland, continued this policy long after strong economic growth kicked in. Government policy for the rental sector has a dual role. Obviously, the longer rents are controlled and kept far below market levels while tenants' rights are kept strong, the weaker are renters' incentives to spend more of their own money to become homeowners. At the same time, a functioning rental housing market is needed to provide housing to those who cannot afford or do not want to become homeowners. Controlled rents also discourage private investment in the sector. Hence, continuing reform of the rental sector is the handmaiden of successful and efficient home ownership policies.

The author is senior fellow at the Urban Institute, Washington, D.C., and director of the institute's Transition Policy Network. This article is based on the overview in the volume Home Ownership and Housing Finance Policy in the Former Soviet Bloc: Costly Populism, edited and coauthored by Raymond Struyk, Sally Merrill, Nadezhda Kosareva, and Andrei Tkachenko and published by the Urban Institute in 2000. For information go to http://www.urban.org/housing/costly-populism.html. To order a copy go to www.uipress.org, or in the United States call toll free (877) 847-7377.

First Step toward Russia's Land Reform

By Ariel Cohen

On October 29, Russian President Vladimir Putin signed the Land Code into law, thereby allowing private ownership of and trade in land for the first time since Stalin's collectivization of 1928–32.

The new legislation will affect only 2 percent of Russia's huge land mass, but the Land Code will cover the most lucrative land: urban housing and industrial real estate. Millions of Russians who formerly had practical possession of the land their homes or dachas sit on will now be able to register it as their own personal property. That means they can sell it or put it up as collateral for a mortgage or loan. However, it also means that they will have to declare the real price of the land and pay taxes accordingly.

Many privatized companies sitting on substantial plots in urban areas could use their purchased land as collateral to raise loans for fresh operating capital. Experts were divided as to whether privatized Russian firms, many of which view land ownership as a tax liability, would leap to seize the opportunity. Experts thought that foreign investors were more likely to be attracted to doing business with Russian companies that owned land as a capital asset. The fact that foreigners now also have the right to buy land could boost foreign investment interest (foreign investment is expected to reach $5.5 billion in 2001). German Gref, minister of economic development and author of the law, pointed out that foreign investors will feel more secure in the knowledge that the land that their factories and shopping centers occupy belongs to them.

With capital flight of $200 billion to $300 billion over the last 10 years, the land and real estate market may become an attractive investment target for Russian money parked in such offshore havens as Cyprus and the Channel Islands. In addition, the law will open the gates for the development of private housing and a mortgage industry, and will allow millions of Russians to improve their living conditions. Housing starts could become a key indicator for the Russian economy in the future. Western economists have said that with time, the law could spawn the growth of a new property-owning class in a country where home ownership is still a novelty despite 10 years of economic reforms.

The authorities will develop a national land registry, an impressive undertaking, especially given that Russia is the world's largest country. Estimates of the value of job growth in construction, banking, real estate, and other related areas are in the millions. Supporters of the Land Code insist that the new law will prevent the further spread of black market land. Over the past decade a shadow land market has sprung up. Thousands of apartments, dachas, and commercial properties change hands every month, but the transactions have been largely illegal and greased by official corruption.

Most important, the Land Code sets the scene for introducing a separate

law allowing the purchase and sale of agricultural land. In czarist times, most agricultural land belonged to peasant communes. Tsar Alexander II had abolished serfdom by 1861, but severe limits to private landholding and dependence on the czar's largesse stymied the development of civil society and democracy. Nevertheless, in 1895 the Russian Empire supplied 25 percent of the United Kingdom's grain and 50 percent of its eggs. It exported grain to most of Europe and successfully competed against Argentina and the United States.

The reforms of Prime Minister Pyotr Stolypin in 1908–12, which included the privatization of agricultural land, laid the foundations for the emergence of a strong agriculture sector based on individually-owned farms. These reforms were cut short by his assassination and the outbreak of World War I.

After the 1917 Bolshevik Revolution, Russia's agriculture was utterly destroyed and millions died because of the resulting starvation. Since the 1970s Russia has been dependent on grain imports from abroad. Tiny private plots of land, 0.3 percent of the former Soviet Union's total arable land, provided more than 30 percent of its vegetables, meat, and poultry. Nevertheless, even today, communists and nationalists oppose private ownership of agricultural land and compare trade or lease in farmland to "leasing your mother or your sister," as the Slavophile Nobel prize winning writer Alexander Solzhenitsyn once put it. Ironically, Solzhenitsyn is the most famous admirer of Stolypin and his reforms.

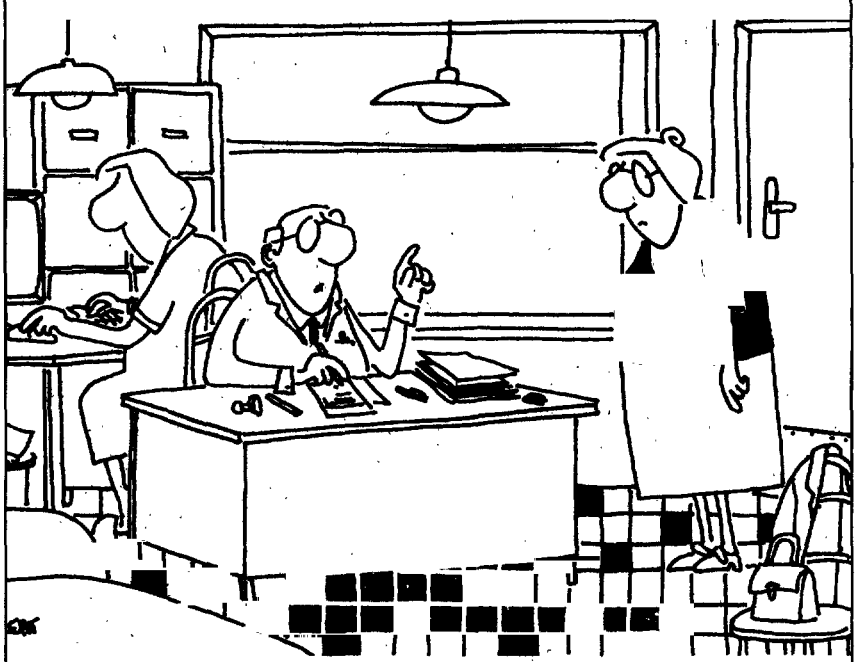
Russia's politicians are already preparing the groundwork for a law that will regulate the buying and selling of agricultural land. The government is expected to submit the bill on farmland to parliament soon. As currently envisaged, the federal law on farmland would leave regional governors to deal with the farmland issue. The governors of southern Russian regions, the country's main crop farming area, have already said that they will not allow private ownership, while the governors of northern regions are more open to privatization.

Many agricultural companies that control former Soviet-era collective farms—which in many ways still function just as they did in Soviet times—are ready to support agricultural land reform, as this might give them access to additional financing by mortgaging the land. Because of the absence of a sufficient legal infrastructure, since 1991 only 260,000 individuals have ventured into private farming.

With Russia seriously considering entering the World Trade Organization, deep reform of the agriculture sector, including private ownership and markets in farmland, is becoming particularly urgent and necessary.

The author is a research fellow at the Heritage Foundation. This article is based on his report originally distributed by United Press International.

Doctor's Advice to the Poor



"Mrs. Kovacs be careful. You shouldn't give up eating so abruptly, you should give it up gradually."

From the Hungarian Daily *Népszabadság*

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Enlargement of the European Central Bank Requires Urgent Reform

By R. E Baldwin, E. Berglöf, F. Giavazzi, and M. Widgrén

Enlargement of the European Monetary Union (EMU) will soon be a reality. Under current rules the central bank governor of each new EMU member will get a vote on the European Central Bank's (ECB's) key decisionmaking body, the Governing Council. Euroland's interest-setting body will thus expand from its current 18 members to 30 or more, clearly too many for efficient decisionmaking.

The economies of the new EMU members will more closely resemble that of Ireland than that of Germany or other core Euroland nations. They are small, with high growth and high structural inflation. The Governing Council thus risks becoming divided between a dozen or more high-growth, high-inflation "Irelands" and a handful of "core" nations, with the Irelands having enough votes to set interest rates while accounting for only 20 percent of Euroland's output.

Decisionmaking Mechanism at Risk

Enlargement will weaken the relative power of the body's leaders, namely, the president and Executive Board. Enlargement without reform would create an opportunity for coalitions formed by EMU members with less synchronized economies to prevail and set interest rates for the whole area. Enlargement might also induce a status quo bias, making reacting to significant changes in the macroeconomic climate more difficult.

The ECB and/or the European Commission should give top priority to formulating a response to this challenge. The urgency arises because even medium-term challenges can have an immediate effect when such challenges are predictable. Every day financial markets must price 10-year euro debt instruments with an eye to future monetary policy, which, ultimately, depends on the ECB's decisionmaking structure. Therefore providing clear indications that the ECB's numbers problem will be solved is important.

Even though ECB reform was not on the Nice agenda, European Union (EU) leaders at the Nice summit recognized that ECB reform is a precondition for enlargement. Article 5 of the Nice Treaty (the so-called enabling clause) enables the EU to modify the ECB's decisionmaking procedures without convening a new intergovernmental conference. Given how the final deal was handled in Nice, this was probably a wise strategy. ECB reform is too important to be thrown into a big, political horse-trading pit. A declaration annexed to the treaty indicates, however, that this matter should now be dealt with rather urgently: "The conference expects that a recommendation ... be presented in the shortest delay possible."

At a June 21, 2001, press conference in Dublin, ECB President Wim Duisenberg acknowledged that a problem exists, but suggested that the process of solving it could wait. In response to a question about ECB reform proposals, the president said: "We will come with suggestions in that respect [solving the numbers problem] as soon as the Nice Treaty has been ratified by all the parliaments, including of course the Irish Parliament, and we hope that at some time that will happen. At least that is my personal hope."

Preparations for Shake-Up

Waiting for ratification would be a mistake. While the enabling clause cannot be employed before the Nice Treaty enters into force, this is not a reason for postponing the discussion and study of reform options, and much less a reason for keeping such preparations secret. Ratification might not come before June 2002, and this is too long to wait, not only because ECB reform might become entangled with the eastern enlargement process, but

also because admitting the existence of a problem but failing to initiate a solution is a sign of weak governance.

There are three leading contenders for reforming the Governing Council's decisionmaking rules: rotation, representation, and delegation. Both rotation and representation have shortcomings: neither of them is likely to lead to appropriate monetary policy decisions. Best practice in central banking strongly argues in favor of delegation to an independent committee.

The EU has clear supranational executive power in only two areas: competition policy and monetary policy. In the case of competition policy, the power is delegated to a committee—the European Commission—and decisions are made without formal consultation with either the Council of Ministers or EU members in general. Delegating interest rate decisions to a committee is thus consistent with both best practice in central banking and current EU practice.

The committee in charge of monetary policy decisions should include the six members of the Executive Board plus a few non-Executive Board members. Our preferred membership of such a committee is 11: 6 Executive Board members and 5 nonmembers.

However, removing national central bank governors from the Governing Council has a cost. National central bank governors have credibility in the eyes of their fellow citizens. They are typically viewed as eminent citizens in touch with national sensitivities. Cutting them out of the ECB process entirely might seriously weaken its accountability and political acceptability. To redress this, and to ensure that the full range of monetary conditions has a voice, we suggest that the views of central bank governors could still enter the process, but only as information that committee members use to reach their decision. The governors would continue to be part of the Governing Council, but as far as monetary policy decisions are concerned, this would become a consultative body that ensures that the governors can continue to function in the role of national listening posts.

Proposal Should Come from the Commission

If ECB reform is an urgent matter, who has the right incentives to put a proposal on the table? The Nice Treaty requires the ECB to act unanimously in making its recommendation, but national central bank governors are unlikely to reach unanimous agreement about any of the solutions outlined here (rotation, representation, and delegation to a committee). As in the case of the composition of the European Commission, many national central bank governors will balk at giving up their vote in the council, even temporarily, as they would have to do in a rotation system. Representation along International Monetary Fund lines is also likely to run into political problems. The current members might agree on the proposal to group the new entrants (though none of the current members) in a couple of constituencies carrying one vote each, but designing a rule that gives a permanent vote to Ireland, but not to Hungary, is impossible. In any case, this would not avoid swelling the composition of the Governing Council, and at the same time it would break the rule whereby governors vote as individuals, not as representatives of a member central bank. The ECB is thus likely to experience deadlock for any reform proposal, with big-member versus small-member schisms at the forefront.

Fortunately, the Nice Treaty allows the European Commission to propose a reform, and we encourage the Commission to do so. The Commission decides by a simple majority, so it will find it easier to come to a decision. Moreover, the commissioners oversee the interests of all EU institutions, including the ECB, and the nature of ECB reform will surely have implications for other EU institutions. EU leaders entrusted the Commission with the responsibility of making sure that a recommendation reaches the Council "in the shortest possible delay." This implies that the Commission may find itself in the position of having to put its own proposal on the table. We recommend that the Commission prepare for such a possibility.

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Monetary Transmission Mechanisms: A Look at the Baltic Economies

By Rudolfs Bems

Over the last decade the three Baltic countries have been regarded as notable examples of successful macroeconomic stabilization programs and the subsequent exercise of monetary policy. Three separate studies presented in Baltic Economic Trends (2001, no. 2) look at the goals and instruments of monetary policy in Estonia, Latvia, and Lithuania and investigate the importance of different monetary transmission mechanisms.

Currency board arrangements, introduced in Estonia in 1992 and in Lithuania in1997, have a major influence on monetary policy. Latvia has pegged its exchange rate to the SDR currency basket since 1994. As of mid-2001 the main goal of Estonia's monetary policy has been to maintain the stability of the national currency, while in Latvia and Lithuania the goal is price stability. As Lithuania operates under a currency board, one might expect that the Bank of Lithuania would have a similar goal to its Estonian counterpart and regard stability of the national currency as its main objective. However, as the Lithuania study points out, Lithuanian policymakers are eager to exercise active monetary policy, which explains their concern about price stability.

Because of their currency boards the only monetary policy instrument that is actively applied in Estonia and Lithuania is the reserve requirement. This implies that most monetary policy effects come through the exchange rate window, which affects base money. In contrast, the Bank of Latvia is not constrained by a currency board, and therefore achieves its objective of price stability by intervening in the foreign exchange market and setting interest rates.

As their main contribution, the studies identify the channels of monetary policy transmission and assess the importance of different channels in Estonia, Latvia, and Lithuania. The authors use different methodologies to achieve this goal and make the following observations:

- **The direct interest rate channel**, as expected, was found to be present in all three countries. In Latvia interest rates set by the central bank have a direct impact on interest rates for domestic credit. Similarly, in Estonia changes in European Central Bank rates have a direct effect on local interest rates. In Lithuania this channel is present, but the impact of European Central Bank rate changes on local interest rates is weak. The study of Lithuania explains this difference by pointing out that the country's banking sector is highly concentrated and that the level of competition among banks is low. Also, until the second quarter of 2000 the future of the currency board in Lithuania was uncertain, which added a considerable risk premium to local interest rates.
- **The credit channel** was found to be important in Estonia and Latvia, but not in Lithuania. The study of Latvia finds that monetary shocks affect a variety of credit aggregates. In the case of Estonia, the study concludes that a credit channel probably exists, because banks are the basic financial intermediaries and the empirical evidence is in favor of credit rationing. The study of Lithuania is less explicit about the reasons why the credit channel proved less important.
- **The exchange rate channel** was found to be important in Lithuania, insignificant in Latvia (the Estonian study did not consider this channel). A possible explanation could be the differences in anchor currencies and trade partners across the three countries. In Lithuania, the use of the dollar as the anchor currency together with the relatively high importance of trade with Russia implies that export and import prices are more affected by swings in the value of the Russian ruble and the dollar/euro exchange rate. By contrast, in Estonia a larger proportion of trade is settled in the anchor currency (formerly the deutschmark, but the euro as of January 1, 2001), and therefore the exchange rate channel is less important.

The Latvia and Estonia studies also point out that the effects of existing transmission channels on the real economy are small and short-lived. This is in line with findings for other emerging markets around the world.

Most important, the studies raise new questions about monetary policy in the Baltic states that may stimulate further work on this topic. A closer look is needed to confirm and expand upon the findings of these studies. Also, the three studies do not formally consider the effects of asset price channels and expectations, although the Lithuania study does provide some discussion of

the effect of expectations. Future research could aim at filling this gap.

Finally, when evaluating and interpreting these studies one should keep in mind the challenges that such studies face in the Baltic states. First, even in industrial countries economists do not agree about the methods to use when examining their monetary transmission mechanisms. Second, the short history of monetary policy in the transition economies and the enormous structural changes these economies have experienced make identifying potential monetary policy shocks and their long-run effects particularly difficult.

The authors of the original three studies summarized here were Raoul Lättemä and Rasmus Pikkani of the Bank of Estonia; Veronica Babich of the International Graduate Program, Stockholm School of Economics; and Igor Vetlov of the Bank of Lithuania. Baltic Economic Trends is a publication of SITE and the Baltic International Centre for Economic Policy Studies (BICEPS), a new Riga-based policy and research center launched by SITE last spring (see www.biceps.org) Rudolfs Bems, a PhD candidate at the Stockholm School of Economics, is a research associate of SITE and BICEPS. He can be reached by email at rudolfs.bems@hhs.se

Latvia's New Super-Regulators Have a Mission

By Alf Vanags

Two new "super-regulators" created in 2001 have radically changed Latvia's institutional landscape. On July 1 the Financial and Capital Market Commission (FCMC) started its activities under the chairmanship of Uldis Cerps, and three months later the Public Utilities Commission (PUC) led by Inna Šteinbuka kicked off.

The PUC has taken over regulatory functions previously performed by separate energy and telecommunications councils and by the Ministry of Transport. The FCMC has taken over responsibility for supervising credit institutions from the Bank of Latvia, as well as responsibilities formerly held by the Deposit Insurance Guarantee Administration, the State Insurance Supervisory Inspectorate, and the Securities Market Commission (see also pg. 54).

These developments have brought to the fore a new style of leadership for public agencies. Inna Šteinbuka comes to the PUC after a two-year stint at the International Monetary Fund in Washington, D.C., where she was advisor to the executive director. (See her article in the February/March 2001 issue of *Transition:* "Latvia's Dilemma: Financing Accession Costs While Maintaining Fiscal Constraint.") She is committed to developing an institution based on transparency and accountability. FCMC chairman Uldis Cerps represents the new generation of Latvian professionals. Educated in Sweden as well as in Latvia, he was appointed to the PUC after a career at the Riga Stock Exchange, where as president of the exchange he helped make it a leader in promoting transparency in Latvian commercial life.

What motivated the creation of such super-regulators? A key practical factor was the need to concentrate scarce resources. The authorities felt that a critical mass was needed to attract the best people. Thus the new agencies are quite large: the FCMC has more than 90 staff and the PUC has 70. Their size will enable the new agencies to take advantage of economies of scale and scope. For example, in the case of the FCMC, the authorities believe that a unified agency will be better placed to regulate financial conglomerates, while the PUC is working on a unified tariff mechanism for public utilities. The agencies' larger scale and size (and the accompanying prestige) also help to maintain their political independence and protect them from the danger of regulatory capture.

The FCMC is modeled on lines similar to the British Financial Services Authority, which assumed its powers and responsibilities as the single regulator of the financial services sector on December 1, 2001. Thus Latvia is actually a leader in this area. As with the United Kingdom's Financial Services Authority, the FCMC has assumed wider responsibilities than those it inherited from the agencies of the previous system. Thus the FCMC's strategic goals are to promote stability and development in the financial and capital market and to support the interests of investors, depositors, and the insured. In addition to normal prudential supervision, the FCMC is expected to strengthen overall trust in the Latvian financial system, which appears to be weaker than in, for example, the European Union (EU). The FCMC is also charged with fighting money laundering, promoting competition, promoting public awareness of financial services and products, and a host of other tasks.

All this is coupled with a tough schedule to re-approve regulatory legislation (five separate laws) in line with EU directives by January 1, 2003, the deadline for completing the harmonization process.

In contrast to the FCMC, which unified different regulators within a single sector, the multisectoral model of regulation adopted for the PUC had no precedent in Western Europe. As a consequence, despite support from the World Bank the super-regulator model encountered opposition in Latvia; however, after much debate, it prevailed. The PUC oversees energy, telecommunications, and the postal and railway sectors. These are important branches of the economy—in 2000 the energy sector accounted for 3.5 percent of GDP and transport and communications together accounted for 14.2 percent—and they include some of Latvia's most powerful enterprises. Latvenergo, the electricity utility, is Latvia's largest and most profitable enterprise, closely followed in size by Lattelekom, the recipient of the largest amount of foreign direct investment, and Latvian Railways, Latvia's biggest employer.

The PUC's strategic goals are to protect consumer interests and to promote both competition and investment-driven development. A major task of the PUC is to approve tariff-structures, and expectations are that it will go for a uniform tariff setting mechanism in all the sectors under its supervision. The PUC is expected to apply the price-capping principle in the form of the retail price index minus X rule, where X is the rate of cost reduction expected by the regulator. This method is widely used throughout Europe and creates strong incentives to improve efficiency. Moreover, it is relatively simple to implement and is relatively easy for the general public to understand.

PUC chair Inna Šteinbuka strongly believes that because regulated sectors share common network features, this will facilitate the development of common tariff mechanisms. Nevertheless, detailed implementation of the price cap in each sector for the first time will be no easy task for the commission, especially as much of the information it needs has to come from inside the regulated enterprises.

Of course, the PUC will do much more than regulate tariffs. It will issue licenses for utility providers; work to ensure service quality; design detailed procedures for regulatory accounting; develop a regime for providing non-competitive services, such as rural postal services; and, most important for the long-run, determine rules and mechanisms that promote competition, such as the rules for access to and pricing of common facilities (for example, cable) or for the constraints on cross-subsidization by incumbent providers.

Both the FCMC and the PUC are politically and financially independent institutions. Each is governed by a council of five members, including the chair, appointed by the Latvian parliament for five years. Financial independence is guaranteed by mandatory levies on the regulated sectors (except for some transitory Bank of Latvia finance for the FCMC), so that funding is independent of the state budget. Technically, for constitutional reasons, the PUC is an arm of the Ministry of Economy, but in practice it will be politically independent. The FCMC has no supreme authority.

Independence is necessary, because tough times may lie ahead. Balancing the interests of customers and industry can be tricky. For the FCMC further concentration of financial services in the hands of a few, mainly foreign-owned, financial institutions could cause problems. For its part the PUC will have to implement EU directives on the liberalization of the energy and telecommunications sectors. Latvia's monopoly providers are not too enthusiastic about these activities. At the same time spending on public utilities looms large in the budgets of Latvia's poorest residents, who will most likely blame the high-visibility regulators for tariff increases, however necessary those may be to meet the country's overall goals.

Creating new super-regulators is no panacea for development. However, it demonstrates the authorities' awareness that a market economy needs a structure, preferably a stable structure, in which rules are clear and transparent and in which surprises are minimized. This is what the new agencies are aiming to deliver.

Alf Vanags is director of the Baltic International Centre for Economic Policy Studies (BICEPS). For more information go to www.biceps.org or email the author at alf@biceps.org.

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Accession Negotiations Surged Ahead under Swedish Presidency

By Claus Schultze

At the June European Union (EU) summit meeting in Göteborg, Sweden, Central and East European leaders praised the Swedish EU presidency for its achievements in advancing EU enlargement. Not only did Sweden stick to the deadlines of the timetable for enlargement negotiations adopted at the Nice Summit in November 2000, but it also pushed the enlargement agenda forward on a number of contentious issues.

Although politely called negotiations, the talks are about changing laws and institutions to conform with EU legislation as set down in the *acquis communitaire*, a huge collection of EU norms, standards, and guidelines the accession countries must adopt. For the sake of the negotiations, the *acquis* has been divided into 31 chapters. The more chapters are closed during accession negotiations, the closer a country is to membership. Nothing is finally agreed until everything has been negotiated. All chapter closures are therefore provisional prior to a final round of negotiations. Even if the leaders of the candidate countries like to portray their dealings with the EU as tough negotiation, in reality there is little room for bargaining.

Sweden upheld the principle of differentiation, recognizing that each accession country should be measured on its own merits, and when ready, accepted to the EU. This contrasts with the approach that bundles countries and lets them join together, like the first wave Luxembourg group or the second wave Helsinki group. Sweden also upheld the catching up negotiation principle, that is, the possibility for those who started negotiations later to catch up with other candidates.

As part of the catching up strategy, the Swedish presidency aimed at putting as many new chapters on the negotiation agenda as possible. By the end of June, all chapters had been opened with 10 countries, 8 of which are likely to join the EU in the immediate future (the Visegrad five, that is, the Czech Republic, Hungary Poland, Slovakia, and Slovenia; and the three Baltic countries, namely, Estonia, Latvia, and Lithuania). Bulgaria and Romania would join later. In addition to opening new chapters, a large number of chapters were temporarily closed.

The catching up strategy has clearly worked. The race to membership has drawn closer, with two Baltic countries, Latvia and Lithuania, closing the gap with frontrunner Estonia. Most observers recognize that the Swedish-Baltic connection has contributed strongly to this success. The final negotiation meeting under the Swedish presidency was held on June 27, 2001. It established the following ranking: Cyprus and Hungary were leading the pack, with each having provisionally closed 22 of the 31 negotiation chapters. Slovenia followed with 20; the Czech Republic, Estonia, and Slovakia with 19 Lithuania with 18; Malta and Poland with 17; Latvia with 16; Bulgaria with 10; and Romania with 6. Since that time Belgium, which took over the presidency from Sweden, has been able to close several more chapters with individual countries.

Even though it was psychologically important for countries such as Latvia and Lithuania to catch up and affirm that they could make it to the finishing line together with the first wave countries, not all want to consider the negotiations for EU membership as a competition. For example, Latvian Foreign Minister Andris Berzins noted

that "it is easy to close chapters if you just give in on all the demands of the EU and request no special deals and transition periods." This is also a reason why countries such as Poland are quite relaxed about lagging behind the faster, but much smaller, front-runner countries. "Closing quickly is not always the best tactic," said Polish chief negotiator Jan Kulakowski in a recent interview with the *Financial Times*. He maintained that holding a hard line on sensitive issues could be a way to put pressure on and extricate concessions from the member countries. The assumption is that the EU is genuinely worried that excessively long negotiations could further undermine public support for enlargement, both within the EU and in the candidate countries.

The Swedish presidency was the first to tackle such difficult chapters as the free movement of goods and services, capital, and labor, as well as the environment. A first breakthrough occurred when the environment chapter was closed with Slovenia in March, and subsequently in June with the Czech Republic, Estonia, Hungary, and Lithuania.

Perhaps the trickiest issue Sweden had to deal with was to find a compromise on the free movement of labor. Whereas in May at an informal meeting of EU ministers for foreign affairs tempers on this sensitive issue were still running high—with the Austrians and Germans demanding a seven-year transition period for the free movement of workers, and the Finns, under pressure from their trade unions, aligning with this position—the Swedish presidency managed to broker a compromise that will enable the EU to impose a two-year restriction on the free movement of workers from candidate countries. Individual countries may extend this period by up to seven years, but only if their labor markets are heading toward serious disruptions. Consequently, the issue of transitional rules for the free movement of workers was agreed on with Cyprus, Hungary, Latvia, Malta, and Slovakia. Countries such as the Czech Republic or Poland that have publicly claimed they would never accept any transition rules on the free movement of labor will most likely ultimately accept this deal.

Transition periods were also granted for the free movement of capital. One of the thorniest issues is the free sale of real estate, which is still extremely cheap in the new member states compared with EU price levels. The EU proposed a five-year transition period for vacation (secondary) properties (a similar arrangement was agreed on during the 1995 enlargement round that brought in Austria, Finland, and Sweden), and a seven-year transition for agricultural properties. The Czech Republic and Hungary approved this arrangement. Cyprus, Estonia, Latvia, Lithuania, and Slovenia—which did not request a transition—have also closed this chapter. Clearly there was a tradeoff between the demand for moratoriums on land purchases in the capital chapter and the request by some EU countries for transition periods for the free movement of workers, which

The Roadmap

In November 2000 the European Commission adopted an enlargement strategy paper that incorporates a roadmap or timetable for the negotiation procedure. The main elements of this roadmap can be summarized as follows:

- **Luxembourg group: Cyprus, the Czech Republic, Estonia, Hungary, Poland, and Slovenia.** According to the timetable, revised EU positions on agriculture should have been achieved during the second half of 2001. These revised positions are not intended to address important and sensitive questions such as direct payments or quotas that have a major impact on the EU's budget, which are likely to be addressed during the first half of 2002. The EU should be in a position to close the negotiations with the most advanced countries, that is, those fulfilling all criteria for membership, during 2002, thereby enabling the EU to welcome new member states from the end of 2002.
- **Helsinki group: Bulgaria, Latvia, Lithuania, Malta, Romania, and Slovakia.** The European Commission endorses the principle of differentiation and welcomes the opportunity for each candidate country, particularly those within this group, to catch up in the negotiations. It recommends that the countries within the Helsinki group prepare their position papers on those chapters where they consider themselves prepared for negotiation, taking into account their state of preparation and the timetable proposed. It is on this basis that the Commission will assess whether it can recommend the opening of these chapters to negotiation.

According to the roadmap, the EU will need to define common positions on a last group of chapters during the first part of 2002: agriculture, regional policy, financial and budgetary provisions, institutions and "other."

demonstrates how individual issues in separate chapters are often connected.

The Swedish presidency was also successful in overcoming the attempt by the coalition of southern member states, led by Spain (the others are Greece, Ireland, and Portugal), to demand continued payments from the EU's Structural and Cohesion Funds to their backward regions, in exchange for supporting the enlargement, that is, for not vetoing it. This sparked furious reactions from the other member states. As a result Spain dropped the demand for a formal agreement, but successfully lobbied for a "verbal understanding" that promised continued EU support to these countries. Ironically, Spain is taking over the presidency in the first half of 2002, when negotiations on the difficult regional policy chapter are scheduled with the candidate countries.

Finally, Sweden has shown a great deal of support for the candidate countries' wish to get clear target dates for accession. It managed to broker a compromise formula that states that the enlargement process is irreversible, and those candidate countries that are ready can complete negotiations in 2002. While the European Council meeting in Nice had cautiously expressed the hope that the new member states would be able to take part in the next European Parliament election in 2004, the document approved in Göteborg called for participation by the new members in much stronger terms, "even if the accession treaties were not formally ratified." This was an encouraging signal to the candidate countries. As the enlargement negotiations progress, the EU is getting ready to calculate the cost of enlargement and to negotiate the remaining financial issues, scheduled for early 2002.

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Debating Baltic Identity

The outcome of World War II was primarily responsible for the Baltic states' current perceptions of their identity. The iron curtain cut the Baltic Sea in two, effectively sealing off Estonia, Latvia, and Lithuania from the Nordic countries, and making any kind of regional cooperation impossible. The foundation of the Nordic Council in 1952 implied formal acknowledgment of the Nordic countries (Denmark, Finland, Iceland, Norway, and Sweden) as a region with the will and a clear agenda for cooperation. In 1991 the Baltic states regained their independence, thereby creating the possibility for stronger mutual cooperation among all the Baltic nations. While Nordic cooperation is widely regarded as a success and has contributed to the building of a strong and positive Nordic identity, cooperation between the Baltic states has been riddled with difficulties. Consequently, the Baltic states perceive "Baltic identity" as a somewhat ambiguous concept. Nevertheless, such cooperation may be able to fulfill its potential on a wider regional scale.

For many citizens in the Baltic states, the word "Baltic" has negative connotations, reminding them of the 1939 Molotov-Ribentropp pact that sealed their destinies for the next 50 years. What unites the Baltic countries today, apart from their common history and the trauma of the Soviet occupation, is their ambition to become members of the European Union (EU) and NATO. The governments of the three countries aim to anchor their national identities and reestablish their sovereignty within a bloc of countries, which seems to be the best option for guaranteeing peace, security, and their citizens' welfare and for providing a framework that will guide their economic and political transformation. Beyond this shared ambition and a long list of shared problems, including relations with Russia and the treatment of Russian minorities, the three Baltic states have little in common, let alone a common Baltic identity. Instead, competition and a lack of solidarity seem to dominate the relationships between the three countries.

Even though the intensity of Nordic cooperation had inspired the Baltic states to establish similar cooperative structures, namely, the Baltic Assembly and the Baltic Council of Ministers, to date considerable disagreement between the three countries has weakened this approach. At the Seventh Baltic Council Meeting, recently held in Riga, Estonia criticized Latvia about tax issues and accused both Latvia and Lithuania of being inactive in trilateral cooperation. The old Latvian-Lithuanian territorial dispute did not go unmentioned.

Estonia and Lithuania publicly protest being classified as Baltic states. Lithuania's government considers the country to be part of Central Europe, and would prefer to develop strong links to Poland and other Visegrad coun-

tries. Estonia wants to see itself as a Nordic country, and consequently looks to the Finns, who according to Estonian Foreign Minister Toomas Hendrik Ilves, successfully "turned themselves into Scandinavians." Other senior officials in Estonia do not share this view. They contend that the Baltic states need to develop closer relations with each other to attract investment, believe that the label Baltic could promote each country as part of a wider dynamic region, and have visions of becoming one of the "three Baltic tigers." This would be easier to accomplish now than a few years ago, as Latvia and Lithuania have caught up in EU accession negotiations and now appear more likely to join the EU around the same time as front-runner Estonia. However, the closer they get to EU integration, the less relevant a group image might appear to the three states.

By contrast, growing prosperity in the Baltic countries may allow for stronger domestic welfare policies in the future, and thus a stronger convergence of the Baltic and Nordic images, driven by the EU and its regulatory framework, including its social and economic cohesion policies. Convergence might also be accelerated by enhanced cooperation on a wider Baltic Sea regional level, and by more cooperation between the Nordic and the Baltic countries bilaterally as well as multilaterally. Such activities are already taking place, and might eventually help the Baltic states reconcile themselves to the Baltic label and each other.

Integrating Russians in the Baltic Societies

The demography of the Baltic states changed significantly following World War II, as the former Soviet Union (FSU) encouraged Russians to migrate to its western borders. By 1991 only half of Latvia's population consisted of ethnic Latvians as large numbers of Russians and others settled in the country. In Estonia the proportion of non-Estonians tripled from 1934 to 1989, when it reached 38 percent. When they regained their independence in 1991, Estonia and Latvia sought to reverse this trend. Both governments decided to limit citizenship to those who had been citizens prior to 1940, the year the FSU had occupied Estonia, and to their spouses and descendants.

The citizenship legislation is not based on ethnicity. In Estonia it enfranchised some 80,000 non-Estonians and disenfranchised many ethnic Estonians who had lived in the FSU in the period between the wars. Nevertheless, most Soviet-era settlers, most of whom are Russian-speakers, became noncitizens. Thus of the total population of 1.4 million people, about 300,000 do not hold Estonian citizenship. Resident noncitizens cannot vote in general elections, but are allowed to vote in municipal elections. This has resulted in the formation of Russian-speaking political parties that can articulate and defend the interests of the Russian community.

Throughout the 1990s, Western countries criticized Estonia's legislation in connection with noncitizens' rights. In 1999 the European Union recommended that Estonia amend a controversial 1995 language law that mandated the use of Estonian as the country's official language.

As of January 2001 visa requirements for those traveling to Russia were extended to noncitizens of Estonia (and Latvia). This will probably speed up noncitizens' adoption of either Russian or Estonian citizenship, as like Latvia, Estonia prohibits dual nationality. The authorities assume that about half of the 300,000 holders of Estonian "aliens passports" will apply for citizenship. For the remainder this would complicate travel to Russia, with which most of them have personal or business ties.

The number of noncitizens in Latvia fell from around 700,000 in 1991 to 570,000 in early 2001. Naturalization procedures were included in the requirements for citizenship and were subsequently amended throughout the 1990s in an effort to integrate noncitizens. Noncitizens cannot run or vote in local or national elections, and initially were not permitted to work for the civil service (a restriction that was later reversed on the condition that they become naturalized within a year). Naturalization requires proficiency in the local language. A 1999 language law confirmed Latvian as the only state language and encouraged its use; a controversial move because Russian-speakers are heavily engaged in business activities. Nevertheless, naturalizations have been slow. International observers estimate that around 300,000 noncitizens, or nearly half the total, mainly the elderly and those who cannot speak Latvian, will never apply for citizenship.

Both Baltic countries have to acknowledge that even in the long term, a large portion of their populations will be resident noncitizens. This underscores the importance of efforts to achieve broader integration of noncitizens into their respective societies to promote ethnic harmony and cohesion and for the sake of state security and economic efficiency.

Kaliningrad: Uncertain Future of Russia's Enclave in the Baltics

Among the many challenges the Baltic countries currently face is a redefinition of their relationship with Russia. Not only do they all share a common border with Russia, but the Russian enclave of Kaliningrad is squeezed between Lithuania's western border and Poland's eastern border. On the one hand, with the forthcoming European Union (EU) enlargement, the Russian oblast of Kaliningrad threatens to become an isolated island of poverty in the EU, a bizarre prospect that has caused many headaches in the international community. On the other hand, its presence is handy for Russia, because its location compels the EU to pay more attention to Kaliningrad and to relations with Russia. Indeed, the EU is keen to invest heavily in the enclave to make it a pilot for EU-Russian cooperation.

Despite Kaliningrad's apparently advantageous position on the Baltic coast, its agricultural and industrial potential, and its status as a special economic zone, the vision of turning Kaliningrad into a Baltic Hong Kong has so far largely failed. According to EU entrepreneurs, the seemingly arbitrary nature of Russian law has deterred foreign investors from taking advantage of Kaliningrad 's position. Even though foreign direct investment in Kaliningrad is higher than in Russia as a whole, it is still much lower than in the neighboring Baltic countries. In addition, problems abound in the Russian enclave. Residents of Kaliningrad are 65 times poorer than EU citizens, and also considerably poorer than people living elsewhere in Russia. Almost one-third of the population lives below the subsistence level. Poverty is aggravated by economic isolation and one of the highest AIDS and tuberculosis rates in Russia. In addition, Kaliningrad is a center of organized crime, smuggling, drug trafficking, and prostitution. Massive environmental pollution is another endemic feature of the enclave. After St. Petersburg, Kaliningrad is the biggest single polluter of the Baltic Sea, because of its high levels of nuclear waste and water and air pollution. Instead of improving, the situation seems to be deteriorating because of endemic corruption and political stalemate.

With major parts of the Russian Baltic Fleet still based there, Kaliningrad will also become a Russian military outpost completely surrounded by EU and NATO territory if Lithuania is invited to join the defense pact at the Prague summit in 2002, as is widely expected.

With the future EU accession of Lithuania and Poland, Kaliningrad's long list of problems will also become EU problems, given the obvious cross-border implications of crime, pollution, and health issues. The EU is extremely concerned about migration flows once the rules regarding free cross-border movement of citizens in member states are applied in the region. Currently some 1 million Kaliningrad Russians enjoy visa-free access to Lithuania, but not for long. By 2003 at the latest, Lithuania will introduce a special visa regime for the residents of Kaliningrad.

Luckily for the city, Kaliningrad has recently become the linchpin of the new ambitions to deepen EU-Russian cooperation, which offers some hope of improving the situation. Discussions on Kaliningrad's future have already taken place in various multilateral settings and arenas, including the high-level EU-Russia summit held in Moscow in May 2001. The document "The European Commission's Communication to the [European] Council—the EU and Kaliningrad," issued in Brussels in early 2001, outlines some of the most urgent issues as well as the corresponding proposals (see http://europa.eu.int/search/s97.vts). In addition, the agreements with Poland and Lithuania have taken up these issues, which were also partly addressed by the EU's new Northern Dimension Action Plan. The following suggestions were put on the table:

- Having Russia and the EU examine the postenlargement trade impact on Kaliningrad
- Arranging for the EU, Lithuania, Poland, and Russia to discuss ways to improve border management and accelerate border crossing procedures
- Facilitating visa issuance, border traffic, and transit procedures
- Designing a multimodal transport strategy and funding transport projects
- Identifying key investment requirements to modernize regional transport infrastructure
- Assessing possible scenarios for Kaliningrad's future energy supply
- Reviewing the consequences of enlargement on fishing access

● Dealing with key issues of Kaliningrad's environmental concerns.

The Kaliningrad issue certainly upgraded Lithuania's position in relation to Russia, but also in relation to the EU, not only because Lithuania provides infrastructure and energy links between Kaliningrad and Russia, but also because out of all the Baltic countries, it has the best relations with Russia. (Unlike Estonia and Latvia, it did not inherit a large Russian-speaking population.)

To date Kaliningrad has received €15 million of TACIS assistance, with another €15 million in the pipeline. (The EU's TACIS program provides assistance for the newly independent states and Mongolia.) Planned projects include improving Kaliningrad 's border crossing, waste management, and health service; developing its port facilities; supporting innovative small and medium enterprises; and promoting trade and investment. Current and future EU member states are also providing support, mainly in areas such as administrative and health reform and environmental protection. This comes on top of bilateral funds from the Nordic countries. The new EU focus is symbolized by the opening of a TACIS office in Kaliningrad and the preparation of a TACIS study on the energy needs of the region, to be launched during 2001. Nevertheless, the EU will need to find ways of providing Kaliningrad with development aid beyond the fairly limited ambit of TACIS.

A recent analysis by a prominent research institute concludes that the enclave's relative isolation in recent years complicated its problems, and if Kaliningrad wants a proper share in the future development of the Baltic region, a "model project" of EU-Russian cooperation, strong leadership, and a vision of the future need to be coupled with local initiatives.

Public Utilities Need Skills to Navigate between Regulation and Competition

By Tamás M. Horváth and Gábor Péteri

One of the basic functions of local governments is to provide public utilities and community services. The proportion of funds allocated to these activities in local government budgets in Central and Eastern Europe varies between 16 percent in Latvia, 18 percent in Hungary, 29 percent in Poland, and 44 percent in Slovakia. Despite the importance of urban services, their share in public expenditures cannot be measured exactly.

Unreliable Statistics

The fiscal statistics on local government expenditures often aggregate various "economic" or "environmental" services, and data are not presented in a consolidated format. Their share also depends on local governments' involvement in providing human services. For instance, Slovak municipalities are not responsible for schools or hospitals.

The primary reason for the lack of specific information on urban services is their mixed character. Despite the public functions of these services, the private sector is deeply involved in their provision. In CEE countries, where the relationship between the public and private sectors is slowly developing, information systems cannot keep up with these changes. Thus the low level of public expenditure on urban services might be because these services have been privatized and outsourced and public expenditure data do not reflect the flow of funds.

Urban utility and community services can be grouped into three categories:

Stages Of Transformation In Public Utility And Communal Services

Stage	*Public utilities (natural monopolies)*	*Community services (mixed goods and services)*
Restructuring	Modest breakup of state-owned monopolies (devolution of assets) Modest unbundling Establishment of independent regulatory authority	Rationalization Establishment of competitive environment
Privatization	Privatization of competitive assets Development of regulatory function	Management of public shares Privatization

- Pure public goods, such as street lighting
- Natural monopoly services, for example, water supplies
- Mixed services, for instance, waste management.

The public nature of services depends on three basic conditions. Ownership matters, but the method of financing is also important, namely, whether services are financed through national and local taxes or user charges. Regulations also have a strong impact on service provision.

Stages of Transformation in Urban Services

Most CEE countries implemented changes in the local utility sector in two major steps (see the table). During the first stage, restructuring, they transferred state-owned property to local governments, combined it with some unbundling of natural monopolies, and transformed budgetary organizations into arms-length corporate entities operating under company law. The next stage was privatization, during which the countries attempted to gain access to foreign or domestic capital through various schemes, including outsourcing, concessions, or the BOT (build, operate, transfer) method.

Transformation Varies from Countryto Country

The speed and character of these processes varied not only by country, but also by service. In the water sector, Hungary and Poland created several hundred service organizations through the extensive fragmentation of formerly state-owned water companies, unlike in Slovakia, which did not adopt this kind of "municipalization." Similarly, most countries transferred solid waste management to local government ownership, but Poland preferred privatization, attracting external capital to assist with this. Romania, meanwhile, created special semipublic service organizations to provide community services.

This diversity is partly explained by differences in policymakers' motives. In the early 1990s the CEE countries believed strongly that market-based mechanisms were superior to the old rules of service delivery in the public sector. At this time traditional public service organizations were transformed into local, market-oriented entities to increase efficiency and improve the quality of local public utility services. This view has changed recently, with political and public debates on local public utilities turning toward issues of equity and affordability that came to light following privatization.

The restructuring and privatization stages should be supplemented by the development of regulatory mechanisms. Regulation should include the rules governing market entry and define what functions and responsibilities remain with local governments and the financial environment the service organizations operate in.

Proposed Policy Actions

We propose the following policy actions for successfully managing the transformation of public utilities:

- All the major elements of a new model of local public service management should be put in place. The roles and functions of public clients, service producers (contractors), and consumers should be established and clearly separated.
- Regulatory institutions should be developed and endowed with clear-cut functions and autonomy from the government. Their progress must be monitored, with new institutions set up as necessary and procedures revised regularly (including the rules for public procurement).
- Anticorruption measures should be introduced in appropriate areas. The area of state purchases is the least transparent field of the public sector.
- European Union laws of transformation should be given priority during the legal harmonization process. However, simply following European Union requirements is not enough. While the transformation of public services must include measures that lead to effectiveness and efficiency, government policies should also reflect other concerns, including consumer protection.
- The process of designing policies for the local provision of public utilities and community services needs improvement and all those affected should be involved in decisionmaking.

This article is based on a report that summarizes the major findings of a policy research project on regulation and competition in the local utility sector in Central and Eastern Europe (CEE). Tamás M. Horváth is research director at the Hungarian Institute of Public Administration. You can email him on h13275hor@ella.hu. Gábor Péteri is research director of the LGI. His email address is gpeteri@osi.hu. *The regional research project was financed by the British Department for International Development and the OSI-Budapest Local Government Initiative, under the Local Government Policy Partnership program. The complete summary report, which includes six country case studies, was published as part of the LGI Books series in November 2001.*

Risks of Outsourcing in Slovakia

By Juraj Nemec

Outsourcing is one of the tools of public sector reform; however, because of a number of problems, it is not proving wholly successful in the industrial countries, and its impact on transition countries in Central and Eastern Europe (CEE) might be limited.

The market supply of effective bids is limited in transition countries, and the argument of possible unit costs savings is far more controversial than in the industrial countries. Private producers in monopoly industries will not behave as suggested by standard theories of competitive markets, but will instead focus on realizing large profits in the short term.

The public administration systems in CEE are still in the early stages of development. The most important problems in working out successful outsourcing strategies are as follows:

- **Old-fashioned auditing**. Current systems for public sector control and auditing in most, if not all, the CEE countries rely on an old-fashioned, administrative type of control. Effective mechanisms to assess the efficiency and effectiveness of public sector institutions and processes are lacking.
- **Lack of professionalism**. Those responsible for public sector control and auditing are not always professionals in the field and often cannot tackle all the issues involved.
- **Lack of modern financial management**. The financial management schemes of most public sector organizations are based on antiquated budgetary rules that create incentives to spend and not to save. Modern cost-centered, outcomes-based financial management is rare or nonexistent, as are capital budgeting and accrual accounting methods. Without calculating depreciation, as is the case in most CEE state administration systems, calculating the real costs of the provision of any service is impossible.
- **Lack of motivation**. The dominant values in CEE public administration systems are bureaucrats' security and individual benefits. This explains the lack of incentives to seek new management solutions, and in some cases motivates the channeling of public resources.
- **Limited role of the media**. Citizens are either unable or unwilling to control their country's political processes. The media and the nonprofit sector have just started to exercise their crucial role in supporting democratic processes in transition countries. Compared with Western countries, their current role is extremely limited.

The development of outsourcing should be based on high-quality legislation and regulations, which are currently not available in the transition countries. The only legislation related to outsourcing is public procurement laws, which simply define the procedure for awarding contracts. No special legislation defines the other steps involved in outsourcing. Under these circumstances, public sector institutions have to rely on limited individual knowledge and experience. The legal aspect of the business environment is also weak, and attempts to enforce the law face significant problems, for example, the average length of litigation of a business-related case in the Slovak courts is almost two years.

The impact on local governments of outsourcing may best be illustrated by taking two randomly selected Slovak cities, Èadca and Turzovka, as examples, and focusing on major community services, such as maintaining local roads, public lighting, and public parks and managing cemeteries and waste collection and disposal. In both cities the municipality does not carry out these services in the traditional way. The variety of solutions ranges from municipal enterprises not directly connected to the municipal budget (these are, in principle, independent institutions that bill the municipality for services rendered) to fully private, outsourcing solutions. Outsourcing at the municipal level is frequently used in Slovakia.

The outsourcing of selected public services to private sector firms in both cities provides examples of the low quality of implementation. The following are the main problems:

- **Selection of private service delivery firm.** The principles of public procurement are murky, and the best bid is not the main selection criterion.
- **Quality of contract preparation.** Contracts do not include basic data about volume, periodicity, quality, supervision, and so on.
- **Quality of contract management**. No effective institutional arrangements are in place to assure good-quality contract management.
- **Outcomes ofoutsourcing**. Expected outcomes are not defined, no indicators of success or failure are in place, and as a result the real outcomes of contracts

are not regularly evaluated. The result is that citizens receive lower quality, but more expensive services than under prior arrangements.

The current situation does not mean that CEE countries should not use outsourcing. These findings are simply a call for more transparency, better quality contract management, and high-quality guidelines for evaluating possibilities for outsourcing and preparing tender documents.

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Local Governance Networks in Central Asia

At a meeting that took place on July 30–August 3 this year, LGI, the United Nations Development Programme, and the World Bank Institute launched a two-year program to develop policy proposals and action plans for local government reform in Central Asia. The project, designed under the Fiscal Decentralization Initiative, a joint undertaking of the LGI, the United Nations Development Programme, the World Bank Institute, the Organisation for Economic Co-operation and Development, the Council of Europe, the U.S. Agency for International Development, the Danish Ministry of Interior, and the Czech Ministry of Foreign Affairs, with the secretariat based in the LGI, started with an initial training and brainstorming workshop in Bratislava.

The main objective of the project, which combines training and policy research, is to help build local expertise to design intergovernmental relations and develop local government capacities in the four Central Asian countries: Kazakhstan, the Kyrgyz Republic, Turkmenistan, and Uzbekistan. During the course of the project the 26 participants—high-ranking public administrators and independent nongovernmental experts—will work in four separate country groups to prepare policy proposals and action plans for improving local governance in their countries. Advisors from the Czech Republic, Poland, and Slovakia will assist individual groups by providing feedback and expertise through an online network. The groups will also take part in regular workshops that will be organized in Central Asia.

The Bratislava workshop was divided into two parts. During the first part the participants familiarized themselves with the program, met their advisors from Central Europe, and took part in two-and-a-half days of training. Delivered by experts from Croatia, the Czech Republic, France, Hungary, Poland, Slovakia, and the United States, the training focused on the legal framework for decentralization and on such fiscal issues as expenditure and revenue assignment, transparency, and accountability as preconditions for more efficient public administration. The training included interactive case studies on water, education, and local financial management, as well as overviews of the decentralization processes ongoing in the Czech Republic, Poland, and Slovakia.

During the second part of the workshop the participants had the floor. They were asked to prepare analyses of decentralization in their respective countries, working in their country teams. Following the presentations of individual country teams and moderated discussion, the participants agreed on the following four topics for their policy research and the follow-up workshops:

- Legal status, responsibilities, and functions of local governments
- Options for the financial viability of local governments
- Capacity building of local government officials and civil servants
- Citizen participation and information technology at the local level.

Each country team will prepare its own policy document on each of the topics. Each country team will also take the lead on one of the topics and prepare a wider regional policy document, summarizing the main points and policy recommendations presented in the individual country studies.

The first follow-up workshop where country teams presented and discussed studies dealing with the legal status and functions of local governments in the Central Asian countries took place at Issyk-Kul Lake, Kyrgyz Republic, on December 2–4.

For more information about this project and other LGI or Fiscal Decentralization Initiative activities in Central Asia, please contact Ondrej Simek at osimek@osi.hu.

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Banking Crises and Bank Rescues: The Effect of Reputation

By Jenny Corbett and Janet Mitchell

In the 1980s and 1990s banking sector problems that frequently escalated to crisis level became common. The countries in which these crises occurred were not all developing and emerging market economies. Despite the frequency with which banking crises occur, investigators have undertaken relatively few formal analyses of regulatory responses to crises. This article focuses on bank rescue packages and on the behavior of troubled banks in response to rescue offers.

Much of the literature on bank regulatory policy suggests that bank rescues are inefficient and can worsen banking sector problems. The whole tenor of prompt corrective action regulation is to avoid having to bail out inadequately capitalized banks; however, in many cases it is already too late for this type of policy response. If many banks become insolvent, policymakers are forced to recapitalize banking systems to avoid credit crunches and premature liquidations of both performing and nonperforming loans. This is the main reason that the International Monetary Fund frequently mandates restructuring packages that involve an element of bank recapitalization.

A puzzling fact is that in many cases policy authorities make offers of bank rescue plans, yet banks are reluctant to accept these offers. In recent years, private banks in both Japan and Thailand have been unenthusiastic about government offers of recapitalization. The failure to convince banks to recapitalize and to restructure and write off nonperforming loans has contributed to the poor performance of the real economy in both countries. By contrast, the Republic of Korea, Norway, and Sweden provide examples of relatively swift recapitalization. This article offers an explanation for these international variations that differs from those previously suggested in the literature.

The current literature does not explain why too few, rather than too many, banks come forward to accept government recapitalization offers. Although some anecdotal evidence suggests that some recapitalization programs failed because the conditions imposed on the banks were too stringent, other anecdotal evidence suggests that this is not the only source of reluctance to accept recapitalizations. Our explanation involves the banks' reputational concerns.

This article investigates banks' behavior during banking crises when asymmetric information exists between banks and outsiders regarding the extent of bad loans on the banks' balance sheets. We show that asymmetric information creates an incentive for banks to roll over their nonperforming loans in an attempt to disguise their true financial situation. Even though a regulator may be able to combat this incentive by offering a "soft" rescue package, bankers' reputational concerns may cause them to reject rescue offers and to continue with loan rollovers.

To induce banks to accept rescue plans and to address their problem loans, regulators may be forced to offer recapitalization in amounts that significantly exceed those necessary to restore banks to solvency. These additional funds serve to compensate bankers for the reputational harm caused by the revelation of bad loans that accompanies their acceptance of a rescue offer. If regulators are constrained in the amount of recapitalization they can offer, they may be unable to induce banks to accept rescue plans and to reveal their bad loans. Alternatively, they may have to wait until the banking crisis becomes

severe and more banks become distressed before the banks are willing to accept rescue offers.

In addition to offering a potential explanation for several observed cases in which banks have refused offers of rescue during banking crises, our approach yields some insight into the link between bank supervisory institutions that are in place ex ante and the policy options that are available to regulators ex post, once a crisis has occurred. In countries with strong supervisory systems, regulators can induce banks to accept rescue plans with lower amounts of recapitalization than if the supervisory system were weak. This suggests the possibility of a vicious circle arising in countries with weak supervisory institutions, namely: weak banking supervision increases the probability of occurrence of a banking crisis, but once a banking crisis has developed, banks are unwilling to reveal their bad loans unless offered a large amount of recapitalization.

A novel policy implication of our analysis is that the optimal rescue plan imposes a cost on banks that reject rescue offers and then exhibit poor performance. By committing to punishing banks that reject rescue offers and are then discovered to be in poor financial shape, the regulator can induce troubled banks to accept rescue offers with less recapitalization than in the absence of such a commitment. If the cost of the punishment is high enough, the regulator can induce banks to accept rescue plans with only negligible recapitalization.

This result points to the informational role that bank rescue offers serve. A rescue offer forces a bank to take an explicit stand with respect to the presence of bad loans on its balance sheets. The bank's acceptance or rejection of a rescue offer conveys information to bank outsiders—which they would not otherwise receive—about the severity of the banking crisis, the bank's type, and the bank's treatment of nonperforming loans. This creates the possibility of punishing banks that are discovered to be trying to hide their nonperforming loans. The ultimate effect of increased information generated by the offer of a rescue plan is to induce banks to reveal their defaulting loans more often than in the absence of rescue offers.

Yet banks may still decide to reject rescue offers. Even when the regulator takes into account bankers' reputational concerns in designing a rescue offer, rejection of the rescue offer may occur in equilibrium. For example, the possibility exists that the high costs of recapitalization may result in an optimal plan whereby the regulator offers an amount of recapitalization that will only be accepted by banks if the crisis is severe enough, but if the crisis is less severe, banks will reject the offer.

Thus far our discussion and analysis have ignored depositor behavior. Like the market, depositors do not observe the state of the world or the bank's type. When a bank rejects a rescue plan in period 1 and succeeds, depositors are unaware of the bank's true financial state. However, we can reasonably assume that depositors do observe the bank's true financial state in period 2. Therefore, even if a bank with loan defaults has succeeded in hiding those defaults in period 1, depositors will observe the bank's true net worth in period 2 and can decide to exit the bank. This would impose an additional cost on the bank that rolled over its defaulting loans in period 1. Thus the more sensitive depositors are to banks' solvency, the greater the costs to banks of rolling over nonperforming loans.

Similar observations apply to the cost the regulator imposes on troubled banks that have rejected rescue plans, but are subsequently discovered by the regulator. In this case depositors also immediately discover not only the existence of the bank's defaulting loans, but also the bank's attempt to deceive outsiders by hiding these loans. Depositors may react to this deception by immediately withdrawing their funds. The likelihood of such a response would increase banks' willingness to accept rescue plans. Thus in countries where depositors exercise strong enough discipline, banks may be willing to accept rescue plans with only small amounts of recapitalization. The discipline exercised by depositors complements the discipline exercised by the regulatory system.

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Who's Afraid of Political Instability?

By Nauro F. Campos and Jeffrey B. Nugent

The analysis of the consequences of sociopolitical instability (SPI) has been a central theme in recent macroeconomic research in general, and in the economic growth literature in particular. Investigators have two completely different views on the relationship between SPI and its effects on growth. This article investigates the existence and direction of a causal relationship between SPI and economic growth.

Some investigators submit that SPI disrupts production and increases uncertainty in the economy. By doing so, it undermines the incentives for accumulating physical capital and reduces the rate of economic growth. By contrast, others argue that economic growth leads to either higher SPI because growth entails substantial structural changes that undo political coalitions and induces painful readjustments in the balance of power among different interest groups, or to lower SPI because it reduces social and political tensions. Even though the existence of a negative relationship between SPI and economic growth has been elevated to "stylized fact" status, the empirical studies on which this purported relationship is based have been heavily criticized for their ad hoc selection of explanatory or control variables, their excessively narrow definitions of SPI, their insufficient sensitivity analysis, and their failure to investigate the direction of causality. Even though we do not agree with all these criticisms, we do believe that this negative relationship should not be elevated to stylized fact status without demonstrating that causality exists, and that it runs from SPI to growth rather than in the opposite direction.

The literature seems to contain two rather different understandings of SPI, one stressing regular and irregular government transfers, the other focusing on much harsher aspects of SPI. The fact that these overlap does little to diminish the different intensities that each attaches to "instability." While the former interpretation constrains it to relatively tame phenomena, the latter places it closer to social chaos. To recognize both views, we construct two measures of SPI: one captures the more severe forms of SPI, while the other captures the less severe forms of SPI. While we could have used many other variants, our justification is that the ones we use can be considered the bounds of the realistic range of such measures, permitting a more complete depiction of the causality between SPI and growth.

Our measure of severe or upper-bound SPI follows the existing literature in using the following three indicators: the numbers of political assassinations per million people, revolutions, and *coups d'etat*. The first of these is particularly important, because it captures a dimension of magnitude that is largely missing from the other measures.

For the measure of moderate or lower-bound SPI we use indicators that include the regulation of political participation and the openness of executive recruitment. Because political actors and processes are subject to systematic regulation, this set of indicators can capture the extent of even subtle changes in both legal and actual practice. The less regulated actors and processes are, the greater the potential for social and political change, and the higher the value of this SPI index.

As both indexes measure SPI, but capture quite different aspects of it, one would expect them to be positively, but not highly, correlated. In general, this expectation is fulfilled except for the Middle East and North Africa. For all other regions the correlation between the respective pairs of SPI indexes is positive and statistically significant.

Next we turn to the rate of real GDP growth and to the time periods chosen. We collected measures of GDP growth for nonoverlapping five-year periods from 1960 through 1995 for an unbalanced panel of 98 developing countries: 14 countries in Asia, 21 in Latin America, 17 in the Middle East and North Africa, and 46 in Sub-Saharan Africa. We found that a significant negative relationship exists both for the pure cross-section relating to growth over the whole period as well as for the individual five-year intervals.

We find that the evidence supporting the hypothesis that high levels of SPI cause lower rates of economic growth is much weaker than generally believed, and we find no traces of a long-run causal relationship. How can we reconcile these conclusions with the differing results of other similar studies? Our sensitivity analysis shows that the Sub-Saharan Africa sample constitutes a large

part of the explanation. Not only is the Sub-Saharan sample much larger than those for other regions, but also its SPI seems to take a more structural form. Our findings support the explanation that, once one controls for institutional development or for the terms of trade, the causality results vanish. Hence we suspect that if other studies were to exclude African countries from their samples, the existing results of a negative relationship between SPI and growth would disappear.

Given the prominence recent macroeconomic research has attached to SPI, we offer a number of suggestions for further research. First, in light of the inconsistency between the existing understanding that a negative relationship exists between SPI and economic growth and our findings of the lack of a causal negative relationship between SPI and growth, one should ask at what frequencies and lag lengths the relationship changes from noncausal to causal. A second direction for future research would be to investigate whether a causal negative relationship emerges between economic growth and other important sources of instability, for instance, policy variability. Third, investigators should readily be able to identify additional omitted variables, especially those of an institutional nature, that might be related to both SPI and growth. Numerous institutional variables may be relevant, like the fairness and effectiveness of the judicial system and the stability of property rights. Fourth, given the difficulties in constructing a lower-bound measure of SPI, exploratory research of this sort with other SPI measures should be encouraged. Finally, in light of the wide variety of other consequences that investigators have ascribed to SPI, an examination of causal relationships between SPI and these other variables should be seriously considered. In particular, seeing whether the Sub-Saharan Africa sample would again play such a determinant role would be interesting.

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The Evolution of Market Integration in Russia

By Daniel Berkowitz and David N. DeJong

The economic reforms Russia initiated in the early 1990s were designed in part to help establish strong internal market linkages across its far-flung and diverse regions. However, recent evidence suggests that the Russian economy more closely resembles a collection of fragmented internal markets, with fiefdoms controlled by regional politicians. Several regions have erected various official trade barriers, while others have established border controls and begun issuing ration coupons to residents in an attempt to limit exports of consumer goods to other regions.

While examples of regional trade barriers can be found within Russia, the pervasiveness and persistence of such barriers is unclear. We investigate this issue by analyzing the extent to which regional borders and distance account for observed differences in commodity prices across 74 regions in Russia. The results indicate substantial variation across time: an initial period of widespread integration gradually gave way to a period of disconnectedness during 1995 through 1997, which had apparently subsided by May 1998.

Next we analyze how these temporal fluctuations in market integration relate to temporal fluctuations in inflation volatility, internal transport costs, international trade, public discontent, and standards of living. With the exception of inflation volatility, we find that these variables exhibit strong statistical relationships with integration. Regarding the relationship between integration and international trade, the widespread disconnectedness observed between 1996 and 1997 coincides with a period when Russia exhibited strong export performance and attracted a large amount of international portfolio investment. A possible interpretation is that the unusually high trade to GDP ratio could signal weakening inter-regional trade relations in Russia.

A growing literature has attempted to measure and explain market integration in transition economies using a variety of different approaches. Several studies have noted a high degree of inter-regional price dispersion, leading the authors to be pessimistic about the opportunities for market integration in Russia. Our goal in studying temporal changes in market integration is to begin to understand the causes of these changes in Russia.

Measuring Integration

In integrated market economies, arbitrageurs and traders can quickly move tradable goods from regions in which sales prices are low to regions in which prices are high, so long as transport costs are not prohibitive. This implies that within a group of integrated regional markets, price differentials for similar tradable goods sold in different regions will increase in proportion to the distance separating the regions.

Our goal is to measure temporal movements in interregional price dispersion. We pursue this goal using a regional dataset that consists of two commodity price indexes: an index that measures the cost of a uniform basket of basic food goods and a regional consumer price index that includes a basket of food goods, nonfood goods, and services. The food basket data span the period April 1994 through November 1999; the regional consumer price index data span the period January 1994 through November 1999. The dataset includes observations collected monthly from 74 Russian cities: Moscow, St. Petersburg, and capital cities in 72 other regions.

The more comprehensive picture of integration we obtain is, as before, roughly U-shaped: an initially high level of integration existed until June 1995, it then fell markedly and remained relatively low until approximately June 1997, and then climbed fairly steadily through the remainder of the sample period. An interesting finding was that the financial crisis of August 1998 had no noticeable impact on integration dynamics.

Market Integration and the Aggregate Economy

Our interest in relation to market integration and the aggregate economy is in analyzing how the temporal fluctuations in regional market integration correspond to related economic and political variables. In earlier studies we showed that voting patterns in the June 1996 presidential elections were important in explaining the regional isolation observed between 1994 and 1996.

Specifically, we classified Russian regions into two categories: those that supported the Communist Party candidate Zyuganov in the final round of elections (termed Red Belt regions), and those that supported Yeltsin. Zyuganov's platform emphasized price controls, price subsidies, and administered resource allocation. In contrast, Yeltsin's platform called for further price liberalization, a cutback in price subsidies, and a deepening of the privatization process. We found that this difference in platforms was an important predictor of differences in policies between the Red Belt and the rest of Russia.

Specifically, we observed significantly more retail price regulation, budgetary and agricultural price subsidization, and less entrepreneurial activity (as measured by the number of legally registered small private firms per capita) in the Red Belt during 1995-96. A possible explanation of this pattern might be that regional governments that use subsidies and price controls to keep basic consumer goods cheap have an incentive to erect borders to limit the outflow of their cheap goods via exports or consumption by nonresidents. The presence of price restrictions and border controls is likely to result in an economic environment that is not conducive to entrepreneurial activity.

To expand on our earlier findings, we begin our analysis here by studying whether regional reformist voting patterns correspond with the evolving pattern of integration reported above. In the June 1994 subperiod, 57 percent of the proreformist voting regions were integrated according to our measure, while 43 percent of the nonreformist regions were integrated.

In the June 1995 subperiod the integration percentages were 24 and 8 percent, respectively. We also find a significant difference in integration percentages for the June 1998 subperiod (66 versus 46 percent). However, this is not the case for the remaining subperiods: integration percentages were nearly identical across classifications in the June 1996 and 1997 subperiods, and in the May 1999 subperiod the integration percentage was actually lower in the proreformist regions (73 versus 86 percent). Thus our findings regarding integration and political attitudes toward economic reform are mixed: the clear positive correspondence observed early in the sample does not hold in the later part of the sample.

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WDI Conference

Second IZA-WDI International Conference on Labor Markets in Emerging Economies
San José, Costa Rica, April 1–6, 2002

Organizers: Hartmut Lehmann, IZA, and Katherine Terrell, WDI.

Part I:
Labor Market Dynamics and Public Policy in a Comparative Perspective: Latin America and Eastern Europe (April 1–3): This part of the conference will focus on microeconomic analysis of labor markets and public policy in these two regions of the world.

Part II:
Job Flows in Transition Economies (April 5–6): The analysis of job creation and job destruction in the old and new sectors is important for understanding the transition from the socialist to a market economy. The papers selected for this workshop will be published in a symposium issue of *the Economics of Transition*, guest edited by John Haltiwanger and Hartmut Lehmann.

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Foreign Investment Boom in Transition Economies Will Withstand Global Slowdown

New Report by the Economist Intelligence Unit

According to a new Economist Intelligence Unit report, East European Investment Prospects, on foreign direct investment (FDI) in 27 transition economies, FDI inflows into the transition economies will remain strong over the medium term, driven by improving business environments across the region. Projections indicate that total FDI inflows into all 27 countries in 2001–05 will reach $162 billion, 36 percent more than the 1996–2000 total of $119 billion.

The projections are based on the Economist Intelligence Unit's model of business environment rankings, which captures current and future trends in business environments and reflects the main drivers of FDI. The model shows that differences in market size, quality of the overall business environment, wage costs, natural resource endowments, privatization methods, and market access explain almost

Table 1. Foreign Direct Investment Inflows, Selected Transition Economies, 1996–2005
($ millions, annual averages)

	1996-2000			2001-05		
		Percentage of			Percentage of	
Country	Total	of GDP	$ per head	Total	of GDP	$ per head
CEE	12,955	4.4	195	16,120	4.0	243
Czech Republic	3,463	6.4	337	4,960	6.9	486
Hungary	2,029	4.4	201	2,030	3.0	205
Poland	6,528	4.3	169	6,900	3.2	178
Slovakia	699	3.5	129	1,640	6.9	303
Slovenia	236	1.3	119	590	2.4	296
Balkans	3,023	3.2	55	4,530	3.8	81
Albania	73	2.4	19	180	3.7	44
Bosnia & Herzegovina	67	1.5	18	340	5.7	82
Bulgaria	594	5.1	74	950	5.6	121
Croatia	882	4.4	196	940	3.6	194
Macedonia	70	2.1	35	180	4.8	90
Romania	1,115	3.0	50	1,350	2.9	60
Yugoslavia, FR	222	1.3	21	580	3.7	54
Baltics	1,173	5.5	154	1,270	4.1	169
Estonia	310	6.3	214	350	4.7	243
Latvia	403	6.7	164	470	5.5	198
Lithuania	460	4.4	124	450	3.1	121
CIS	6,699	1.7	24	10,540	2.1	37
Armenia	112	6.1	30	130	6.0	34
Azerbaijan	681	17.5	86	450	7.4	55
Belarus	239	1.8	24	210	1.6	21
Georgia	152	3.0	28	160	2.7	29
Kazakhstan	1,289	6.7	86	1,300	5.2	88
Kyrgyz Republic	59	3.7	13	90	5.0	18
Moldova	72	4.9	17	120	6.8	28
Russia	3,246	1.1	22	6,600	1.7	46
Tajikistan	25	2.3	4	30	2.2	5
Turkmenistan	94	3.1	20	130	2.2	26
Ukraine	596	1.5	12	1,060	2.1	21
Uzbekistan	135	0.9	6	250	2.2	10
Total	23,851	3.0	57	32,460	3.1	78

Source: Economist Intelligence Unit.

the entire intercountry variation in FDI receipts in the region in 1996–2000.

Lower growth in countries of the Organisation for Economic Co-operation and Development and increased risk perceptions will dampen FDI inflows into the transition economies in the near term. However, this will be offset by the increased relative attractiveness of the region compared with most other emerging markets, a politically-driven positive impact of recent events on FDI prospects for Russia and Central Asia, large sales of state assets, and increased cost-cutting pressures on Western companies that will enhance the attractiveness of relocating operations to Eastern Europe. Thus even though global economic activity is not expected to pick up until the second half of 2002, FDI inflows into the region are forecast to reach almost $32 billion in 2002, which will represent a new record total.

About half of all inflows into the region in 2001–05 will go to the countries of East Central Europe (table 1). Inflows into Russia are projected to average $6.6 billion per year in 2001–05, more than double the modest $3.2 billion annual average recorded in 1996–2000. FDI will be a significant share of GDP in many countries of the region, up to 7 percent in the Czech Republic, Slovakia, and some countries of the Commonwealth of Independent

Table 2. Business Environment Scores and Ranks

	2001–05		*1996–2000*		*2001–05/1996–2000*	
Country	*Total score*	*Regional rank*	*Total score*	*Regional rank*	*Change in score*	*Change in rank*
Estonia	7.40	1	6.86	1	0.54	0
Hungary	7.26	2	6.42	2	0.83	0
Poland	7.07	3	6.22	3	0.85	0
Czech Republic	7.01	4	6.18	4	0.83	0
Slovenia	6.96	5	6.08	5	0.87	0
Lithuania	6.95	6	5.74	7	1.21	1
Latvia	6.88	7	5.87	6	1.01	–1
Slovakia	6.57	8	5.46	8	1.11	0
Croatia	6.33	9	5.23	9	1.10	0
Bulgaria	5.94	10	4.03	17	1.91	7
Kazakhstan	5.59	11	4.30	13	1.29	2
Russia	5.49	12	4.12	14	1.36	2
Armenia	5.34	13	4.50	10	0.84	–3
Azerbaijan	5.28	14	4.35	12	0.92	–2
Romania	5.24	15	4.10	15	1.14	0
Yugoslavia, FR	5.23	16	2.79	27	2.44	11
Macedonia	5.21	17	4.47	11	0.73	–6
Albania	5.09	18	4.01	19	1.07	1
Ukraine	4.95	19	3.27	23	1.69	4
Georgia	4.87	20	4.01	18	0.86	–2
Moldova	4.78	21	4.04	16	0.74	–5
Kyrgyz Republic	4.77	22	3.75	22	1.02	0
Bosnia & Herzegovina	4.66	23	3.98	20	0.68	–3
Belarus	4.16	24	3.91	21	0.25	–3
Tajikistan	3.55	25	2.81	25	0.74	0
Turkmenistan	3.46	26	3.05	24	0.41	–2
Uzbekistan	3.18	27	2.80	26	0.38	–1

Note: Since the late 1990s the Economist Intelligence Unit has provided a quantitative representation of global trends in its international business environment rankings. The framework covers 60 of the world's leading economies that are analyzed regularly in the Country Forecasts publications. The model seeks to measure the quality or attractiveness of the business environment and its key components by using quantitative data, business surveys and expert assessments. The quantitative assessment of the business environment—the opportunities for business—enables a country to be ranked on its overall position and in each of ten categories, on both a global and regional basis. The rankings model is extended and applied to the 27 transition economies.
Source: Economist Intelligence Unit.

States. As privatization opportunities wind down, new greenfield investment and follow-on investment by established investors will play an increasingly important role.

The region's real GDP grew by 6 percent in 2000, by far its best performance since the start of the transition. Average growth is projected to slow to a still respectable 4.5 percent in 2001 and 3.8 percent in 2002. However, strong investment growth, rapid structural change, and dramatic improvements in competitiveness (driven mainly by FDI) in recent years have put most Central and Eastern European economies in a strong position to withstand the short-term slump in demand in the European Union. Growth of 4 to 5 percent per year should be sustainable over the medium term, driven by the returns to earlier reform, the effect on productivity of rising imports of capital goods and technology, and the improvements in infrastructure.

Improved business environments will be the main spur to FDI inflows, especially as privatization opportunities wind down in the region's more advanced economies. Productivity growth will tend to offset the negative impact of rising wage costs on FDI. Estonia is expected to retain the best business environment in the region in 2001–05. The Federal Republic of Yugoslavia is expected to record the greatest absolute and relative improvements, jumping from the bottom spot to 16th place (table 2). Macedonia is expected to suffer the sharpest decline in rank, by six places, between the two periods.

Even though the implementation of reforms will remain a serious problem, Russia is nevertheless expected to substantially improve its business environment in the medium term. The refashioning of Russia's political relations with the West in the aftermath of the September 11 terrorist attacks could have a major impact on FDI by facilitating Russia's integration into the global economy (including through World Trade Organization membership), by altering perceptions of Russia in the West, and by eroding hostility toward foreign capital in Russia.

Financial Supervision in the Baltic Countries

By Jaana Rantama

The banking structures in Estonia, Latvia, and Lithuania were only established in the 1990s, following their independence from the former Soviet Union, and are still in the early stages of development. The initial years of banking sector operations were characterized by both robust growth and crises. Banks were forced to learn how to operate in a market-led environment and had to establish supervisory frameworks. Over the last decade, the three Baltic nations have built their supervisory and banking regulation systems virtually from scratch.

Financial supervision in Estonia is to be renewed by the end of 2002 and is currently undergoing complete restructuring. About three years ago, the Estonian authorities decided to combine supervisory functions for the banking, insurance, and securities sectors. This integrated "super-agency" will launch its operations in early 2002, and is to be staffed by some 50 to 60 people. The agency will be financed by contributions from participants, but initially, until 2004, the Bank of Estonia and the Estonian government will cover some of the costs of setting up the agency. The hope is that the combined supervisory authority will bring about overall improvement in supervisory standards, particularly for capital markets.

Latvian financial supervision commenced in July 2001. In 1997, with the support of the World Bank and the Swedish government, Latvia worked out a combined supervisory authority framework. Legislation in relation to this combined financial supervisory authority was passed in June 2000, and the new body began its operations, as scheduled, in July 2001. The mandate of the Financial and Capital Market Commission is to supervise the banking, securities, insurance, and pension fund sectors, as well as to administer deposit insurance funds. The commission's objective is to promote the interests of investors, depositors, and insurance policyholders.

Lithuanian financial supervision is shared among three separate authorities. The Bank of Lithuania's

68-person supervisory division is responsible for overseeing credit institutions, that is, banks, banking groups, and credit companies. The Securities Commission, established in 1992 through a Ministry of Finance initiative, oversees securities dealers. Its status was altered in 1996, when it was reestablished as an independent authority directly responsible to parliament. Finally, the State Insurance Supervisory Authority operates under the auspices of the Ministry of Finance. In December 2000 the Bank of Lithuania, the Securities Commission, and the State Insurance Supervisory Authority signed an agreement facilitating the the coordination and exchange of data. This cooperative agreement is particularly important, because unlike Estonia and Latvia, Lithuania has not contemplated combining the functions of the supervisory authorities within a single organization

The author is a senior banking supervisor in the Financial Supervision Authority in Finland. This is a shorter version of an article published in the November issue of Baltic Economies—The Quarter in Review, available on http://www.bof.fi/bofit.

Russian Banking Sector Reform in 2004?

By Vesa Korhonen

Russia's banking sector is burdened by a dual legacy of large, state-owned banks inherited from the Soviet era and a plethora of banks of various sizes with diverse ownership structures that sprang up during the economic transition of the 1990s. Together with slow institution building processes, this situation means that Russia faces an abundance of banking reform issues. The Central Bank of Russia and the government only recently moved toward implementing more comprehensive bank reform.

The state holds majority stakes in more than 20 banks that represent a third of the banking sector's total assets. The state also holds minority stakes in a few hundred other banks. According to the banking reform strategy, the state plans to exit from some banks, including two large banks, Vneshtorgbank in 2002, and Vnesheconombank, which will be split into a state debt agency and a commercial bank.

Sberbank, the national savings bank, in which the Central Bank of Russia holds the majority stake, controls more than a fifth of the banking sector's total assets, including a third of credits to corporations and three-quarters of household deposits. Public ownership does not necessarily have to mean less competition, but many market participants and public observers note that Sberbank, which also enjoys government deposit insurance, can undercut loans from other banks by offering better terms. The banking reform strategy does not hold out the prospect of privatizing Sberbank, as its dominance is anticipated to complicate privatization. Instead, the aim is to strengthen the competition. Sberbank's privatization will only be addressed if its market share shrinks when the deposit insurance scheme is extended to most banks.

Weak public trust in banks, along with tendencies toward tax avoidance and established payment traditions, has kept bank deposits small, at 11 percent of GDP, and reliance on ruble cash (7 percent) and foreign currency (some 10 to 15 percent) high. To redress the situation, the bank reform strategy spells out the formation of a general deposit insurance scheme (with a deposit ceiling). The scheme is initially voluntary, but will become compulsory, and deposit-taking rights will be available only to sound banks. Sberbank is unwilling to switch to the scheme until it becomes compulsory.

In another area of bank funding, the Central Bank of Russia initiated most of the major recapitalizations in Russia's banking sector since the 1998 crisis. The aim of the banking reform strategy is to motivate private owners to make their banks more sound through higher capital adequacy requirements. However, the concept of a minimum capital requirement is deemed controversial, because an increase in this requirement could wipe out half of all Russian banks, even though these represent only a small fraction of the sector's assets. As for foreign capital, the process of acceptance gradually continues as the capital requirements for foreign banks are to be lowered and profit repatriation is to be freed up.

The author is an economist at BOFIT. This is a shorter version of an article published in the December issue of Russian Economy—The Month in Review, available on http://www.bof.fi/bofit.

World Bank\IMF\EBRD Agenda

Continued from page 16

the international community that has to help pick up the pieces," said Krueger. As the *Financial Times* put it, Krueger's comments mark a major departure for the IMF, which has looked doubtfully at such ideas and has generally dealt with financial crises by providing massive loans to the afflicted countries. The new scheme would stop bondholders from taking countries to court during the standstill. Debtor countries would be permitted to impose temporary capital controls to prevent capital flight.

Russia Expects $2 Billion Public Sector Loans from EBRD

The Russian government is seeking more than $2 billion over the next three years from the European Bank for Reconstruction and Development (EBRD), the *Moscow Times* reported. The increased focus on public sector—as opposed to private sector—borrowing is expected to push the number of loans to Russia in the bank's total portfolio to 30 percent in the coming years, with €1 billion ($900 million) in new loans approved annually. Economic Development and Trade Minister German Gref has already said that Russia is expecting to receive $800 million from the EBRD in 2002. "Of this amount, 40 percent will be spent for concrete projects, covered by sovereign guarantees, and the remaining 60 percent will go to the private sector," he predicted. The government is ready to provide sovereign guarantees for five projects worth about €370 million. Three of those projects—and the bulk of the money—are slated for St. Petersburg.

The EBRD has invested €4 billion in the Russian economy since 1991, more than 80 percent of which has gone to the private sector, which the bank considers to be its priority. Over the last 10 years only nine loans with sovereign guarantees, totaling $710 million, have been approved. With the new approach the government is taking, the proportion of private sector loans will decrease significantly, which means a new phase in EBRD activity in Russia. The EBRD expects to invest more in infrastructure. With the absence of a fully functioning financial system and the reluctance of Russian banks to finance large infrastructure projects, the EBRD seems ready to fill this gap. It has recently announced a €100 million loan to Unified Energy Systems to help restructure the national power grid, and talks are under way for a $200 million credit for various transportation projects.

The private sector accounts for about 70 percent of the EBRD's overall portfolio. The figure tends to be higher in advanced countries and lower in less developed countries, for instance, it is 53 percent in Uzbekistan and 60 percent in Poland. The EBRD committed €1.24 billion in new loan and equity investments in 33 projects in Central and Eastern Europe and the Commonwealth of Independent States in the first six months of 2001, compared with 27 projects worth €581 million in the first half of 2000.

World Bank Releases $100 Million for Ukraine

On December 7 the World Bank approved the release of $100 million as the second tranche of the Ukraine Programmatic Adjustment Loan, having released the first tranche of $150 million last September. The Bank's statement points out that conditions for the release of the latest tranche were successfully met: the collection of cash from enterprises for the use of electricity (denied for years) went ahead, the obstacles to the next round of privatization of 12 regional power supply and distribution companies were removed, the price of electricity was adjusted, and the action plans for improved financial accountability and public procurement were approved.

Strong GDP growth of 5.8 percent in 2000 was followed by even stronger growth of 9.3 percent during the first three quarters of 2001, and may amount to more than 8 percent for the whole of 2001. Economic growth has now expanded from traditional industrial export goods to encompass agriculture, construction, and food processing.

During an October visit to Ukraine, World Bank President James D. Wolfensohn met Prime Minister Anatoly Kinakh to discuss the Bank's program in Ukraine and the status of economic reforms in the country. Wolfensohn underlined the need to translate Ukraine's strong growth performance into better conditions for the poor and congratulated the government on the recent adoption of a comprehensive poverty reduction strategy.

Balkan States Gain Funding Boost

Donors participating at a conference of the Stability Pact for South-Eastern Europe in Bucharest, Romania, in late October, pledged €2.4 billion ($2.14 billion) for 27 infrastructure projects to improve transport links and to fund energy and environment investments, with the latter focused on water and waste management, as well as to deepen economic integration among the nations of southeast-

ern Europe in a new support package for the Balkans.

About half the financing will take the form of loans from the large multilateral lending institutions, with the rest including soft loans and grants. Romania, with $535 million, and Bulgaria, with $400 million, both negotiating entry into the European Union, will be among the biggest recipients. The Republic of Yugoslavia will obtain another $400 million. Croatia and Bosnia-Herzegovina can expect about $300 million each, while Albania is expected to secure about $250 million. (The Balkan Stability Pact was formed after the 1999 Kosovo war with the goal of delivering regional peace and prosperity.)

World Bank-IMF Paper Assesses Economic Policies in Southeast Europe

The World Bank and the IMF presented a paper to the conference entitled Building Peace in Southeast Europe: Macroeconomic Policies and Structural Reforms since the Kosovo Conflict. The paper paints a guardedly optimistic picture of the region's economic prospects despite the global economic slowdown, which is projected to have a relatively modest impact on the region, although there will be considerable variation across countries. Continued growth is important in tackling two stubborn problems: poverty and unemployment. Governance remains a major weakness that undermines the capacity to implement reforms and enforce the law, and contributes to high levels of organized crime and corruption. The paper warns that the record of attracting investment remains poor, which points to the need to further improve the overall investment climate and, more generally, to create the conditions that stimulate private sector development.

World Bank Regional Office Opened in Zagreb

The World Bank Regional Office for South Central Europe became operational as of November 12. This Zagreb-based office covers the Bank's assistance programs in Bulgaria, Croatia, and Romania. The relocation of the regional office from Washington, D.C. to Zagreb is part of the Bank's decentralization policy. "The Zagreb-based regional office allows us to be closer to our clients and to be more cost-effective in our operations. Also, we will better support steps toward European Union accession of all three countries as well as respond to the Stability Pact initiatives in Southeast Europe," pointed out Andrew N. Vorkink, country director and head of the regional office. The Bank's portfolio in Bulgaria, Croatia, and Romania is almost $5.5 billion. The World Bank's local offices in the three capitals, Sofia, Zagreb, and Bucharest, will be maintained and will now report to the regional office in Zagreb.

Vietnam Receives Assistance from World Bank and IMF

On November 6 the World Bank approved two IDA credits for Vietnam. A $110 million credit will support a new project aimed at reducing poverty in northern mountainous areas. It will help build infrastructure and provide basic education and health care for about 1 million people, 85 percent of whom are ethnic minorities, in six northern provinces, the poorest region of Vietnam. Another $103 million will fund small grants to poor communities to replace old or build new infrastructure (including roads, tracks, trails, bridges and ferry crossings, schools and health centers, irrigation and flood protection works, drinking water systems and sanitation, and electricity), also in the mountainous poor regions, helping 2.4 million people.

In another development, on November 21 the IMF Board approved the disbursement of $52 million to Vietnam, the second tranche of a $368 million loan to assist the country's reform efforts. "Vietnam has made exceptional progress in reducing poverty over the last decade," said Shigemitsu Sugisaki, deputy managing director and acting chairman of the IMF during an earlier visit to Vietnam, and he praised the government for its "sound macroeconomic management, which has kept economic growth relatively robust and inflation low even in a difficult external environment." The IMF will provide additional technical assistance to the country's tax reform efforts.

IFC Examines Russian Investments

Peter Woicke, executive vice president of the International Finance Corporation (IFC), visited Russia in October to examine planned funding projects worth $300 million and assess an already existing loan portfolio of $1 billion. Edward Nassim, head of IFC's Moscow office, said that IFC was optimistic about business opportunities in Russia, and that it hoped to get back to the same level of lending as before the 1998 financial crisis. IFC loaned various companies operating in Russia some $300 million in 1997, but curtailed its activities dramatically in the wake of the August 1998 debt default and ruble devaluation. IFC's net investments increased more than 14 percent to $2.73 billion in the last fiscal year, which ended June 30, 2001. Almost 40 percent of its investments went to high-risk or low-income countries.

Conference Diary

International Conference: Institutional and Organizational Dynamics in the Post-Socialist Transformation
January 25–26, 2002, Amiens, France

Organizers: Le Centre de recherche sur l'industrie, les institutions et les systèmes économiques d'Amiens, the University of Picardie; and Organisation et efficacité de la production, University of Marne-la-Vallée, with the support of the European Association of Comparative Economic Studies, the East-West Network and the *East-West Journal of Economics and Business*, the Centre Interuniversitaire d'Etudes Hongroises, and University La Sorbonne nouvelle. (Languages: English, some workshops in French.)

Topics: Postsocialist transformation, including organizational, institutional, and systemic approaches; the state and the new social compromise; monetary and financial institutionalization; nature, boundaries of the firm, and corporate governance; networks, entrepreneurship, and industrial cooperation; institutional dynamics of regional integration (European Union, Far Eastern Asia); and organizational and institutional impact of foreign investment.

The transformation of former socialist economies entailed new organizational dynamics and the emergence of new institutions. Following the emergence of sometimes new, and more or less stable, social forms, these mechanisms of collective action deeply influenced the specific direction of the transition in different countries. After the redistribution of property rights, the implementation of new legal and regulatory frameworks, the sometimes problematic consolidation of financial systems, and the restructuring of enterprises, former and new actors (*nomenklatura*, foreign investors, entrepreneurs, industrial groups, banks, state agencies, international organizations, employees) participate in the redefinition and sharing of power. They establish relationships and devise organizational approaches that serve as laboratories for testing new rules and methods of coordination.

Analysis of the emergence, development, and stabilization of the new organizational and institutional patterns can contribute to an understanding of the factors that influence the growth pace of these economies, their ability to create virtuous circles, their relationships with the advanced Western economies (competitiveness, regional integration dynamics, and the like), and their monetary and financial strengths, along with the impediments to the transformation process and the characteristics of the late transition countries.

All papers accepted for presentation will be published in a CD-ROM conference proceedings. Selected papers will be published in a special issue of the *East-West Journal of Economics and Business*.

Transformation, Integration, and Globalization Economic Research
March 14–15, 2002, Warsaw, Poland

The Transformation, Integration, and Globalization Economic Research (TIGER) economic think tank will hold the second round of an international conference on the New Economy and Old Problems: The Prospects for Fast Growth in Transition Economies. The conference will feature almost 20 economists from the Organisation for Economic Co-operation and Development, the United Nations University/World Institute for Development Economics Research, the London Business School, the Russian and Hungarian Academy of Sciences, China's National Economic Research Institute, and Poland's Leon Kozminski Academy of Entrepreneurship and Management. *More information about the conference, along with abstracts of the papers, is available on TIGER's web site at http://www.tiger.edu.pl.*

Cultural Legacies of the Soviet Experience
April 26, 2002, Stanford University, U.S.A.

Sponsored by the Center for Russian and East European Studies at Stanford University and the Institute of Slavic, East European, and Eurasian Studies.

Information: University of California, Berkeley, Institute of Slavic, East European, and Eurasian Studies, 260 Stephens Hall #2304, Berkeley, California 94720-2304, tel.: 510-642-3230, fax: 510-643-5045, email: iseees @uclink4.berkeley.edu, Internet: http://socrates.berkeley.edu/~iseees/

International Conference on Globalization and Catching Up in Emerging Market Economies
May 16–17, 2002, Warsaw, Poland

Members of TIGER's scientific advisory board from Chile, China, India, Israel, Italy, Japan Hungary, Poland, Tanzania, Russia, and the United States will discuss prospects, conditions, and challenges for faster economic growth of emerging market economies. Douglas C. North, 1993 Nobel Laureate in Economics,

will deliver the conference's special lecture. More information about the conference is available on http://www.tiger.edu.pl.

CEPR/WDI Annual International Conference on Transition Economics, Riga, June 27–30, 2002

Organizer: Baltic International Centre for Economic Policy Studies (BICEPS).

Call for Papers—**Deadline Monday, February 25, 2002.**

This call for papers invites you to submit a paper proposal for the Annual International Conference on Transition Economics organized by CEPR and WDI and hosted by SITE. The Scientific Organizing Committee for this conference consists of Erik Berglöf (SITE, Stockholm School of Economics, and CEPR), Gérard Roland (ECARES, the Free University of Brussels, CEPR, and WDI), and Jan Svejnar (William Davidson Institute, University of Michigan, CERGE–EI, and CEPR).

Request a submission and reply form from Jessica Mason at CEPR by email at jmason@cepr.org, or by fax on +44 20 7878 2999. All applications must reach CEPR by **Monday, February 25, 2002**. If you would like to submit a paper, please include a one-page abstract and copy of the paper with your reply form. We will confirm your participation by the end of March 2002.

Spatial Inequality and Development Conference
June 27–29, 2002, London School of Economics, London, U.K.

Organizers: Cornell University, London School of Economics, and the World Institute for Development Economics Research.

Spatial inequality is a dimension of overall inequality, but it has added significance when spatial and regional divisions align with political and ethnic tensions to undermine social and political stability. Also important in the policy debate is a perceived sense that increasing internal spatial inequality is related to greater openness of economies and to globalization in general.

Despite these important popular and policy concerns, remarkably little systematic and coherent documentation of what has happened to spatial and regional inequality over the past 10 to 20 years is available. Correspondingly, understanding of the determinants of internal spatial inequality in a globalizing world is insufficient.

The conference seeks to attract contributions that document and analyze within-country spatial inequality and its determinants, especially during the increased globalization of the last two decades. It will take a broad view of inequality, covering the distribution of such variables as economic activity, economic structure, population, income, social indicators, infrastructure, and public expenditure. While the main focus is on the empirical analysis of recent history, contributions that conceptualize the measurement of spatial inequality or analyze its evolution in a longer historical frame will also be considered.

The papers presented at the conference will be collected in a volume edited by Professor Ravi Kanbur, Cornell University, and Professor Tony Venables, London School of Economics, and published by a leading academic press. Decisions on papers accepted for presentation will be communicated by the end of December 2001.

Information: Ravi Kanbur, Cornell University 309 Warren Hall, Ithaca, NY 14853, U.S.A., fax: 607-255-9984, email: sk145@cornell.edu.

11th Conference of the International Association for the Economics of Participation: Participation Worldwide
July 4–6, 2002, Catholic University of Brussels, Belgium

Conference themes: The biannual International Association for the Economics of Participation conferences provide an international forum for presenting and debating current research and scholarship on the economics of participation. The major themes of the 2002 conference will be the following:

- Development and combination of forms of workers' participation around the world
- Theoretical and empirical studies on the economic and social effects of participation
- Workers' participation across borders, in a transnational and global context
- Employee participation and European Union enlargement
- Employee ownership in transition economies
- Workers' participation and social economy in developing countries
- Workers' participation, social dialogue, and civil society.

Information Daniel Vaughan-Whitehead, Avenue du Pesage, 127, B-1050 Bruxelles, Belgium, email: Daniel.Vaughan-Whitehead@cec.eu.int.

New Books and Working Papers

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

Shahid Yusuf, **Globalization and the Challenge for Developing Countries,** WPS 2618, June 2001, 46 pp.
To order: Shahid Yusuf, room MC3-511, tel.: 202-458-2339, fax: 202-522-1150, email: syusuf@worldbank.org.

David Coady, Xinyi Dai, and Limin Wang, **Community Programs and Women's Participation: The Chinese Experience,** WPS 2622, June 2001, 37 pp.
To order: Limin Wang, room MC5-208, tel.: 202-473-7596, fax: 202-522-1735, email: lwang1@worldbank.org.

Elena Ianchovichina and Will Martin, **Trade Liberalization in China's Accession to the World Trade Organization,** WPS 2623, June 2001, 35 pp.
To order: Lili Tabada, room MC3-333, tel.: 202-473-6896, fax: 202-522-1159, email: ltabada@worldbank.

Varun Gauri, **Are Incentives Everything? Payment Mechanisms for Health Care Providers in Developing Countries,** WPS 2624, June 2001, 20 pp.
To order: Hedy Sladovich, room MC2-204, tel.: 202-473-7698, fax: 202-522-1154, email: hsladovich@worldbank.org.

George R. G. Clarke, **Bridging the Digital Divide: How Enterprise Ownership and Foreign Competition Affect Internet Access in Eastern Europe and Central Asia**, WPS 2629, July 2001, 27 pp.
To order: Paulina Sintim-Aboagye, room MC3-300, tel.: 202-473-7644, fax 202-522-1155, email: psintimaboagye@worldbank.org.

Roberto Rocha and Dimitri Vittas, **Pension Reform in Hungary: A Preliminary Assessment**, WPS 2631, July 2001, 29 pp.
To order: Lynn Gross, room H6-148, tel.: 202-473-7030, fax: 202-522-0005, email: lgross@worldbank.

Hungary's pension reform package has been largely successful, significantly reducing imbalances in the pay-as-you-go system and the implicit pension debt while introducing a mandatory, funded, privately-managed pillar that seems to be operating fairly well despite initial problems in the payment and registration systems and some regulatory weaknesses. Roughly half the labor force joined the new system voluntarily. Most who switched were younger than 40. The voluntary switching strategy achieves the same outcome as a forced switch based on an arbitrary cutoff age, while preventing legal problems and helping to reduce the implicit pension debt. However, it does leave a few individuals worse off, a problem that a well-designed public information campaign could ease.

Harry G. Broadman and Francesca Recanatini, **Where Has All the Foreign Investment Gone in Russia?** WPS 2640, July 2001, 29 pp.
To order: Sandra Craig, room H4-166, tel.: 202-473-3160, fax: 202-522-2753, email: scraig@worldbank.org.

Not only has Russia had a poor record of attracting foreign direct investment (FDI) since the advent of reform in the early 1990s, but close to 60 percent of FDI goes to four western regions—Moscow City, Moscow *oblast*, St. Petersburg, and Leningrad *oblast*—that account for only 22 percent of Russia's GNP and 13 percent of the population. Only two of Russia's 85 other regions account for more than 2.5 percent of the country's FDI, and most account for much less. Factors associated with market size, infrastructure development, and the policy environment seem to explain much of the observed variation in FDI flows to different regions in Russia.

Harry G. Broadman and Francesca Recanatini, **Is Russia Restructuring? New Evidence on Job Creation and Destruction,** WPS 2641, July 2001, 33 pp.
To order: Sandra Craig, room H4-166, tel.: 202-473-3160, fax: 202-522 2753, email: scraig@worldbank.org.

Russia's labor market has taken few, limited steps toward becoming more flexible and competitive. Evidence from case studies—based on more than 50 site visits in 2000—suggests that jobs have been destroyed, but only to a limited degree in some sectors and regions, largely because of institutional and incentive constraints and a still widespread "socialist" corporate culture. Jobs have been created—particularly in sectors where devaluation had the most pronounced effect on import substitution and export promotion—but only slowly, mostly because of the lack of skilled workers and limited regional mobility. Labor turnover appears to be higher within regions than across regions. Official data for 1996–99 covering about 128,000 enterprises nationwide indicate that the typical firm has experienced only modest

downsizing in the number of employees: about 12 percent. Smaller firms have entered some sectors and larger, mature businesses have exited. Except for a lull in 1998, the rate of job creation has increased steadily and the rate of job destruction has declined, dropping substantially in 1998–99. "Voluntary" worker separations remain the main—and growing—form of layoffs, and the proportion of layoffs through redundancies is shrinking, and now accounts for about 4 percent of total separations.

Ilker Domaç, Kyle Peters, and Yevgeny Yuzefovich, **Does the Exchange Rate Regime Affect Macroeconomic Performance? Evidence from Transition Economies,** WPS 2642, July 2001, 65 pp.
To order: Armanda Carcani, room H4-326, tel.: 202-473-0241, fax: 202-522-2755, email: acarcani@worldbank.org.

Bartlomiej Kaminski and Beata K. Smarzynska, **Foreign Direct Investment and Integration into Global Production and Distribution Networks: The Case of Poland,** WPS 2646, July 2001, 27 pp.
To order: Lili Tabada, room MC3-333, tel.: 202-473-6896, fax: 202-522-1159, email: ltabada@worldbank.

Yan Wang and Yudong Yao, **Sources of China's Economic Growth, 1952–99: Incorporating Human Capital Accumulation,** WPS 2650, July 2001, 24 pp.
To order: Agnes Datoloum, room J4-259, tel.: 202-473-6334, fax: 202-676-9810, email: adatoloum@worldbank.org.

Between 1978 and 1999, a period of reform, the accumulation of human capital in China—as measured by average years of schooling for the population age 15 to 64—was quite rapid and contributed significantly to growth and welfare. Considering China's need for an innovation-based knowledge economy, the recent declining rate of human capital accumulation is cause for concern. Funding for basic education is unevenly distributed and is insufficient in some poor regions.

Shaohua Chen and Yan Wang, **China's Growth and Poverty Reduction: Trends between 1990 and 1999,** WPS 2651, July 2001, 24 pp.
To order: Agnes Datoloum, room J4-259, tel.: 202-473-6334, fax: 202-676-9810, email: adatoloum@worldbank.org.

Graciela Kaminsky and Sergio Schmukler, **Emerging Markets Instability: Do Sovereign Ratings Affect Country Risk and Stock Returns?** WPS 2678, September 2001, 34 pp.
To order: Emily Khine, room MC3-347, tel.: 202-473-7471, fax: 202-522-3518, email: kkhine@worldbank.org.

Paul Collier and Jan Dehn, **Aid, Shocks, and Growth,** WPS 2688, October 2001, 21 pp.
To order: Audrey Kitson-Walters, room MC3-304, tel.: 202-473-3712, fax: 202-522-1150, email: akitsonwalters@worldbank.org.

Jyotsna Jalan and Martin Ravallion, **Household Income Dynamics in Rural China,** WPS 2706, November 2001, 28 pp.
To order: Catalina Cunanan, room MC3-542, tel.: 202-473-2301, fax: 202-522-1151, email: ccunanan@worldbank.org.

World Bank Country Studies

Czech Republic: Enhancing the Prospects for Growth with Fiscal Stability, October 2001, 120 pp.

Because of its worsening fiscal situation, the Czech Republic has to undertake fiscal retrenchment, which would permit the expansion of private demand without putting undue pressure on interest rates and/or on the external current account. Adjustments should be made on the expenditure side rather than on the revenue side. However, correcting expenditure flows will present challenges in such areas as bank restructuring, social protection, health, education, transport, and housing.

Poland's Labor Market: The Challenge of Job Creation, October 2001, 96 pp.

World Bank Technical Papers

Carmela Martin, Francisco J. Velazquez, and Bernard Funck, **European Integration and Income Convergence: Lessons for Central and Eastern European Countries,** Technical Paper 514, August 2001, 40 pp.

Other World Bank Publications

Yair Baranes and Ronald C. C. Cuming, **The Albanian Collateral Law System Handbook,** November 2001, 286 pp.

The Albanian economy clearly needs more access to development capital if it is to progress and expand. Though international private and public lenders can be of some assistance, much of this capital must come from private domestic sources. However, those supplying it would need some assurance that their loans or grants of credit would be repaid. The state of the law is one of the most important factors in risk assessment and management. This book describes the Albanian collateral law system and details,how

recent changes in the law can facilitate and encourage secured financing in Albania.

Carl J. Dahlman and Jean-Eric Aubert, **China and the Knowledge Economy: Seizing the 21st Century,** World Bank Institute Development Study, October 2001, 200 pp.

Merlinda Ingco and L. Alan Winters, (eds.), **Agricultural Trade Liberalization in a New Trade Round: Perspectives of Developing Countries and Transition Economies,** World Bank Discussion Paper 418, September 2001, 172 pp.

Jane Malme and Joan Youngman, (eds.), **The Development of Property Taxation in Economies in Transition: Case Studies from Central and Eastern Europe,** October 2001, 112 pp.

Transition—The First Ten Years: Analysis and Lessons for Eastern Europe and the Former Soviet Union, November 2001, 150 pp.

World Development Report 2002: Building Institutions for Markets, a copublication of the World Bank and the Oxford University Press, September 2001, 256 pp.

International Institute for Applied Systems Analysis (IIASA) Publications

To order: Schlossplatz 1, A-2361 Laxenburg, Austria, tel: +43 2236 807 342, fax: +43 2236 71313, email: publications@iiasa.ac.at, Internet: http://www.iiasa.ac.at.

Vladimir Benacek, **The Generic Private Sector in an Economy of Transition: Developments and Impacts on the Czech Economy,** IR-01-046, October 2001, 63 pp.

Zoltán Ákos Kovács, **Saving, Investment, and Growth: Catching-Up of Central and Eastern European Countries to the EU,** IR-01-040, September 2001, 64 pp.

TIGER (Warsaw, Poland) Publications

Transformation, Integration, and Globalization Economic Research (TIGER) is Poland's independent, interdisciplinary economic think tank, founded in August 2000. TIGER is devoted to research of postsocialist transformation in Central and Eastern European countries, the former Soviet Union, and Asia. Research topics also include European Union accession, as well as the economic, social, and political effects of globalization in emerging market economies.

To order: Transformation, Integration, and Globalization of Economic Research, ul. Jagiellonska 59, 03-301, Warsaw, Poland, tel.: 48-22-519-2108, fax: 48-22-814-0870, email: tiger@tiger.edu.pl, Internet: http://www.tiger.edu.pl.

Grzegorz W. Kolodko, **Globalization and Transformation: Illusions and Reality,** Working Paper Series (WPS), no. 1, January 2001, 33 pp.

The globalization of economic relationships and the systemic transformation of postsocialist countries are inter-related processes and a characteristic of the turn of the century. Globalization, that is, the institutional integration of national and regional markets into a single worldwide entity, is neither restricted to the last few decades, nor is it, as yet, an irreversible, let alone a complete, process. Even in its most advanced form it does not prevent nations from conducting economic policy whose quality is essential for their economic efficiency and growth rate. In contrast, the market transformation of postsocialist economies and their integration into the world economy along capitalist lines is irreversible, precisely because of globalization. The transformation will soon be complete, unlike globalization, because the latter, as a dynamic, open-ended process, has no end, just as there is no end to socioeconomic development.

Stanislaw Flejterski, **E-Finance and Macro-, Mezzo-, and Microeconomics: An Introduction to Costs and Benefits Analysis**, WPS no. 2, March 2001, 17 pp.

The phenomenon of "e-finance," just like the "new economy," "e-commerce," or "e-business," is at a nascent stage. The current universal surge of globalization in the financial sector has been sparked by a combination of factors led by the Americanization of the world system. The process of e-finance is not a panacea in itself: it is a necessary, but insufficient, mechanism for development and growth. From the perspective of postcommunist countries, including Poland, the so-called new economy, e-commerce, e-business, e-finance, and so on could pose a serious threat, delegating them to secondary, or even marginal, status. However, under certain circumstances they can also present tremendous opportunities. The Internet can become an engine of economic growth in Poland. The following are some of the most important issues that countries striving to lay the foundations for a healthy e-economy should consider:

●Awareness and education—promoting high and ongoing interest in

the Internet, as well as increased and growing computer literacy

●Market economy—ensuring ethical competition, limited state intervention, and the unobstructed transfer of goods and services across borders

●Legislative basics—introducing legislation to eliminate limitations to Internet access and to regulate the status of e-commerce

●Telecommunications infrastructure—ensuring market competition and transparent agreements regarding mutual access to networks

●Easy access to terminals—providing up-to-date technologies and cheaper and better consumer products (new generation cell phones, broadband services, and so on)

●Suitable settlements systems—ensuring the ready accessibly to and safety of cash cards or e-wallets.

Witold Matecki, **The Risk of Currency Crisis in Poland,** WPS no. 3, March 2001, 20 pp.

Grzegorz Wojtowicz, **Monetary Policy: Goals, Conditions, and Limitations,** WPS no. 4, April 2001, 15 pp.

Jan Woroniecki, **New Economy: Illusion or Reality? Doctrine, Practice, and the OECD Perspective,** WPS no 5, May 2001, 38 pp.

Marcin Piatkowski, **Leveraged Buyouts in Poland,** WPS no. 7, June 2001, 46 pp.

Grzegorz W. Kolodko, **The "New Economy" and Old Problems: Prospects for Fast Growth in Postsocialist Countries,** WPS no. 9, June 2001, 19 pp.

László Csaba, **Russia's Political Economy 1**, WPS no 11, June 2001, 11 pp.

Can Russia's recovery be sustainable? If oil prices remain high, growth will continue, albeit slowly. According to United Nations statistics, Russia's GDP is still about two-thirds of its pre-1989 level, thus the potential for quasi-automatic recovery is substantial. Slow and steady institutional improvements are conceivable. A state dominated by oligarchs may well be replaced by a system of oligarchs, nominated and dominated by the state. Insider dominance continues to be an overriding characteristic of Russian capitalism.

If International Monetary Fund and World Bank involvement were the dominant, or at least the most visible, channels in the early 1990s, this period is clearly over. Russia is more likely to be involved and included through such organizations as the Group of Eight, the Paris and London Clubs, or KFOR. Membership in the World Trade Organization is an attainable target that may help formalize reform measures, particularly in the trade sector. Involvement in various organizations that define good banking standards and fiscal, accounting, and disclosure practices may slowly, but steadily, help Russian reformers to change the socio-economic environment.

Grzegorz W. Kolodko, **2025: Two Histories of Economic Growth**, WPS no. 12, September 2001, 22 pp.

Ewa Okon-Horodynska, **Education and the Ability to Function in the Global System,** WPS no. 13, October 2001, 19 pp.

Andrzej K. Kozminski, **Masters and Craftsmen in Management,** WPS no. 14, November 2001, 18 pp.

Other Publications

Paul Dax, József Fucksó, Péter Krajner, and Gábor Ungvári, **Public Grants and Private Investment in Solid Waste Management—Alföld, Hungary,** Discussion Paper no. 19, Open Society Institute, 2001, 88 pp.
To order: Open Society Institute, Nador utca 11, H-1051 Budapest, Hungary, tel.: 361-327-3104, fax: 361-327-3105, email: lgprog@osi.hu.

The authors' research confirmed the hypothesis that, on the whole, government programs fostered inefficiencies in landfill development, both in terms of cost effectiveness and location pattern, and that the programs have not been accompanied by overall modernization and enhancement of waste management services. The government program, which favors small and poorer towns often in the operating area of private landfills, cuts into the potential market of private operators and has inhibited the regionalization of waste management.

Herman W. Hoen, (ed.), **Good Governance in Central and Eastern Europe: The Puzzle of Capitalism by Design,** Edward Elgar Publishing, September 2001, 168 pp.
To order: Edward Elgar Publishing Inc., 136 West St., Suite 202, Northampton, MA 01060-3711, tel.: 413-584-5551, fax: 413-584-9933, email: tgorvine@e-elgar.com.

Kataryna Wolczuk, **The Moulding of Ukraine—The Constitutional Politics of State Formation,** Central European University Press, 2001, 250 pp.
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Volume 12, Number 4
October-November-December 2001

Printed on recycled paper