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Trade in the New Independent States

Edited by
Constantine Michalopoulos and David G. Tarr

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Washington, D.C.

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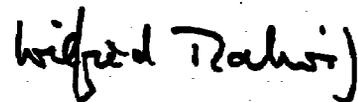
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Foreword

In the fifty years of the World Bank's existence, its economic and sector work has provided the analytical underpinnings for lending programs and policy dialogue with borrower countries. Trade policy is the one area of reform in developing countries that has benefited greatly from analyses conducted in the context of the Bank's economic and sector work. These analyses formed the basis for trade liberalization undertaken by developing countries in the 1980s and early 1990s, supported by World Bank structural and sectoral adjustment lending. Yet, little of this work has been published or disseminated widely.

It is fitting that international trade issues would also be the focus of economic and sector work conducted by the World Bank in the economies in transition. In these countries trade policy is an integral part of price and enterprise reform and has an important bearing on foreign exchange earnings and macro-economic stabilization. This volume is based on economic and sector studies undertaken by World Bank staff and consultants in the context of trade policy reform supported by World Bank lending in eight new independent countries of the former Soviet Union. This work is augmented by a separate analysis of the issues of trade market access that affect these countries' export prospects in OECD markets. I am pleased that the work is being disseminated through this volume both because the findings are of inherent interest to a wide audience and because they provide insight into the analytical basis of World Bank support for trade policy reform.



Wilfried P. Thalwitz
Vice President
Europe and Central Asia

Preface

All fifteen of the new independent states established in the economic space of the former Soviet Union have embarked on economic reforms, each at a different pace and on a different scale. All have experienced substantial declines in output and trade. Their heavy economic interdependence, its roots in the centralized state planning system of the Soviet Union, has intensified the linked contraction in output and trade. This volume explores the factors that have contributed to these declines and identifies policies for restoring trade and output and promoting fuller integration with the world trading community.

Understanding that trade is a crucial component of the economic transformation of these countries, the World Bank has been engaged in an extensive program of research and analysis of international trade and payments as part of its country economic and sector work. This volume reports on important elements of that program: eight country studies, work on improving trade statistics, analysis of the obstacles to expanding exports to OECD markets, and several syntheses of these interrelated issues prepared by the editors of this volume.

The studies have been conducted by World Bank staff of the Europe and Central Asia Region in collaboration with staff from the International Economics Department and outside consultants. Much of this work is unknown or unavailable outside the World Bank. For this volume the principal authors of earli-

er, comprehensive country economic studies undertaken by the Bank revised and updated their work on trade and placed their analysis in the context of the overall framework of each country's macroeconomic, regulatory and enterprise adjustment. This volume collects these studies to facilitate their use by a growing community of scholars and policymakers interested in the problems of economic transition in general and trade and payments issues in particular. Bringing together the principal experiences in this area, and noting the commonalities and the differences, should broaden our understanding of which policies have worked well and which have not and improve policymaking in the future. The studies in this volume were prepared in the spring of 1994 and revised in early summer. In general, they depict the trade and foreign exchange regime that prevailed as of end June 1994. Though the analyses are relatively recent, the fast pace of transition has meant that in some countries the policy environment has evolved significantly from that described in the studies. Publication of the volume is supported by the World Bank-UNDP Trade Expansion Program as well as by the Europe and Central Asia Region and the International Economics Department of the World Bank.

The first chapter brings together the findings of the country studies in an overview of trends in trade and payments and examines the different policy regimes that evolved in the eight countries and the key factors responsible for the collapse of trade. An appendix to the chapter describes the statistical methodology for the data used throughout the volume. Individual country chapters follow on Russia, Ukraine, Estonia, Latvia, Lithuania, Moldova, Kyrgyz Republic, and Uzbekistan. These countries account for more than 90 percent of the trade of the former Soviet Union.

Following the country chapter on Ukraine, chapter 4 presents the results of an enterprise survey of Ukraine that illuminates the implications of trade and payments policy at the microeconomic level. Chapter 11, which follows the country presentations,

addresses the institutional changes that the new independent states need to put in place to improve their prospects for integrating into the world trading community. Chapter 12 addresses the steps OECD countries can take to improve access to world markets for the new independent states. The final chapter offers conclusions and recommendations about the courses of action governments could pursue to increase trade and stimulate growth.

There are six comments in the volume: two on Russia, two on Ukraine, one on Estonia, and one on the Interstate Bank. The comments on the country chapters are based on earlier drafts of the papers that were presented at a conference in McLean, Virginia on June 15-16, 1994. The country chapters have since been revised. The comments were written by authors who, with one exception, are not affiliated with the World Bank but who have extensive first-hand knowledge of the issues of trade and payments reform in individual countries (see contributors page). Typically, these comments complement the country studies by elaborating on the political economy of trade policy decisionmaking.

We gratefully acknowledge the help of Michael Michaely and L. Alan Winters, who reviewed all chapters for the conference. We also thank Morris Morkre, staff of the International Monetary Fund for their comments at the conference, and Daniel Citrin for organizing the participation and comments of the IMF.

Many others have assisted in putting this volume together. Jeff Hayden performed a variety of tasks extremely effectively, including desktop composition, initial design of the cover, production coordination, editorial support, and indexing. Misha Belkindas and his statistical team produced a consistent data set and checked the data in all the chapters. Meta de Coquereaumont edited the volume and greatly improved its presentation. Leonila Oteyza and Minerva Pateña resourcefully coordinated the conference. Minerva Pateña, Maria Luisa de la Puente, Jennifer Ngaine, and Shirlene Coward provided effective secretarial support and word processing.

Contributors

Editors

Constantine Michalopoulos

Constantine Michalopoulos is Senior Advisor in the Russia and Central Asia Department of the World Bank and Adjunct Professor of Economics at American University. His previous assignments in the Bank since 1982 include Senior Economic Advisor to the Vice President for Economics and Research and Director, Economic Policy Analysis and Coordination. Before joining the Bank, he was Chief Economist of USAID. He also taught at Clark University and Trinity College. Mr. Michalopoulos has published extensively on trade and financial policy issues related to development. In the last five years, his writings have focused on trade and payments issues of economies in transition. He holds a Ph.D. in economics from Columbia University.

David G. Tarr

David G. Tarr is Principal Economist in the International Trade Division of the World Bank. His work on transition economies includes numerous journal articles and World Bank missions to Estonia, Hungary, Latvia, Lithuania, Poland, Russia, and Ukraine. Prior to joining the Bank, he taught at Ohio State University and was Senior Economist at the US Federal Trade Commission. Mr. Tarr has authored several books and numerous articles in *Econometrica*, *Review of Economic Studies*, *Quarterly Journal of Economics*, *Journal of International Economics*, *International Economic Review*, *Review of Economics and Statistics* and other journals. He holds a Ph.D. in economics from Brown University.

Chapter Authors

Greta Bull

Greta Bull is Director of the Kiev Regional Office of the Eurasia Foundation. In Ukraine, she has worked as Director of the Kiev Office of Harvard University's Project on Economic Reform in Ukraine (PERU) and later as an associate at the consulting firm Putnam, Hayes and Bartlett, Ltd. The research for the paper included in this volume was conducted under the auspices of the World Bank's McNamara Fellows program from September 1992 to July 1993. Ms. Bull holds a master's degree in public policy from the John F. Kennedy School of Government at Harvard University.

Michael Connolly

Michael Connolly is Visiting Professor of Economics and Acting Director, Program in Economic Policy Management at Columbia University, on leave from the University of Miami. Recent work and missions on trade reform in Mongolia, Peru, Uruguay, and Uzbekistan led to the writing of his joint article Silvina Vatnick on trade reform in a cotton-based economy. His recent publications appear in *Economica*, *Oxford Economic Papers*, and the *Journal of International Money and Finance*. He co-edited *The Effects of Protectionism on a Small Country: the Case of Uruguay*. Mr. Connolly holds a Ph.D. in economics from the University of Chicago.

John Hansen

John Hansen is Senior Economist for Estonia in the Baltics Operations Division of the World Bank. In this capacity he has undertaken a number of studies including one on external trade in the Baltic States in collaboration with Piritta Sorsa and others. He first joined the World Bank in the Industry and Trade Division and also served as the macroeconomic team leader for a major economic mission to Romania when it rejoined the Bank in 1990. Prior to his work on Estonia, he worked as a macroeconomist in Guatemala, Sudan, and India. In addition to World Bank country studies on each of these countries, he has published articles on

industrial development and a book on economic project evaluation. He holds a Ph.D. in economics from the University of Colorado.

Bartłomiej Kaminski

Bartłomiej Kaminski is a long-term consultant to the World Bank and Director of the Center for the Study of Post-Communist Societies at the University of Maryland. He is the author of several books including *The Collapse of State Socialism* (Princeton University Press 1991). For the last three years his research has focused on trade-related issues of transition economies. He holds a Ph.D. from the University of Warsaw.

Vladimir Konovalov

Vladimir Konovalov is Principal Economist for Russia in the Russia and Central Asia Department of the World Bank. He joined the Bank in 1986 and has extensive experience in issues of industrial policy and trade reform. Prior to joining the Bank he held senior positions in the Australian Government. Mr. Konovalov graduated from the Australian National University.

Kathie L. Krumm

Kathie L. Krumm is Principal Economist, Office of the Vice President, Europe and Central Asia Region of the World Bank. She led the trade mission to the Kyrgyz Republic and regularly reviews the trade and finance work on other countries of the former Soviet Union for the Chief Economist. She also has worked in the Southern Africa and Country Policy Departments of the Bank. Prior to joining the Bank she had wide experience in international trade and finance in Latin America, the United States, and Africa. Ms. Krumm holds a Ph.D. in economics from Stanford University.

Francoise Le Gall

Francoise Le Gall was Senior Economist for Ukraine at the World Bank in 1992-94. The article in this volume is based on her work during this period. She has previously held positions in the Asian and African Departments of the International Monetary Fund. She holds a Ph.D. from the University of Michigan.

John Nash

John Nash is Senior Economist in the International Trade Division of the World Bank and Codirector of the World Bank/UNDP Trade Expansion Program. He is currently undertaking missions and research on Georgia. He served as Assistant Professor of economics at Texas A&M University and as Assistant Director and Economic Advisor to the Chairman of the US Federal Trade Commission before joining the World Bank in 1986. He holds a Ph.D. in economics from the University of Chicago.

Piritta Sorsa

Piritta Sorsa is Senior Economist in the International Trade Division of the World Bank. She has published articles on European integration, trade and the environment, and the Uruguay Round. She holds a Ph.D. in international economics from the Graduate Institute of International Studies in Geneva.

Silvina Vatnick

Silvina Vatnick is Senior Economist in the Russia and Central Asia Department of the World Bank, with major responsibility on Uzbekistan. She has worked extensively on issues related to economic reform in the former Soviet Union since 1992. She has also worked on debt, trade, and capital flows policy issues in Africa and Latin America and has published various articles on macroeconomic stabilization, external debt, and capital flight. Ms. Vatnick is a Ph.D. candidate at Columbia University.

Jonathan Walters

Jonathan Walters has been Country Economist for Moldova at the World Bank for the past two years and has led several policy-related missions to the country. He has also undertaken similar work in Armenia during that period. Previously he worked on macroeconomic issues in West Africa and trade policy analysis in the customs unions of central Africa and southern Africa. Mr. Walters has an M.Sc. in economics from the University of London and an M.A. in philosophy, politics and economics from Oxford University.

Other Contributors**Misha Belkindas**

Misha Belkindas is Statistical Advisor in two departments of the World Bank that deal with the countries of the former Soviet Union. Prior to joining the Bank, he was Director of the Centrally Planned Economies Service at the WEFA Group. He has worked in economic forecasting and statistical issues, including trade statistics of the former Soviet Union and Eastern Europe, for the past fifteen years. He holds a Ph.D. in mathematical economics from the Central Economics and Mathematics Institute of Moscow.

Yuri Dikhanov

Yuri Dikhanov is a consultant in the Office of the Director of Russia and Central Asia Department of the World Bank. His responsibilities include foreign trade, national accounts, and price statistics for countries of the former Soviet Union. His previous research includes work in index number theory. He holds an M.S. in applied mathematics and mathematical economics from the Moscow Institute of Physics and Technology. He is a Ph.D. candidate at the Institute of Economic Forecasting of the Russian Academy of Sciences.

Sergei Glaziev

Sergei Glaziev is a member of the State Duma of the Federal Assembly of the Russian Federation and chairman of its Economic Policy Committee. Between October 1991 and October 1993 he was First Deputy Minister and subsequently Minister of Russia's Ministry of Foreign Economic Relations. He holds a Ph.D. from the Central Economics and Mathematics Institute, Moscow.

Daniel Gros

Daniel Gros is Senior Research Fellow at the Center for European Policy Studies in Brussels and Visiting Professor at the Johann-Wolfgang Goethe Universitat Frankfurt am Main. Since July 1992 he has been Head of the Group of Experts of the European Union's program for Technical Assistance for the Commonwealth of Independent States (TACIS). In that capacity he has advised a number

of CIS governments on intra-CIS trade and payment affairs. He holds a Ph.D. in economics from the University of Chicago.

Ardo Hansson

Ardo Hansson is a Research Fellow at the Stockholm Institute of East European Economics, Economic Advisor to the government of Estonia, and Member of the Board of the Bank of Estonia. His academic work focuses on the economic transformation in the Baltic States. His advisory work in Estonia has concentrated on monetary reform and macroeconomic policy. He holds a Ph.D. in economics from Harvard University.

Oleh Havrylyshyn

Oleh Havrylyshyn is an Alternate Executive

Director (Ukraine) at the International Monetary Fund. He had previously been Professor of Economics at George Washington University before serving as Deputy Minister of Finance of Ukraine. He has written extensively on trade policy issues and recently on Ukrainian reform problems. He holds a Ph.D. from MIT.

Daniel Kaufmann

Daniel Kaufmann is Chief of the World Bank Mission in Kiev, Ukraine. He has previously been Principal Economist in the Europe and Central Asia Department, a core team member of the 1991 World Development Report (*The Challenge of Development*), and Senior Economist in East Africa. He holds a Ph.D. in economics from Harvard University.

1

Summary and Overview of Developments Since Independence

*Constantine Michalopoulos
and
David G. Tarr*

- Trends in Trade
- The Trade-Macroeconomy Link
- Trade with the Rest of the World: The Bias Against Exports
- Conclusions

The break up of the former Soviet Union left trade in the fifteen new independent states in disarray. Between 1990 and 1993 the combined exports and imports of these countries with the rest of the world ("third country" trade) fell by half, while trade among these countries ("interstate" trade) declined even more. Though actual declines were less severe than the precipitous drops recorded in official statistics, there is little doubt that trade has contracted sharply. This sharp contraction has been caused in part by contractions in output, but the trade decline has also caused the output decline, and the trade decline has been exacerbated by inappropriate policies. Thus, trade policy reforms are essential for macroeconomic recovery of output in the immediate future as well as for efficient resource allocation and growth in the longer term.

This chapter summarizes the main developments and issues affecting the trade of the fifteen states from 1992 to the first half of 1994. It begins with the trade data that establish the empirical basis of the subsequent discussion and then explains the interactions between the decline in output and the fall in trade.

An exploration of the problems of trade with the rest of the world makes clear that, except in the case of a few countries, mostly the Baltics, third-country trade had been restrained by limitations on exports and by the continued

dominance of state trading organizations. Formal import barriers have been, until 1994, low or nonexistent, though undervalued exchange rates or foreign exchange rationing have, in most cases, shielded domestic producers from competition from imports.

Interstate trade among these countries has been plagued by all the problems of third country trade, but with even greater export controls and state intervention, prompted in part by severe payments difficulties. Liberalization of energy prices has dealt the energy importers among these countries a more severe terms of trade shock than that sustained by energy importers when oil prices soared in 1973 and has generated a commensurate need for adjustment and financing. Partly in response to these problems countries established a network of massive intergovernmental barter agreements that are fundamentally incompatible with the development of a market economy.

The fifteen countries emerged in 1992 with the common heritage of the centrally planned economy and trade of the Soviet Union. Their experience in coping with the complex challenges

posed by international trade has been sharply different. Differences in initial conditions account for some of the disparity, but differences in policies affecting trade have had the greater impact.

Trends in Trade

Over the period 1990-93 recorded trade of the new independent states fell by more than 60 percent. Trade among these states bore the brunt of the decline. The lack of consistent and reliable data makes estimating changes in the international trade of the new independent states more problematic than usual, particularly for interstate trade. The following quantitative analysis is based on the most up-to-date information available from national and international sources, and its general conclusions are confirmed by evidence from separate enterprise surveys (see chapter 4 and de Melo and Ofer 1994; a detailed discussion of issues related to trade statistics in the former Soviet Union is contained in the statistical appendix to this chapter).

Exports to the rest of the world fell from \$105 billion in 1990 to \$58 billion in 1993, or 46 percent. Imports shrank even more, from \$121 billion to

Table 1.1 Trade with the Rest of the World, 1990-93
(millions of current U.S. dollars)

	1990		1991		1992		1993	
	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
Armenia	109	855	70	830	40	95	29	188
Azerbaijan	723	1,413	487	1,248	754	333	351	241
Belarus	3,438	5,256	1,661	1,957	1,061	755	737	777
Estonia	198	592	50	204	242	254	461	618
Georgia	515	1,543	30	480	161	269	222	460
Kazakhstan	1,777	3,250	1,183	2,546	1,489	961	1,529	1,269
Kyrgyz Republic	89	1,298	23	785	77	71	112	112
Latvia	304	1,642	125	478	429	423	460	339
Lithuania	679	1,543	345	475	557	342	696	486
Moldova	405	1,432	180	656	157	170	174	210
Russia	80,900	82,900	53,100	45,100	41,600	37,200	43,900	33,100
Tajikistan	609	655	424	706	111	132	263	374
Turkmenistan	195	523	146	618	1,145	543	1,156	749
Ukraine	13,390	15,907	8,500	11,300	6,000	5,500	6,300	4,700
Uzbekistan	1,390	2,217	1,257	2,048	869	929	1,466	1,280
Former Soviet Union	104,721	121,026	67,581	69,431	54,691	47,977	57,857	44,903

Note: The rest of the world refers to countries outside the former Soviet Union

Source: National official statistics and CIS Goskomstat

\$45 billion or 63 percent (table 1.1). Undoubtedly, part of the decline simply reflects the overvaluation of the official exchange rate for the ruble in 1990. Moreover, it is quite likely that the actual decline in the volume of this trade was smaller than the recorded one. There is strong evidence of high levels of unrecorded "illegal" exports, underinvoicing and transshipments to the rest of the world—mostly transshipments of Russian goods through the Baltic states (see chapter 12). But the declines in exports were so large that unrecorded flows are unlikely to explain most of the drop. It is estimated, for example, that oil exports to the rest of the world fell from almost 100 million tons in 1990 to 66 million tons in 1992 before rebounding to 80 million tons in 1993. Even after accounting for unrecorded exports—it seems probable that real exports declined substantially.

Russia and Ukraine, the two largest countries, experienced significant drops in trade with the rest of the world. Russia's recorded exports, for example, fell from an estimated \$80.9 billion in 1990 to \$43.9 billion in 1993, imports from \$82.9 billion to \$33.1 billion. Ukraine's exports plunged from an estimated \$13 billion in 1990 to \$6 billion in 1993.

At the same time, though, several other countries reported increases in third country exports, notably Estonia, Kyrgyz Republic, Latvia and Turkmenistan. For Turkmenistan the changes probably reflect greater accuracy in the reporting of energy exports previously attributed to Russia rather than real increases in exports, and for Latvia and the Kyrgyz Republic reexports from Russia probably account for much of the increase. For Estonia, however, the increase seems to reflect the deliberate decision starting in 1992 to reorient its trade toward Europe.

Interstate trade declined more than trade with the rest of the world; but it is difficult to develop statistical estimates that accurately capture this decline. This trade has been almost completely denominated in rubles (Soviet and, since mid-1993, Russian), which have been subject to very high inflation. Three alternative estimates of the evolution of interstate trade were calculated for this study: in constant rubles; in US dollars, first (in

1990) at the official exchange rate and then at market exchange rates; and at implicit exchange rates that attempt to capture the rates used in interstate transactions, which frequently differed substantially from both market and official rates. All three estimates suffer from shortcomings, (discussed in the statistical appendix), but despite significant divergence among them, all three point to drastic declines in interstate trade of at least 65 percent over three years (table 1.2).

There is little information on the composition and direction of interstate trade and how these have changed. The information that is available suggests that trade between Russia and most of the other states has declined by less (64 percent) than trade among the other states (71.5 percent). Two sets of factors account for this development. First, Russian exports consist primarily of hard to replace energy and raw material products. Second, although payments problems and financing difficulties have handicapped all interstate trade, these problems were especially acute in non-Russian trade among these countries. Imports from OECD countries appear to have displaced some interstate trade as well. For example, the supply of temperate-climate foodstuffs to Russia on credit, combined with subsidies for such foodstuffs in the domestic market, has reportedly undercut traditional suppliers of these products in the Russian market, such as Moldova.

Estimates of total trade (interstate trade and trade with the rest of the world) using two alternative estimates for interstate trade clearly show a significant decline in total trade, as well as a sharp drop in the share of interstate trade that today may be as little as one third of the total (tables 1.3 and 1.4). Some longer term decline in interstate trade was expected, since previous trade patterns among these countries had not been based on comparative cost or locational advantage. On balance, however, and recognizing that the actual drop is less than the recorded one, significant declines in trade volumes are worrisome because they contribute to the disruption of production and falling incomes. The contraction of output then can have further multiplier effects on trade.

Table 1.2 Trade among the Countries of the Former Soviet Union, 1990-93

	1990		1991		1992		1993	
	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
<i>Millions of 1990 Rubles</i>								
Armenia	3,428	3,508	1,835	2,407	1,294	851	554	622
Azerbaijan	6,105	4,247	4,575	3,685	2,318	1,716	1,124	863
Belarus	17,224	14,841	12,415	11,152	9,659	8,488	7,349	6,895
Estonia	2,468	2,803	1,928	1,603	732	620	414	282
Georgia	5,724	4,949	2,723	2,532	662	951	617	835
Kazakhstan	8,443	14,314	7,231	9,140	6,928	10,065	4,610	6,609
Kyrgyz Republic	2,445	3,179	2,605	2,248	1,193	1,261	595	709
Latvia	5,028	4,711	3,116	2,377	2,479	1,912	734	596
Lithuania	6,575	6,509	4,741	3,422	2,287	2,432	1,372	969
Moldova	5,853	4,992	2,991	2,962	1,558	1,815	1,373	1,389
Russia	74,710	67,284	58,837	42,915	42,464	37,006	27,493	23,280
Tajikistan	2,377	3,359	1,621	2,284	423	735	245	371
Turkmenistan	2,469	2,923	2,614	1,910	2,496	2,192	1,425	1,910
Ukraine	38,319	38,989	27,342	32,970	17,722	26,152	10,878	18,615
Uzbekistan	8,169	11,864	6,642	7,371	2,989	3,639	2,874	3,213
Former Soviet Union	189,337	188,472	141,216	128,978	95,204	99,834	61,657	67,158
<i>Millions of current U.S. dollars at official and commercial exchange rates</i>								
Armenia	5,810	5,946	3,823	4,686	243	292	124	159
Azerbaijan	10,347	7,198	9,091	7,013	521	434	629	461
Belarus	29,193	25,154	23,151	20,375	1,939	2,128	3,092	3,348
Estonia	4,183	4,751	3,836	2,996	147	146	341	326
Georgia	9,702	8,388	5,594	4,806	144	224	295	433
Kazakhstan	14,310	24,261	14,285	16,949	2,141	2,463	3,126	3,576
Kyrgyz Republic	4,144	5,388	5,163	4,293	236	344	282	378
Latvia	8,522	7,985	5,920	4,365	451	472	587	649
Lithuania	11,144	11,032	9,268	5,251	505	624	929	1,111
Moldova	9,920	8,461	6,190	5,525	244	377	636	743
Russia	126,627	114,041	108,571	83,333	10,954	9,246	15,752	10,546
Tajikistan	4,029	5,693	3,456	4,361	93	172	118	198
Turkmenistan	4,185	4,954	6,314	3,684	616	410	1,731	876
Ukraine	64,947	66,083	49,598	61,217	5,262	6,425	5,669	9,185
Uzbekistan	13,846	20,106	13,761	14,100	628	827	2,085	2,225
Former Soviet Union	320,910	319,444	268,022	243,954	24,124	24,583	35,396	34,211
<i>Millions of current U.S. dollars at implicit exchange rates</i>								
Armenia	3,509	5,477	1,882	3,766	1,335	1,339	583	999
Azerbaijan	8,213	7,300	6,167	6,347	3,144	2,972	1,555	1,526
Belarus	27,660	28,740	19,977	21,640	15,636	16,568	12,144	13,739
Estonia	3,289	5,257	2,574	3,013	983	1,173	568	543
Georgia	5,168	7,608	2,463	3,900	602	1,473	573	1,321
Kazakhstan	13,993	24,810	12,008	15,874	11,574	17,586	7,863	11,788
Kyrgyz Republic	3,250	5,120	3,470	3,628	1,599	2,048	814	1,175
Latvia	6,516	8,302	4,046	4,197	3,239	3,396	978	1,082
Lithuania	7,213	12,082	5,211	6,365	2,529	4,551	1,548	1,852
Moldova	4,984	8,442	2,552	5,019	1,337	3,093	1,203	2,417
Russia	146,183	95,802	115,355	61,227	83,753	53,113	55,355	34,109
Tajikistan	2,760	5,375	1,886	3,662	495	1,186	292	611
Turkmenistan	4,603	4,042	4,883	2,646	4,691	3,055	2,734	2,717
Ukraine	60,348	71,841	43,147	60,872	28,133	48,573	17,628	35,294
Uzbekistan	11,327	18,818	9,228	11,715	4,177	5,818	4,100	5,243
Former Soviet Union	309,016	309,016	234,851	213,869	163,227	165,944	107,942	114,417

Note: Total interstate exports of the former Soviet Union may not equal imports because country data were independently estimated.
Source: 1990 and 1991, official statistics; 1992 and 1993, World Bank staff estimates. See Appendix on foreign trade statistics.

Table 1.3 Total Trade of Countries of the Former Soviet Union, 1990-93
(millions of current U.S. dollars)

	1990		1991		1992		1993	
	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
<i>At official and commercial exchange rates</i>								
Armenia	5,919	6,801	3,893	5,516	283	387	153	347
Azerbaijan	11,070	8,611	9,578	8,261	1,276	766	980	702
Belarus	32,631	30,410	24,812	22,332	3,000	2,883	3,829	4,125
Estonia	4,381	5,343	3,886	3,200	389	400	802	944
Georgia	10,217	9,931	5,624	5,286	305	493	517	893
Kazakhstan	16,087	27,511	15,468	19,495	3,630	3,424	4,655	4,845
Kyrgyz Republic	4,233	6,686	5,186	5,078	313	414	394	490
Latvia	8,826	9,627	6,045	4,843	880	895	1,047	988
Lithuania	11,823	12,575	9,613	6,726	1,062	966	1,625	1,597
Moldova	10,325	9,893	6,370	6,181	400	547	810	953
Russia	207,527	196,941	161,671	128,433	52,554	46,446	59,652	43,646
Tajikistan	4,638	6,348	3,880	5,067	204	304	381	571
Turkmenistan	4,380	5,477	6,460	4,302	1,761	953	2,887	1,625
Ukraine	78,337	81,990	58,098	72,517	11,262	11,925	11,969	13,885
Uzbekistan	15,236	22,325	15,018	16,148	1,497	1,756	3,551	3,505
Former Soviet Union	425,631	440,470	335,603	313,385	78,815	72,560	93,253	79,114
<i>At implicit exchange rates</i>								
Armenia	3,618	6,332	1,952	4,596	1,375	1,434	613	1,187
Azerbaijan	8,936	8,713	6,654	7,595	3,898	3,305	1,906	1,767
Belarus	31,098	33,996	21,638	23,597	16,697	17,323	12,881	14,516
Estonia	3,487	5,849	2,624	3,217	1,225	1,427	1,029	1,161
Georgia	5,683	9,151	2,493	4,380	763	1,742	795	1,781
Kazakhstan	15,770	28,060	13,191	18,420	13,063	18,547	9,392	13,057
Kyrgyz Republic	3,339	6,418	3,493	4,413	1,675	2,118	926	1,287
Latvia	6,820	9,944	4,171	4,675	3,668	3,819	1,438	1,421
Lithuania	7,892	13,625	5,556	6,840	3,086	4,893	2,244	2,338
Moldova	5,389	9,874	2,732	5,675	1,494	3,264	1,377	2,627
Russia	227,083	178,702	168,455	106,327	125,353	90,313	99,255	67,209
Tajikistan	3,369	6,030	2,310	4,368	606	1,318	556	985
Turkmenistan	4,798	4,565	5,029	3,264	5,836	3,598	3,890	3,466
Ukraine	73,738	87,748	51,647	72,172	34,133	54,073	23,928	39,994
Uzbekistan	12,717	21,035	10,485	13,763	5,046	6,747	5,566	6,523
Former Soviet Union	413,737	430,042	302,432	283,300	217,918	213,920	165,799	159,319

Source: Tables 1.1 and 1.2

The geographic distribution of trade with the rest of the world has also changed substantially since the breakdown of the USSR. The geographic distribution of Russia's trade over time, for example, shows that the collapse of the trade arrangements of the Council for Mutual Economic Assistance (CMEA) and the shift by East European countries to convertible currency trade at world market prices contributed to the dissolution of traditional trade links with the Soviet Union (table 1.5).¹ Other trade has suffered as well. Russia's trade with India, for example, has fallen by more than 50 percent in the last two years. Only trade

with OECD countries and China has held up fairly well. There seems to have been some reduction of exports of energy and raw materials to these markets in order to obtain foreign exchange, while imports have been sustained through OECD credits for foodstuffs and other products. As a result the OECD countries are now the biggest trading partners of Russia (see table 1.5) and several other new independent states.

The Trade-Macroeconomy Link

Several factors have contributed to the disarray in trade relations in the new independent states

Table 1.4 Trade with the Rest of the World as Shares in Total Trade, 1990-93 (percent)

	1990		1991		1992		1993	
	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
<i>At Official and commercial exchange rates</i>								
Armenia	1.8	12.6	1.8	15.0	14.1	24.6	19.2	54.2
Azerbaijan	6.5	16.4	5.1	15.1	59.1	43.4	35.8	34.3
Belarus	10.5	17.3	6.7	8.8	35.4	26.2	19.2	18.8
Estonia	4.5	11.1	1.3	6.4	62.2	63.5	57.5	65.5
Georgia	5.0	15.5	0.5	9.1	52.8	54.5	43.0	51.5
Kazakhstan	11.0	11.8	7.6	13.1	41.0	28.1	32.8	26.2
Kyrgyz Republic	2.1	19.4	0.4	15.5	24.5	17.0	28.4	22.9
Latvia	3.4	17.1	2.1	9.9	48.8	47.2	43.9	34.3
Lithuania	5.7	12.3	3.6	7.1	52.5	35.4	42.8	30.4
Moldova	3.9	14.5	2.8	10.6	39.1	31.1	21.5	22.0
Russia	39.0	42.1	32.8	35.1	79.2	80.1	73.6	75.8
Tajikistan	13.1	10.3	10.9	13.9	54.3	43.5	69.0	65.4
Turkmenistan	4.5	9.5	2.3	14.4	65.0	57.0	40.0	46.1
Ukraine	17.1	19.4	14.6	15.6	53.3	46.1	52.6	33.9
Uzbekistan	9.1	9.9	8.4	12.7	58.1	52.9	41.3	36.5
Former Soviet Union	24.6	27.5	20.1	22.2	69.4	66.1	62.0	56.8
<i>At implicit exchange rates</i>								
Armenia	3.0	13.5	3.6	18.1	2.9	6.6	4.8	15.8
Azerbaijan	8.1	16.2	7.3	16.4	19.3	10.1	18.4	13.6
Belarus	11.1	15.5	7.7	8.3	6.4	4.4	5.7	5.4
Estonia	5.7	10.1	1.9	6.3	19.8	17.8	44.8	53.2
Georgia	9.1	16.9	1.2	11.0	21.1	15.4	27.9	25.8
Kazakhstan	11.3	11.6	9.0	12.8	11.4	5.2	16.3	9.7
Kyrgyz Republic	2.7	20.2	0.7	7.8	4.6	3.3	12.1	8.7
Latvia	4.5	16.5	3.0	10.2	11.7	11.1	32.0	23.9
Lithuania	8.6	11.3	6.2	6.9	18.1	7.0	31.0	20.8
Moldova	7.5	14.5	6.6	11.6	10.5	5.2	12.7	8.0
Russia	35.6	46.4	31.5	42.4	33.2	41.2	44.2	49.2
Tajikistan	18.1	10.9	18.4	16.2	18.3	10.0	47.4	38.0
Turkmenistan	4.1	11.5	2.9	18.9	19.6	15.1	29.7	21.6
Ukraine	18.2	18.1	16.5	15.7	17.6	10.2	26.3	11.8
Uzbekistan	10.9	10.5	12.0	14.9	17.2	13.8	26.3	19.6
Former Soviet Union	25.3	28.1	22.3	24.5	25.1	22.4	34.9	28.2

Source: Tables 1.1 and 1.2

and the significant decline in output since 1990.² Some problems were inherited problems from the Soviet economy and planning system,³ some are part of the transition from central planning, and some arise from the policies countries have introduced to cope with these problems.

In the Soviet era the central plan (determined by Gosplan) established mandatory production and delivery targets for enterprises. Trade among republics was domestic trade and, along with foreign trade, was directed as part of the centralized allocation of resources. The planning mechanism often called for a few large facilities to supply all

of the Soviet Union; their location was determined with little regard for comparative or locational advantage. Raw materials allocations within and between republics were implemented by Gosnab and its local subsidiaries at the republic level, while the foreign trade plan, which determined exports and imports, was implemented by state foreign trade organizations. The banking system was an instrument of Gosplan and played a passive (basically accounting) role in domestic and international trade. Enterprises were guaranteed payment. Their key concern was the delivery of inputs, which were essential to their fulfillment of output targets. A

large share of total international trade was directed to CMEA countries and was conducted on the basis of massive bilateral barter agreements between governments, which in effect extended the central plan mechanism outside the Soviet Union.

Domestic prices were controlled and did not reflect relative scarcities. A system of trade taxes and subsidies—the so-called price equalization system—isolated domestic prices from world market prices. The exchange rate of the ruble was fixed and reflected a significant overvaluation. The price structure that resulted involved large net subsidies by energy and raw material exporters: Within the USSR energy-exporting republics subsidized energy importers (Tarr 1994), while the USSR as a whole tended to subsidize the rest of the CMEA (Marrese and Vanous 1983; Oblath and Tarr 1992).

This system came under increasing strain in the late 1980s as enterprises were given dramatically increased autonomy, most notably the right to pay higher wages. Economic decisionmaking was being decentralized before enterprises had been privatized or had developed an effective corporate governance structure. Managers, increasingly under the influence of labor, were paying higher wages and bartering enterprise output for consumer goods.⁴

This diversion of enterprise output led to problems with plan fulfillment and to declining output.⁵ Of course, with less output there was less to trade.

In addition, the central government's control over implementation of the plan at the republic level had diminished. In 1991, a transition year, international trade suffered as a consequence of the USSR's deteriorating capacity to supply exportables such as oil, while the demise of the CMEA contributed to the decline of that portion of trade that could not efficiently compete with imports from the West (Michalopoulos and Tarr 1992). Republican authorities began to challenge Moscow openly over a range of economic policies: They began to withhold taxes, to restrain exports to other republics, and, in the case of the Baltics, to initiate market oriented economic reforms, including the liberalization of prices.

Once the USSR broke up, the centralized allocation of resources by Gosplan and Gosnab ended, but new market-based mechanisms for allocating resources were slow to emerge in most countries. With production highly concentrated as it was in many industries, the failure to receive needed inputs from suppliers in the other new countries led to output declines in downstream industries whose failure to deliver inputs to enterprises in the next stage of production often affected production levels in yet another new independent state. These problems were exacerbated by payments issues that arose immediately after independence (see below).

Traditional exports to the rest of the world were concentrated in the raw material and natural

Table 1.5 Geographic Distribution of Russia's Trade Outside the Former Soviet Union, 1990-93
(millions of U.S. dollars)

	1990		1991		1992		1993	
	Amount	Percentage share						
EXPORTS	80,900	100.0	53,100	100.0	41,600	100.0	43,900	100.0
OECD	30,282	37.4	37,195	70.0	25,376	61.0	26,607	60.6
Former CMEA countries	34,818	43.0	12,162	22.9	8,320	20.0	7,680	17.5
Rest of the world	15,800	19.5	3,742	7.0	7,904	19.0	9,613	21.9
IMPORTS	82,900	100.0	45,100	100.0	37,200	100.0	33,100	100.0
OECD	32,401	39.1	30,906	68.5	22,947	61.7	18,310	55.3
Former CMEA countries	34,757	41.9	11,071	24.5	5,390	14.5	3,771	11.4
Rest of the world	15,743	19.0	3,123	6.9	8,862	23.8	11,019	33.3

Source: Goskomstat of Russian Federation and tables 1.1 and 1.2

resource goods that were more easily marketed in the West than industrial products. Some countries had a greater capacity to export these goods than others. For example Kazakhstan and Turkmenistan started off with significantly greater capabilities to export energy and raw materials than, for example, Belarus or Ukraine. But following independence, supply problems linked to the availability of parts and equipment constrained exports of several of these products, particularly oil.

Despite very favorable exchange rates, nontraditional exports were handicapped by the past orientation of production toward sheltered markets, which, especially in the machinery sector, had stifled product innovation and resulted in low quality products. These products (known as "soft" goods) were very difficult to market in OECD markets, a problem exacerbated by enterprises' lack of marketing expertise and knowledge of customers' information residing almost exclusively in the foreign trade organizations in Moscow.

Meanwhile, the continued reliance on state trading inhibited the development of the infrastructure needed to conduct trade in a market economy. The available methods of payments did not protect traders from the risks of nonpayment by buyers or nonperformance by suppliers. The legal and the administrative framework for enforcing trade-related financial and shipping contracts was inadequate, and modern mechanisms of payment such as letters of credit were unavailable. Preshipment finance was unavailable because commercial banks avoid extending loans except for very short maturities in periods of high inflation and uncertainty. Postshipment finance was unavailable because financially viable buyers pay in advance and financing supplies to indebted clients is considered too risky. Finally, most countries had no capacity in areas of quality control, standards, and marketing arrangements (see chapter 11).

In sum, the breakup of central planning created a shock that reverberated across the fifteen new independent states. The need was clear for major institutional and policy reforms to meet the many challenges of conducting international trade while undergoing fundamental economic and political

transformation. The paths countries took in pursuit of such reforms diverged, and so did their overall economic performance and patterns of trade.

Trade with the Rest of the World: The Bias Against Exports

The new independent countries were quick to take control of commercial relationships for their major exportables and to establish their own links with correspondent banks in major financial centers. The most striking feature of trade policy in all countries following independence was the presence of extensive export controls to "keep goods at home" and the absence of explicit import restraints to protect domestic producers. Most countries had no import licenses or quotas, and import tariffs were low. Export restraints, by contrast, were numerous and extensive, including export licenses and quotas, export taxes, limited licensing of authorized exporters, monopsony purchases on the domestic market of exportables by state trading organizations, and surrender of foreign exchange at below market exchange rates.

The consequences of export controls and import protection are similar: distorted resource allocation and reduced efficiency (relative to an open trading regime). Import protection explicitly taxes imports and implicitly taxes exports; keeping goods at home explicitly restrains exports and implicitly taxes imports.

Export Policy

Though starting from the same position, countries soon developed quite different export policies (the trade regimes of the eight countries in this study around mid-1994 are summarized in table 1.6).

At the one extreme were the Baltics, most notably Estonia, which substantially reduced export restraints and the role of state trading organizations in international trade. By the beginning of 1994, with few exceptions, very little of their exports to the rest of the world were restrained or flowed through state trading organizations. As early as the end of 1992, these countries had introduced new currencies, begun to stabilize their economies, and, in the case of Estonia, established a liberal regime

for exports and imports. Special interests were beginning to call for protection in 1994, as the new currencies strengthened, but these protectionist pressures were for the most part resisted.

At the other extreme, in countries like Georgia, Turkmenistan, Ukraine, and Uzbekistan, export restraints were common and state organizations continued to control the bulk of foreign trade, especially key exports. As of mid-1994, these countries had not yet undertaken stabilization efforts.

In between were countries like the Kyrgyz Republic, Moldova, and Russia that have made only intermittent stabilization efforts and have retained a significant but declining role for the state in the control of key commodity exports to the rest of the world, while liberalizing other trade policies.

Countries that restrained exports did so for various reasons. Export taxes produced government revenue and offset the undervaluation of the currency. Many governments restrained exports to slow the adjustment to world market prices. Certain "critical" imports, usually industrial and agricultural inputs, foodstuffs, and pharmaceuticals, were sold domestically at below world market prices. In a system similar to the old price-equalization scheme, state trading organizations would pay domestic producers prices significantly below those prevailing in international markets and use the proceeds of the export sales to subsidize these imports.⁶ It is estimated that at their peak in 1992, import subsidies in Russia amounted to 25 percent of GDP (see chapter 2); though by the spring of 1994 the subsidies had been almost completely eliminated. Other countries, such as Uzbekistan, seem to have retained such subsidies even into 1994.

Finally, export controls are perhaps the last instrument of control for the line ministries that oversee enterprises (see Glaziev's comment on Chapter 2). Control-oriented ministries use export restraints to induce raw material producers to deliver inputs to favored enterprises, thereby maintaining some influence over enterprises. In this constrained domestic supply framework, exports are viewed with suspicion and keeping goods at home

is desirable. So even though central planning had ceased, Russian ministries continued to perform "material balance" calculations through 1993 (reminiscent of the planning process) to determine the residual above domestic "needs" that could be exported.

With few exceptions export controls have been administered in a nontransparent fashion, with numerous ad hoc exceptions and frequent changes of direction. Thus the controls have introduced uncertainties and reduced incentives to trade discouraging both traditional exports and the emergence of new exportables. The controls have also prompted significant levels of unrecorded "illegal" exports and transshipments of raw materials and oil and led to substantial capital flight through the underinvoicing of exports and overinvoicing of imports. As a consequence, exports taxation has not generated as much revenue as anticipated and export licensing has created strong incentives for rent-seeking activities and corruption. The Baltics, which liberalized exports early and more thoroughly than the other countries, seem to have had the best performance so far.

Though export restraints have been progressively reduced since 1992, significant export controls remained in force in mid-1994 in countries such as Moldova, Kazakhstan, and Russia and dominated trade in Ukraine, Uzbekistan (see later chapters), Georgia, and Tajikistan. Because the tariff equivalents of the export restraints have been very high, the costs of failing to adjust output and sales toward export markets in accordance with comparative advantage have also been high.⁷ A preliminary estimate by Gros (see comment to chapter 2) places the static costs of Russia's export restraints in 1993 at roughly 20 to 25 percent of Russia's GDP—the dynamic costs would be even greater.

Import Policies

Before 1994 most new states had imposed few formal import restraints. Instead, domestic goods competing with imports received very high protection through undervalued exchange rates (see table 1.7 for a summary of the average monthly wage

Table 1.6 Summary of Trade Regimes in Eight Countries of the Former Soviet Union, Mid 1994

Country	Export restraints		Import restraints			
	Taxes	Licenses & quotas ^a	tariffs	Quotas & licenses ^a	State trading	Foreign exchange
Estonia	Taxes for cultural items only; 0.5% on other items	Tobacco, alcohol, some agriculture and forest products, metals, broadcast equipment, oil shale, petroleum, and mineral oil.	0.5% for statistical purposes	None	None	Convertible current account with a currency board mechanism since June 1992; no surrender requirement since early 1994; virtual capital account convertibility
Kyrgyz	Subject to taxes at 30% maximum rate on 10 goods (with one exception)	Limited number of goods as of June 1994	Duties eliminated except for 10% surcharge on non-FSU imports	None	Extensive state procurement	Floating exchange rate at interbank auctions, but payments problems on interstate trade remain
Latvia	Subject to export taxes of 1 to 100% on 383 tariff lines (at the six-digit harmonized system, HS, level), with 90% of them below 10%. Covers mostly agricultural products and metals and raw materials such as sands, wood, and leather	None	Average tariff of 10%; low rates on inputs	No licenses but specific duties on 130 products (at six digit HS)	None	Convertible with wide access to foreign exchange through commercial bureaus; no surrender requirement
Lithuania	Export taxes on less than 15 products at 4-5 digit level, ranging from 0-50%, with 90% of them below 10%	None except for temporary bans on red clover seed, untreated oak, and ash timber.	Unweighted average of 3.2%, with a 0 to 30% range; 75% have a zero tariff; inputs have low rates	About 10 products	Abolished	Convertible since 1992; currency board since April 1994; no surrender requirements

Moldova	None	Exports of cereals, leather, and energy products are banned	0 to 300%, most below 30%; inputs have low rates; private barter subject to 30% surcharge	None	Continues for state barter agreements with CIS states; extensive state procurement used	Convertible for current account transactions; surrender requirement to Interbank market
Russia	Specific taxes on energy, natural resources, and some intermediaries; selective exemptions	Quotas on oil and oil products; limited list of companies authorized to export energy and raw materials on own account and on behalf of smaller exporters	12% average tariff weighted by imports; 0 to 100% range; high tariffs on arms, electronics and electrical appliances, motor vehicles, food, pipes, and machine tools; widespread exemptions, often by enterprise	None	Applies to both CIS and third countries; state procurement used	Convertible; access through interbank auctions and commercial exchanges; no surrender requirement
Ukraine (June 1994)	None	Most important exportables (104 goods)	0 to 50%, with most 0 to 10%; luxury goods subject to 60 to 350%; zero rate for noncompeting imports	None	Extensive use of state orders	Poor access to foreign exchange markets; 50% surrender requirement at nonmarket rates (Russian ruble also subject to surrender requirements)
Uzbekistan	10 to 50% on a wide range of consumer goods and many intermediate goods	Most important export items are licensed; state controls result in a large, implicit tax on key exports, especially cotton	None	Rationed access to foreign exchange for imports	Extensive use of state orders	Very limited access to foreign exchange; 30% surrender requirement at official rate overvalued by 80%

a. Licenses for health and safety are ignored.

Source: Summaries of country studies below and interviews of World Bank economists.

converted at market exchange rates for the countries of this study)—in part a consequence of the export restraints. Thus, in most sectors competition from abroad remained feeble. For example, a survey of 92 newly privatized firms (average size 1,518 workers) in two Russian oblasts in October 1993 revealed almost no import competition.⁸

Several factors influenced the exchange rate. First, financial demand for foreign exchange was very strong in almost all countries through most of 1993, which along with significant capital flight, depreciated the value of domestic currencies. Because of large fiscal deficits, high rates of domestic inflation, and negative real interest rates, residents seeking a store of value other than domestic currencies—and unable to rely on domestic assets because of unclear property rights—chose to buy foreign exchange as an asset that would hold value.

Second, export restraints, by reducing the supply of foreign exchange, also impaired the ability to import. The cost of importing was extremely high as evidenced by real wages of only \$10-\$20 a

month in 1992, and only slightly higher in many countries in 1994 (see table 1.7). If the convertible currency earnings foregone as a result of restraining exports to convertible currency areas had been available, the market price of foreign exchange would have risen and made imports less expensive.

In addition, import subsidy programs siphoned off scarce foreign exchange for favored imports, that would not seriously threaten domestic suppliers.⁹ The large subsidies provided for industrial and agricultural inputs contributed to the delay in domestic adjustment and the restructuring of enterprises.

In some countries, including Ukraine, the government appropriated a significant share of the foreign exchange earnings, either through direct state trading or through compulsory sales of foreign exchange by exporters. The central allocation of foreign exchange is itself a nontariff barrier to imports, because the rationing authorities typically protect import-competing industries through their allocation decisions and because less foreign exchange is available for the market, further driving up the exchange rate. As a consequence, the avail-

Table 1.7 Average Monthly Wage in U.S. Dollars, 1992-94^a

	1992		1993		1994 ^g
	Jan. to Jun.	Jul. to Dec.	Jan. to Jun.	Jul. to Dec.	
Russia	21	33	37	79	94
Ukraine	18	21	12	16	21
Moldova	12	17	13	20	21
Belarus	24	33	24	22	25
Kyrgyz	7	11	13 ^e	18	20
Uzbekistan	10 ^b	10 ^b	31 ^b	31	—
Latvia	29 ^c	29 ^c	64	89	112
Lithuania	14 ^b	14 ^b	30	57	81
Estonia	12 ^d	60	77	86 ^f	—

a. Average monthly wage in domestic currencies divided by market exchange rates of domestic currency per U.S. dollar.

b. Average for the year in question.

c. Average monthly wage for all of 1992, state sector only.

d. January 1992.

e. An exchange rate for rubles to dollars was used prior to April 1993; som to dollar rate was used after April 1993.

f. Average monthly wage for the third quarter (July-September) of 1993.

g. Data for 1994 are averages of months as follows: Russia, January to May; Ukraine, January to March; Moldova, January to April; Kyrgyz, May; Latvia and Lithuania, January to February.

Source: For Lithuania in 1992, see *Lithuania: The Transition to a Market Economy*, World Bank (1993). For Estonia in early 1992, see Michalopoulos and Tarr (1992). Otherwise, internal World Bank Country Department databases.

ability of foreign exchange has been limited to exporting enterprises and to those that could get access through the often very thin foreign exchange markets. Since neither import subsidies nor foreign exchange allocations were generally provided for goods that competed with domestic production, the programs reduced the amount of foreign exchange available for competitive imports, or, in market-determined environments, drove up the price of foreign exchange.

Thus, regardless of the motivating philosophy—traditional protectionism or the legacy of the planning mentality restraining exports to keep goods at home—there is an equivalency: the tradables sector is taxed. Many of the new independent states continue to provide extensive protection to import-competing industries and to export and import considerably less than they would have in the absence of the restraints.¹⁰ And most countries that have employed export controls further retarded adjustment by providing additional support to enterprises in the form of explicit subsidies and directed bank credits at highly negative real interest rates.

This picture started to change in 1993. More foreign exchange was becoming available through foreign exchange markets in Russia and elsewhere, as markets were strengthened and new currencies were introduced. The appreciation of currencies in real terms prodded more domestic enterprises to seek protection from international competition. Several countries including Latvia, Lithuania, and Russia, responded to such pressures with new tariff regimes in early 1994 or with plans for new higher tariffs.

Market Access

Though the supply side problems outlined above bear most of the responsibility for the decline in trade in the last few years, it is also the case that most of these countries face potentially significant tariff and nontariff barriers in OECD markets. Energy and raw materials, which account for a significant portion of total exports, encounter few problems of market access; but barriers on other products are formidable. As they address their sup-

ply side problems, these countries may find that problems of market access seriously constrain their future export expansion.¹¹

Following independence the new states faced the external barriers that had been applied to the former Soviet Union. Barriers in the OECD countries were high and discriminatory either for political reasons or to counter the state trading practices of the Soviet regime. Moreover, since these new countries, like the Soviet Union before them, are not members of the GATT, they are subject to individual rules decided by each importing country.

Though the average OECD tariffs facing the new independent states were only about 5 to 7 percent (see chapter 12), the tariff preferences the OECD countries extended to developing countries and to each other constituted a serious competitive disadvantage to exports from the former Soviet Union. The margin on individual items especially manufactures and processed food, which account for about 20 percent of total exports of the former Soviet Union, can be quite high. For example, ethyl alcohol exports to the European Union (EU) faced a tariff (73.8 percent) that was more than 30 percentage points higher than the average duty for ethyl alcohol. There is considerable tariff escalation as well, with effective tariffs ranging up to eight times nominal tariffs for such items as vegetable oils.

Nontariff barriers have also been an important impediment to trade, especially in agriculture, food products, leather, textiles, and ferrous metals (chapter 12). Antidumping actions have been a particular problem for several countries. The new independent states "inherited" antidumping actions started against the Soviet Union and were subject to many new ones in 1992 and 1993. Belarus, Georgia, Kazakhstan, Russia, Tajikistan, and Ukraine have all been the object of some sort of antidumping action on a variety of products from aluminum to ferro-silicon and uranium. The EU has alleged that since transport and energy prices are below world market levels, some sectors are artificially competitive.

And because the exports of these countries tend to be relatively concentrated—for most of

them their top ten exports (at the three-digit trade classification level) account for more than three-quarters of total exports—protection of any of these industries in OECD markets can have a large impact. For example, Ukraine's concentration on steel exports means that fully 44 percent of its manufactures exports to OECD markets face non-tariff barriers or significant tariff discrimination.

In the course of 1992, most OECD countries started to grant most-favored-nation treatment and eligibility for the Generalized System of Preferences (GSP) to countries of the former Soviet Union, beginning with the Baltics (chapter 12). All but four new independent states have applied and been granted observer status at the GATT, though none is yet a member. There is little evidence, however, that these steps significantly reduced trade barriers to these countries. GSP programs exclude many of the major manufactures exports of these countries. Moreover, nontariff barriers seem to have increased rather than decreased, as evidenced by the growing number of antidumping actions. These remaining barriers, together with the preferences extended to other countries, the lack of membership in GATT, and continued treatment as "state trading" countries, mean that the new independent states face perhaps the most severe obstacles to market access of any other group of countries in the world today. The Baltics are an exception: they have concluded a series of agreements with Finland, Norway, Sweden, and Switzerland providing for free trade treatment for Baltic products (except agriculture), and they have concluded association agreements with the EU.

Interstate Trade

At independence the pattern of trade among the fifteen countries of the former Soviet Union was unusual by the standards of market economies in two notable respects: trade was highly concentrated, with some goods produced by a single or very few producers, and trade among the countries of the former Soviet Union absorbed an unusually high proportion of total trade, even when compared with other regional trading blocs (see table 1.8). At 61 percent of total trade, Russia had the lowest

dependence on trade with the other republics in 1990; for the others, such trade amounted to more than 80 percent of the total.

The precipitous decline in interstate trade between 1990 and 1993 was in part caused by the output decline that reduced demand for all imports. But because of the extensive interlinkages in production, the trade decline also worsened the output decline.

The introduction of market forces could also be expected to lead to some decline in the trade among these countries. Brada (1992) argues that for the purpose of analyzing trade flows, the former Soviet Union can be viewed as similar to the CMEA, except that a supranational power planned both trade flows and the pattern of investment and specialization. But the central planners' investment preferences reflected comparative advantage only in a very limited way either among the states or against the rest of the world. Thus, several studies have estimated that although the total external trade of the CMEA countries was not excessive, the intra-CMEA share of that trade clearly was ¹²—and that share will decline substantially when placed on an equal footing with other trade (Biessen 1991; Brada and Mendez 1985; Havrylyshyn and Pritchett 1991; Winters and Wang (1993) and Collins and Rodrik 1991). In particular, the collapse of sales of machinery and related sectors in Eastern Europe and the former Soviet Union suggests that these sectors lack comparative advantage. It is thus likely that a large part of trade in manufactures among the fifteen states was based on trade diversion and, therefore, that the introduction of market forces had some impact in reducing uneconomic trade.

It does not appear, however, that the bulk of the decline involved such uneconomic trade. Rather, five other factors seem to have had a greater impact:

- Payments problems, with economic agents either unwilling or unable to use the banking system to pay for goods and services from other countries. This problem was especially severe in 1992 during the period of the common ruble zone, but it continued after the introduction of new—often inconvertible—currencies.

Table 1.8 Total and Intra-regional Foreign Trade as a Percentage of GNP for Soviet Republics, Eastern Europe, and the EU

	Foreign trade ^a		Share of Intra-regional
	Total	Intra-regional	
USSR (1990)			
Russian Federation	18.3	11.1	60.6
Ukraine	29.0	23.8	82.1
Belarus	47.3	41.0	86.8
Uzbekistan	28.5	25.5	89.4
Kazakhstan	23.5	20.8	88.7
Georgia	28.9	24.8	85.9
Azerbaijan	33.9	29.8	87.7
Lithuania	45.5	40.9	89.7
Moldova	33.0	28.9	87.7
Latvia	41.4	36.7	88.6
Kyrgyz Republic	32.3	27.7	85.7
Tadjikistan	35.9	31.0	86.5
Armenia	28.4	25.6	90.1
Turkmenistan	35.6	33.0	92.5
Estonia	32.9	30.2	91.6
Eastern Europe (CMEA) (1989)			
Bulgaria	30.1	16.1	53.4
Czechoslovakia	23.0	10.9	47.2
Hungary	34.1	13.7	40.3
Poland	19.6	8.4	43.1
Romania	17.6	3.7	21
EU (1990)			
Belgium	74.2	44.5	60
Denmark	32.7	13.7	41.7
Germany	29.8	14.4	48.2
Greece	26.8	13.3	49.4
Spain	19.8	9.0	46.3
France	23.3	13.0	55.6
Ireland	59.9	38.9	64.9
Italy	20.4	9.7	47.5
Netherlands	54.4	34.2	62.9
Portugal	42.1	24.6	58.4
United Kingdom	26.0	10.7	41.2

a. Total trade is measured as the average of exports and imports as percentage of GNP; intra-regional trade refers to trade within the USSR, the CMEA, or the EU.

Source: USSR: Goskomstat for trade data in foreign trade prices, and unpublished World Bank estimates for GNP. Eastern Europe: UNECE (1990) for trade data, and World Bank Atlas for GNP. EU: Pisani-Ferry and Sapir (1992).

- Massive terms of trade shifts against importers of energy and raw materials, which have induced these countries to severely compress their imports.

- Export restraints at least as severe as those that impede trade with third countries.
- Pervasive state trading and monopsony purchases of exportables in many countries which prevented a market-based determination of international trade while failing for a variety of reasons to reestablish trade links.
- An erratic framework of regional trade preferences and discrimination.

Payments Problems

Payments problems may well have been the most serious impediment to interstate trade. The dissolution of the Soviet Union brought with it the dissolution of unified banking (under Gosbank) and monetary systems. Fifteen independent central banks quickly emerged and exporters no longer had the Gosbank guarantee for interstate payments. More problematic, the existence of fifteen independent central banks, in a common ruble zone gave rise to a severe free-rider problem in money creation and trade deficits. During the first six months of 1992, Russia alone could create cash rubles, but the central banks of all fifteen states could expand the aggregate money supply by creating credit in rubles. In the absence of monetary coordination among the central banks, monetary restraint by one central bank could be exploited by others.

In addition to limiting the ability to control inflation, this arrangement created problems in interstate trade. Although enterprises would be indifferent between selling domestically and exporting anywhere in the ruble zone for the same price (risk adjusted) in rubles, the governments saw no value in exporting in the ruble zone. All they gained for the exports were ruble credits in their banking system, something their central banks could create independently and they had too much of in any case. Governments, including the Baltics, quickly responded by imposing export licensing requirements on interstate trade. These export licenses were in place by January-February 1992, and major problems rapidly ensued in raw material supplies.

A network of correspondent accounts was established in early 1992 among the central banks

of the fifteen states, and all payments orders were cleared through these accounts. But the system became clogged: it took up to two to three months to clear an interstate payments order. In an inflationary environment, the long delays implied huge costs for traders attempting to use the banking system. The payments situation deteriorated even further after July 1992. With rising relative prices for energy products, Russia's main export, Russia began to accumulate large surpluses on its bilateral trade balances with most of the former republics. To avoid unlimited financing of its trade surpluses while the free-rider problem continued and to stem the outflow of goods, Russia imposed credit limits on the central bank correspondent accounts in July 1992. When a country exceeded its limit, the Central Bank of Russia could refuse to clear the payments orders (the equivalent of checks) of enterprises in the debtor country. That meant that Russian exporters would not be paid for the goods they shipped to that country, even if the importer had funds in its commercial bank to cover the payments order.

In effect, the system distinguished the different national rubles from those used by Russia and reintroduced the incentive by non-Russian states to export to Russia. But the system was still plagued by huge uncertainties and long delays (about three months) in a highly inflationary environment. By late 1993 all countries except Tajikistan had introduced their own currencies, which eliminated the free-rider problem. Countries no longer had to fear that direct trade between enterprises facilitated through the commercial banking system would result in trade surpluses that had no value. As a result, the requirement by the Central Bank of Russia for clearing through the central bank correspondent accounts was dropped, and a growing network of correspondent accounts among commercial banks spread through some countries, (Russia and Ukraine) providing reasonably fast turnaround on payments. But while this network was facilitating some trade in 1993 and early 1994, a host of new issues had emerged:

- The new currencies, with few exceptions (again the Baltics), were not convertible and

could not be used in trade. Denominating trade in rubles, however, was a problem because of the ruble's instability,¹³ and use of correspondent accounts was further constrained by the general weaknesses of the commercial banking system.

- Many of these countries were facing a serious foreign exchange shortage and so were unwilling to use foreign exchange for the denomination or settlement of interstate trade transactions. As a result barter continued to be the favored instrument of trade among most of the new states.

Price Adjustment and the Terms of Trade

In all the new states price controls or export restraints initially kept the domestic prices of many products below world market levels. For example, even after some price liberalization, world oil prices in early-1992 were thirty-two times greater than domestic prices in Russia (Michalopoulos and Tarr 1992, 17). Governments also tried to control the prices of certain "essential" goods, which included some foodstuffs as well as important raw materials. The rationale for the price control was to ease the adjustment of enterprises and consumers to world prices. Since price controls were not the same across all countries, restraints were placed on exports to prevent price-controlled commodities from being exported to markets with higher prices, including other ruble zone countries.

But most prices in international and interstate trade were liberalized. As a consequence, there were significant adjustments in terms of trade, especially between exporters and importers of energy and raw materials. Estimates show that moving to world prices in interstate trade would have implied a severe deterioration in the terms of trade for energy and raw material importing countries like Moldova and the Baltics, with losses ranging as high as 10 to 15 percent of GDP, while raw material and energy exporters, such as Russia and Turkmenistan, would stand to gain (Tarr 1994).¹⁴ A terms of trade loss of this magnitude is substantially larger than that suffered by oil importers after the oil price shock of 1973.

Energy importers attempted to mitigate the problem through special arrangements with exporting countries to supply oil and other raw materials at less than world prices (discussed below). Some countries (Belarus) managed to work out such arrangements during a transition period, but others (the Baltics) could not. Russia has repeatedly indicated that it was moving to world prices for all its energy exports and has progressively moved in that direction. As of mid-1994 energy prices in the bilateral agreements were differentiated across countries. Some agreements that included energy subsidies called for compensatory subsidies of Russia's raw material imports (Uzbekistan); others (Belarus) apparently did not.

Energy-importing countries such as Armenia, Moldova, Lithuania, and Tajikistan, are estimated to have experienced enormous declines in their interstate terms of trade of 25 to 35 percent from 1991 to 1993 (table 1.9). Russia and Turkmenistan were the obvious gainers with improvements of 20 percent and 50 percent on their interstate trade. By 1993 the bulk of the movement to relative world prices in interstate trade seems to have been accomplished, as indicated by a comparison with projections of the terms of trade adjustment implications of moving entirely to world prices (at constant quantities based on 1990 prices) based on the Tarr (1994) estimates (table 1.9).

Many countries have not made the necessary domestic adjustment to these price changes. Even where substantial progress has been made (as in the Kyrgyz Republic) high energy import prices mean that countries either have to sell larger quantities of their exports or find other means of financing imports. They are finding it difficult to do either. Incomes are still falling and it is difficult to obtain enough external financing for oil imports. As a consequence countries are running up arrears in interstate trade, inducing their trading partners to reduce the volume of trade even further.

State Trading

Countries reacted to these interstate trade problems in two ways. Estonia and, to a lesser extent, the other Baltic states moved quickly to

Table 1.9 Terms of Trade for Interstate Trade among the Countries of the Former Soviet Union, 1991-93 (1990=100)

	1991	1992	1993	World market prices (1990)
Armenia	107.2	85.0	75.1	68.3
Azerbaijan	105.3	94.8	97.9	73.9
Belarus	103.2	87.7	83.4	80.1
Estonia	107.5	87.7	83.0	68.2
Georgia	105.9	75.4	72.9	55.2
Kazakhstan	95.1	98.1	97.0	98.5
Kyrgyz Republic	104.0	87.3	81.5	87.3
Latvia	104.1	87.3	81.4	75.7
Lithuania	105.1	80.7	74.2	65.2
Moldova	106.1	66.4	65.0	46.6
Russia	97.4	113.6	120.1	137.6
Tajikistan	110.3	86.8	75.5	75.3
Turkmenistan	109.9	121.9	152.0	134.7
Ukraine	96.0	94.1	88.8	86.2
Uzbekistan	109.3	94.5	91.6	91.0

Source: For 1991-93, see Appendix; for 1990 see Tarr (1994).

abandon most of the machinery of the planned economy. The others reestablished what they knew best: a network of massive intergovernmental barter agreements analogous to the system of state trading under CMEA countries, with goods to be distributed through state ministries of material resources, the successor to Gosnab.¹⁵ The agreements were frequently implemented through national systems of state orders and controls of interstate trade shipments.

Governments saw these agreements as the answer to several problems: the problem of controlling exports for key inputs, the problems with the payments and banking systems, and the terms of trade problem (by permitting barter exchanges of products at prices beneficial to importers). Perhaps most important, these agreements gave policymakers a sense of control over what appeared a chaotic situation. Under the agreements, trade was divided, in most cases, into three categories or lists: obligatory, indicative, and enterprise to enterprise.

Obligatory list trade comprised only a small number (usually five to fifteen) of the most important products in trade, primarily energy, raw materials, and foodstuffs. This barter trade under the

obligatory lists was supposed to balance: prices and quantities were negotiated in advance so that trade would exactly balance if both countries met their obligations.¹⁶ Prices were denominated in U.S. dollars and were supposed to approximate world market prices. In practice, however, that did not occur. For example, the 1993 agreement between Uzbekistan and Russia established the basis for the exchange of cotton from Uzbekistan for oil from Russia; a similar agreement between Russia and Kazakhstan involved oil and wheat. The Uzbekistan agreement was supposed to be at world prices, but in practice both commodities appear to have been set at less than world prices though the relative prices involved no subsidy. The Kazakhstan agreement reportedly contained some continued net subsidy by Russia, but the actual prices paid by Kazakhstan probably resulted in a terms of trade deterioration relative to Russia (World Bank 1994b).

The *indicative lists* represented an effort to limit interstate exports in order to ensure adequate supplies for domestic consumption and for export to hard currency areas but with less government involvement than in obligatory trade. These lists specified the most important products in trade—after those included in the obligatory list—between the two countries involved. The lists usually included a wide range of intermediate products and consumer goods that were still under export licensing or quotas. The agreements generally specified the maximum quota of a good that would be licensed for export to each country. The state incurs no obligation to supply the specified amount in the indicative lists, but each government agrees to license exports up to the specified amount, provided that agreements are reached at the enterprise-to-enterprise level. Individual enterprises are responsible for the terms of the sale, including price and financing arrangements.

All products that are not on the obligatory or indicative lists may be traded freely on an enterprise-to-enterprise basis without export licenses. Although smaller countries like the Kyrgyz Republic would have liked to perpetuate the old arrangement of assured deliveries of key imported

inputs, especially energy, in exchange for an assured market for some of their soft manufactures exports—which they fear are uncompetitive—they have been forced to export relatively hard goods under the obligatory portion of the agreements.

Networks of these agreements were concluded in 1992, 1993 and 1994. The later agreements contained fewer items on the “obligatory lists” and prices appeared to be closer to world market prices than in 1992. Domestic procurement has been liberalized over time in some countries. The Kyrgyz Republic, Moldova, and Russia have moved away from state orders to competitive procurement by state agencies in the domestic market.

The bilateral trade agreements failed to maintain the level of interstate trade. Deliveries were frequently less than half the contracted amount. The price controls that motivated the bilateral agreements also undermined them. Price controls on exports reduced incentives to export. Enterprises, lacking the needed inputs, often failed to supply the agreed quantities or found it unprofitable to export under these arrangements and sought their own export arrangements instead. Evading the agreements had become easier since the system of state orders had weakened. Moreover, analogous to the CMEA problems, there was no agreement on how to settle imbalances in the agreed trade.

The distortionary impact of the obligatory trade remained pervasive, even though by 1993 Russia had narrowed the list of goods traded under state obligation to a few commodities (except in agreements with Ukraine). Countries such as Uzbekistan and the Kyrgyz Republic tax their agricultural sector on their exports to Russia (offering low prices to their domestic producers) in order to subsidize the energy—using sectors that rely on imports of Russian energy. Russia, for its part, no longer has a system of state orders, but uses export restraints to keep the domestic energy prices low. Through mid-1994, Roskontract (the successor to Gosnab in Russia) purchased energy cheaply on the Russian domestic market to meet its obligations under the interstate agreements and then sold the underpriced imported inputs, such as cotton from

central Asian states, at below world market prices in Russia. Such arrangements greatly extended the range of products that enterprises received at less than world prices.

But the principal shortcoming of the state trading agreements is that they perpetuate the system of managed trade and retard the introduction of market forces. As long as trade is conducted on the basis of bilateral pacts, governments rather than markets determine the allocation of resources and the volume and terms of trade.

Regional Cooperation in Trade and Payments

Governments have also tried to foster interstate trade through cooperative agreements. Many of these agreements reflect the governments' desire to demonstrate political and economic solidarity. They are often short on concrete measures of cooperation beyond preferential tariff or export duty treatment. By and large these preferences have not been extended to the Baltic states. Until the spring of 1994, the Baltics and some of the other smaller countries (Moldova) faced discriminatory tariff and nontariff barriers in some major markets (Russia), against which they applied discriminatory treatment in turn. Moreover, these "free trade agreements," while providing tariff-free access to markets, have not typically ended the use of export restraints, the most pervasive trade restraints these countries employ. Of the many efforts at regional cooperation four are the most notable:

Russia-Belarus Economic Union. The Russia-Belarus economic Union was announced in early 1994 and implemented in June 1994, but its implications are still unclear. It involves Belarus' reintegration in the new ruble zone and related measures of monetary and fiscal policy coordination and duty-free movement of goods. A customs union was implemented between the two countries under the first phase of this agreement.¹⁷

Kazakhstan-Kyrgyz Republic-Uzbekistan Economic Cooperation. The details of this three-party agreement, announced after the introduction of new currencies in 1993, are not well known. It appears that all three countries would retain export controls for some key tradables—Kazakhstan and Uzbekistan

more than the Kyrgyz Republic since these two countries maintain export controls on many major exportables. Also, the agreements apparently have no provisions on rules of origin or transshipment of goods.

Baltic Free Trade Area. The Baltic Free Trade Area agreement, which came into force on April 1, 1994, lays down the principles of trade in industrial goods. Trade in agricultural products will be covered in a separate agreement. Provisions cover customs cooperation and the rules of origin under which goods qualify for tariff-free status. Estonia, Latvia and Lithuania agreed to liberalize trade and to create favorable conditions for competition. While state assistance to enterprises and dumping are considered out of line, emergency safeguard measures—tariffs of no more than 25 percent for no more than five years—can be taken if certain imports seriously threaten the domestic market.

The Interstate Bank. Ten countries of the former Soviet Union (all except the Baltics, Azerbaijan and Georgia) have agreed to establish an institutional mechanism for the multilateral clearing and settlement of interstate payments in Russian rubles (or hard currency). The agreement provides for monthly settlement in rubles and for interim finance limited to one month's imports. Use of the bank would be voluntary, and transactions could also be cleared through correspondent accounts.

The benefit of such an arrangement is less the limited finance it would make available but rather the opportunity to maintain trade flows despite continued weaknesses in the commercial bank correspondent accounts system and limited access to foreign exchange, especially for enterprises outside Russia. Though seven countries have ratified the bank's charter (Belarus, Kazakhstan, Moldova, Russia, Tajikistan, Uzbekistan, and Turkmenistan) and the first board meeting was held on December 8, 1993, (the governor of the Central Bank of Russia was elected Chairman), there has been little evidence of further progress. The bank's future appears uncertain (see comment by Gros).

Conclusions

Contraction in output and in the supply of

exportables, the imposition of export controls, and the breakdown in the payments system appear to be largely responsible for the contraction in international and interstate trade flows. Little of the decline in interstate trade can be attributed to competition and adjustment to international prices and comparative advantage since competition from industrialized countries has been weak. But while the external environment and market access do not appear to have significantly affected export performance so far, issues of access are likely to rise in importance as domestic market reforms proceed.

The Baltics, especially Estonia, stand out for adjusting most rapidly to the new environment and introducing the most far reaching changes in their trade and payments regime. They also seem to have made greater adjustments in reorienting their trade away from the former Soviet Union and towards broader international markets. Of the other countries, Moldova, the Kyrgyz Republic, and Russia have made the most progress in liberalizing trade. Russia, and the other energy exporters have also undergone significant adjustment and are shifting more of their production to the rest of the world, where the risk of nonpayment is lower. Though several initiatives for trade cooperation have been introduced, few have really gotten underway, and it is too early to assess what their impact may be.

Notes

1. It can be argued that the decline in USSR trade with the CMEA countries and with Finland in 1991 was the result of introducing convertible currency settlements. Clearly, the conversion of trade to a convertible currency basis contributed in large measure to the collapse of that portion of trade induced by trade diversion. There is also evidence, however, that the reduced Soviet supply of exports contributed strongly to the problem.

Brada (1992) has shown that, relatively speaking, trade among Czechoslovakia, Hungary, and Poland held up better than might have been expected in 1991 despite a similar shift to convertible currency payment in this trade. Moreover, the sharp decline in Soviet-Eastern European trade in 1991 only continued a trend of declining Soviet exports to its partner countries in the CMEA that had begun as early as 1988, even though trade was based on the transferable ruble over that time. (The annual Soviet trade balance with the aggregate of Eastern European CMEA worsened from a trade surplus of 60 million transferable rubles in 1987 to a trade deficit of 4 billion transferable rubles in 1989 [UNECE 1990] and further worsened more than

twofold in 1990 [UNECE 1991]. If this trade were revalued at world prices, however, the former Soviet Union would have had a surplus [Oblath and Tarr 1992].)

Soviet trade with India continued on the basis of bilateral clearing, and Soviet imports from India were maintained at a high level until the Soviet Union failed to meet commitments for crude oil deliveries, at which time India also restricted its exports (Brada 1992). Since the former Soviet Union was also suffering a decline in trade in its intergovernmental barter arrangements, and other countries in the region made a relatively successful transition to convertible currency trade, these facts suggest that a significant explanation for the decline in Soviet imports from Eastern Europe was its deteriorating capacity to supply exportables. This was partly due to capacity problems in such industries as oil.

2. Output is reported to have declined by 40 percent in Russia between 1990 and 1994 (see chapter 2), but as is the case for trade, official data may exaggerate the decline (see appendix). Official data on output and interstate trade are based on enterprise surveys which ignore the newly emerging private sector. Military output has declined precipitously, but this will have less than a proportionate impact on consumer welfare. Moreover, with the removal of price controls, the queues for goods have largely been eliminated, so that the enormous loss of leisure time spent in the queues has been recaptured. Consumer welfare is likely to have fallen by less than would be indicated by official real GDP.

3. See Ofer (1987) and William Easterly and Stanley Fischer (1994) for a discussion of the output decline in the Soviet Union.

4. Tax revenue from enterprises, which had been the main source of government revenue, declined, and the central government started facing mounting inflationary pressures (McKinnon 1991a).

5. Saldanha (1992) has effectively argued that decentralized economies without owners of capital, such as a labor-managed economies, distort incentives to such a degree that they would likely collapse without corrective intervention, which inevitably occurs. Among other problems, these types of firms display little innovation, pay excessive wages and avoid hiring labor. Thus, transition economies must give high priority to privatization and corporate governance issues. Also see Ward (1958) for a description of perverse responses by managers of decentralized firms without owners.

6. In Russia the state trading organization has limited monopsony power, but export restraints result in domestic prices that are below world prices.

7. The costs of a trade restraint rise geometrically with the level of the restraint.

8. Webster (1994) states that "The almost nonexistent foreign penetration was evident in the fact that only 2 percent of managers said that their main competitors were imports, and none named joint ventures or foreign firms as competitors."

9. In some cases, such as wheat in Russia, import subsidies were provided for a domestically produced good; but these subsidies were provided only to the extent that domestic demand could not be met by domestic suppliers at a price acceptable to the authorities.

10. More generally, there is an equivalence between a tax on exports and a tax on imports in terms of the impact on imports. The intuition for this theorem of international economics (known as the Lerner symmetry theorem) is that while import tariffs restrain imports directly, export taxes restrain exports and foreign exchange earnings. Since a country requires foreign exchange to import, a country cannot import if it does not export. Although governments have not imposed significant tariffs on imports, the export restraints limit imports and protect import-competing industries as if there were tariffs on imports.

11. The Baltics have had duty and quota free access for their exports of manufactures (but not agriculture) to the Nordic countries. They also have not been hit by quotas in their exports of textiles to the European Union. For details see Chapters 5-7 and Chapter 12

12. Collins and Rodrik used historical measures of trade patterns, while the other studies used gravity models: that is, except for the Collins and Rodrik study, predicted trade was based on a regression of actual trade against such explanatory variables as distance, income of the home and partner country, and participation in a region of trade preference.

13. In some countries, for example, Georgia and Ukraine, the Russian ruble was regarded as a relatively stable currency and was subject to surrender requirements analogous to those imposed on hard currencies in these countries.

14. Based on 1990 prices, all FSU countries could be expected to gain on their terms-of-trade with the rest of the world. This is for two reasons: First, as shown in studies such as Marresse and Vanous (1983) and Oblath and Tarr (1992), the aggregate FSU would gain by moving to world prices in their trade with the CMEA countries. Second, and somewhat surprising, all 15 FSU countries were exporting hard goods outside the FSU while importing soft goods, so all individual countries would be expected to gain as well. Because trade with the rest of the world was a very small share of total trade, for those countries that were importing hard goods and exporting soft goods within the FSU, the terms-of-trade gains with the rest of the world were far smaller than the losses sustained in intrastate trade. See Tarr (1994) for details.

15. Characteristically, most of these agreements originally were planned and negotiated by ministries of the economy (the successor to Gosplan), which had responsibility for domestic economic matters, rather than ministries of external economic relations, which controlled trade relations with the rest of the world.

16. In the case of the Baltics, the original agreements contained no obligatory deliveries and the indicative lists contained no maximum amounts of deliveries. These agreements were abandoned after 1992.

17. Although there are no tariffs between Russia and Belarus, Belarus applies its value added tax to both imports and exports, a bias against trade that is inconsistent with a customs union.

References

See references for Chapter 13.

Appendix: Foreign Trade Statistics in the Former Soviet Union

Misha Belkindas and Yuri Dikhanov

Discussions on statistics always start with data reliability. Foreign trade statistics in the Soviet Union would appear to be reliable because foreign trade was a monopoly of the state. A limited number of foreign trade organizations engaged in foreign trade activities and reported their transactions to the Ministry of Foreign Economic Relations,

which published an annual handbook on foreign trade statistics of the USSR. The data were presented according to the Soviet Foreign Trade Nomenclature by product category, by destination of exports, and by country of origin for imports. Exports of armaments and other politically sensitive commodities were not shown separately although they appeared in the trade totals.¹

The ministry shared its data with Goskomstat, which was in charge of estimating macroeconomic indicators. Exports and imports had to be included in the balance of gross social product and national income to prepare NMP accounts for the Soviet Union as a whole and for each republic.

The valuation of foreign trade flows presented a bigger problem. Exports and imports were valued in foreign trade rubles, (called Valuta Rubles) and converting them into domestic rubles or foreign currency is difficult because the conversion coefficients are not reported.² Establishing the matching domestic prices for certain traded products was difficult because the domestic price had to be adjusted for differences in quality between products sold domestically and those that are exported.

Separating data on foreign trade by republic presented an even bigger problem. The establishments that sold the goods to the foreign trade organization were not recorded for statistical purposes, so it was difficult, if not impossible, to allocate export flows to a particular republic. The same was true for imports. The foreign trade organization "sold" these goods to the Ministry of Trade and the Committee for Material Technical Supply, which then distributed the goods by republic.

In the absence of direct estimates, input-output tables were used to estimate interrepublican trade and foreign trade by republic in domestic prices. The 125 sector input-output tables by republic were compiled every five years. A census of enterprises was conducted as part of the compilation to gather data on foreign and interrepublican trade in domestic prices.

Mirror statistics on interrepublican trade flows were reviewed by the Goskomstat of the USSR and adjusted to achieve a zero balance. The last input-output tables are for the year 1987. Comprehensive trade data for 1987 were initially published in 1988. For the first time these data estimated interrepublican trade flows in foreign trade rubles.³ Similar data were also published for 1988-90.

The last published set of comprehensive trade data based on a consistent methodology for the fifteen countries of the former Soviet Union (FSU) covers 1990. Those former Soviet Union data,

which include information on trade with third countries, are the starting point for the analysis in this volume.

Recent Developments

With the dissolution of the Soviet Union, the unified statistical system broke up and interrepublican trade became trade between sovereign countries. Each national statistical office is charged with compiling data on the economic and social activity in the country. Because customs services—the recorders of trade statistics—are not yet fully operational on the borders between the former republics, most goods cross these borders unrecorded.

Statistical agencies in charge of collecting foreign trade statistics rely on direct reporting from enterprises. The rate of nonresponse to questionnaires is high. Newly established private firms are not subject to reporting in many countries. Data on trade by small vendors can be collected only through sample surveys, which these countries do not use. The reported data also include a high margin of error, because enterprises have strong incentives to underreport their foreign economic activities.

Data have become even more unreliable since most countries have introduced national currencies or coupons in near hyperinflationary environments. Different exchange rates are being used to convert data recorded in national currencies into rubles and U.S. dollars, and foreign trade transactions are recorded at different times. Furthermore, some countries collect and publish information only on selected foreign trade activities, such as trade covered by intergovernmental agreements or consumer goods only.

For these reasons, the exact value and volume of foreign trade flows in this period of transition will never be known. Nevertheless, the effort has been made to present trade estimates, using data for prereform years as benchmarks, employing other economic indicators, and making reasonable assumptions about possible developments in order to prepare consistent estimates. The detailed sources, procedures, and approaches to preparing tables in chapter 1 are described below.

Foreign Trade Estimates

Trade with the Rest of the World in Current U.S. Dollars (Table 1.1)

For 1990 the official data set on international and interrepublican trade flows in domestic and world market prices was employed. This data set has been widely used at the World Bank (see, for example, World Bank, 1993a) and the IMF. It is referred to here as "1990 official data set". For 1991-93, data reported by national statistical offices, CIS Goskomstat, World Bank, and IMF staff estimates were used.

Trade among Countries of the Former Soviet Union in Current Rubles (Table 1.2).

The sources for this table are:

1990

"1990 official data set."

1991

Data reported by national statistical offices and published in *Statistical Handbook: States of the Former USSR* (World Bank 1993a).

1992

Information (direct and mirror) on bilateral trade was analyzed.⁴ The 1992 flow matrix was reconstructed to recover underreporting in trade. The difference between the data from direct reporting and those from the partner country was attributed to underreporting of trade in each case.

- A balanced trade flow matrix model was developed. Russia's exports and imports were

used as the control total and were not adjusted.⁵ Data for the other countries, derived as described above, were further adjusted to derive a "balanced" set of interstate trade flows. The matrix is presented below.

1993

- Data on trade flows between Russia and the CIS states for 1993 as reported by the Russian authorities were used with the totals adjusted to include trade between Russia and the Baltic states.

- Data reported by the Russian Goskomstat have been supplemented with information for 1993 reported by Kazakhstan, Kyrgyz Republic, Turkmenistan, and Uzbekistan.

- For the Baltic states estimates of annual trade flows with the rest of the former Soviet Union were obtained from the national statistical authorities, or Bank or IMF staff estimates were used.

- Where information on trade flows between any two countries was not available for 1993 (usually the case for trade other than with Russia), interstate trade totals were allocated to each of the countries using the geographical distribution in 1992. Define the following notation:

α_{ji} = the share of country j 's total exports that goes to country i ;

β_{ji} = the share of the total imports of country i that originates from country j ;

Trade flow matrix for FSU countries

		Exports from			
		1	...	j	Total
Imports to	1	$\alpha_{11}X_1 = \beta_{11}M_1$			M_1

	i			$\alpha_{ji}X_j = \beta_{ij}M_i$	M_i
	Total	X_1	...	X_j	$\Sigma X_i = \Sigma M_i$

x_{ij} = the exports of country i to country j ;

m_{ji} = the imports of country i originating from country j ;

X_j = total exports of country j ;

M_i = total imports of country i .

Note in the share notation we have a flow of goods from the country of the first subscript to the country of the second subscript. We utilize the available share data from 1992 combined with the aggregate import and export data for 1993 to construct the trade flow matrix. We have that $x_{ij} = \alpha_{ij} \cdot X_i$ and that $m_{ji} = \beta_{ij} \cdot M_j$.

By definition, exports from country i to j , must equal imports of country j from i . Therefore, for any time period, we must have that $x_{ij} = m_{ji}$ for all countries. Consequently, we average the two estimates of trade flows among the fifteen NIS countries as follows:

$$(1) \quad x_{ij}(1993) = m_{ji}(1993) = 1/2[\alpha_{ij}(1992)X_i(1993) + \beta_{ij}(1992)M_j(1993)]$$

Equation 1 generates the full trade matrix for 1993.

- When the derived trade figures estimated to achieve "balanced" trade for the former Soviet Union did not deviate substantially from officially reported data, the official data were used.

Trade among Countries of the Former Soviet Union in Constant 1990 Rubles (Table 1.2)

To estimate trade volumes in 1990 rubles the following information was used:

- Flows in current prices.
- Price indexes of trade for the years 1991-93.

The application of price indexes to the base structure was carried out in three steps: first, the 1991-93 sectoral price changes in interstate trade were assumed to be equal to Russian domestic sectoral price changes (sectoral WPI); second, energy prices were adjusted to include information on actual transaction prices of Russian energy exports; and third, export and import prices of energy for

Azerbaijan and food for Moldova and Georgia were adjusted (see table A.1 below). For Azerbaijan, the adjustment was done because prices increased less for energy exports (mainly oil) than for imports (mainly natural gas). For Georgia and Moldova - agricultural exporters- the adjustment was made because of significant differences in their exports' food prices and average food prices in this interstate trade (in 1990, the base year, food prices were at 439 percent of the world price in Georgia and 365 percent in Moldova compared with an average of 242 percent for the former Soviet Union as a whole). This price discrepancy was due mainly to the fact that these countries traded a basket of goods-fruits, vegetables, wines and brandies-whose relative prices were considerably higher than those of many other agricultural products (which have been and, in many cases, continue to be controlled).

Total Foreign Trade (Table 1.3)

Estimates of total exports and imports for each country were derived by combining figures for interstate trade and trade with the rest of the world, using a common denominator. Since 1992, the latter has been reported in U.S. dollars and the former in domestic currency. To estimate total trade, U.S. dollars were used as the common denominator.

Interstate Trade in Current U.S. Dollars, by Official and Market Exchange Rates (Table 1.2)

One method to denominate trade of the former Soviet Union in U.S. dollars is to use the official or market exchange rates. For the years in which the official exchange rate was used (1990 and 1991 in our estimates) the ruble was overvalued relative to the dollar. The value and consequently the share of interstate trade in total trade will be artificially lower if such an exchange rate is used. Since 1992, when the market exchange rate is used, local currency is undervalued. The estimates were derived using current ruble data and annual official or commercial exchange rates: 1990, R 0.59/US\$; 1991, R1.26/US\$; 1992, R196/US\$; 1993, R938/US\$. Converting trade in this way undervalues it in dollar terms. Using market exchange-rate converted

data artificially shrinks the share of interstate trade and creates the impression of substantial changes in the geographical distribution of trade. This is nothing more than a statistical phenomenon, as is illustrated in table 1.2.

Interstate Trade at Implicit Exchange Rates
(Table 1.2)

The second method attempts to capture the reality that trade among the states was valued at other than international prices or, what amounts to the same thing, at different implicit exchange rates. To denominate interstate trade flows in U.S. dollars at implicit exchange rates, interstate trade in 1990 at world market prices in 1990 U.S. dollars was taken from the "official data set".⁶ This is equivalent to repricing interstate trade into international trade prices in 1990 US dollars.

To derive interstate trade in constant 1990 dollars for 1991-93, the growth rates of interstate trade in constant rubles (described above) were applied to it. Subsequently, the flows were converted into current U.S. dollars using the World Bank deflator for the world trade (1990=100, 1991=98.5, 1992=100.4, 1993=96.1).

Russia's Trade with the Rest of the World by Destination (Table 1.5)

Data presented in table 1.5 were reported by the CIS and Russian Goskomstats. For 1990 and 1991, data originally reported in "valuta" rubles were converted into U.S. dollars using the exchange rates cited above. For 1992 and 1993, the data were reported in U.S. dollars. An adjustment has been made for 1993 totals to account for the fact that Goskomstat of Russia distributed by destination only \$27 billion of imports out of a total \$ 33.1 billion. The difference is reported to be the so-called "unorganized" trade, conducted by small companies and private individuals, and represents Goskomstat's estimates. The difference has been distributed by destination in the same proportion as the previous total.

The data are interesting from the point of view of mirror statistics. For 1992 exports from Russia are lower than those reported by OECD countries

(see chapter 12). Some discrepancies are due to differences in f.o.b. and c.i.f. prices, valuation, and so on. However, the differences are so high that they cannot be explained by those factors alone. It is impossible to say, however, how much of the apparent underreporting is due to "illegal exports" and how much because OECD agencies attributed to Russia exports from other states.

Terms of Trade Effects on Trade Among the NIS

The price indexes used for the terms-of-trade calculation were those (described above) used to convert trade from current to constant rubles. Thus, the terms of trade estimates include all the data deficiencies described above. We chose 1990 as the base year for estimation since it was the last year for which a comprehensive set of information was available.

Basic data on expenditures are a set of official statistics on trade flows to the rest of the world and among the countries of the former Soviet Union by commodity (105 sectors) for each of the republics for 1990 in domestic and world market prices ("official data set"). For a discussion on the consistency of this set of data, see Tarr (1994).

The vectors of price indexes estimated for fifteen sectors (for 1991/90, 1992/90 and 1993/90) were applied to the base year trade structures of the republics. Terms of trade were defined as the ratio of Laspeyres export and import price indexes.

In order to present the formula for terms of trade, we first define the following notation:

${}_j P_x^i_t$ is country j's export price of commodity group i to other FSU states in year t (expressed in Russian or Soviet rubles);

${}_j P_m^i_t$ is country j's import price of commodity group i from other FSU states in year t (expressed in Russian or Soviet rubles);

${}_j X_t^i$ is the quantity of country j's exports of commodity group i to the FSU states in year t;

${}_j M_t^i$ is the quantity of country j's imports of commodity group i from the FSU states in year t;

${}_j sX_0^i$ is the value of commodity i exports as a share of country j 's total exports to the FSU states in 1990, i.e.,

$${}_j sX_0^i = \frac{{}_j P X_0^i \cdot {}_j X_0^i}{\sum_{i \in S} {}_j P X_0^i \cdot {}_j X_0^i}$$

${}_j sM_0^i$ is the value of commodity i imports as a share of country j 's total imports from the FSU in 1990, i.e.,

$${}_j sM_0^i = \frac{{}_j P m_0^i \cdot {}_j M_0^i}{\sum_{i \in S} {}_j P m_0^i \cdot {}_j M_0^i}$$

The terms of trade for country j in year t are defined as the ratio of the price index of aggregate exports— Px_t to the price index of aggregate imports— Pm_t . Thus, the percentage change in the terms of trade is 100 times the ratio of the terms of trade in two different periods. Since the largest shocks in the terms of trade that occurred in FSU countries between 1990 and 1993 are due to price changes on trade among the FSU states, in table 1.9 we have focused exclusively on the terms of trade among the FSU countries. Therefore our foreign trade price indices are restricted to prices among the FSU countries.

To estimate the change in the terms of trade on its trade with other FSU states in year t relative to the base year, for any country j we utilize the equation:

$$(2) \quad TOT_0^t = \frac{\sum_{i \in S} \frac{{}_j P x_t^i}{{}_j P x_0^i} \cdot {}_j sX_0^i}{\sum_{i \in S} \frac{{}_j P m_t^i}{{}_j P m_0^i} \cdot {}_j sM_0^i}$$

For any FSU country j , equation (2) is an estimate of the change in the price of its FSU exports relative to the change in the price of its FSU imports, assuming fixed quantities. This formula is the ratio of two Laspeyres price indexes. The evolution of the terms of trade over 1990-93 period is presented in the first three columns of Table 1.9. Column 4 of Table 1.9 should be treated separately as a reference point. It relates to a special hypothetical case of how terms of trade of the FSU countries would change if in 1990 trade among the FSU countries were carried out at world market prices. This case was discussed extensively in Tarr (1994). Thus, one can compare the first three Columns to Column 4 in order to assess how far the transition to the world market price structure has proceeded.

For the Baltic states, the results should be interpreted cautiously, because the price structure in trade between them and states of the former Soviet Union is different than the structure within the CIS, and lies in effect between the former Soviet Union and world price structures. Thus, the terms of trade for Baltic states in 1993 may lie closer to Column 4 of Table 1.9, i.e., the transition to world market price structure has been more profound there.

Table A.1 Sectoral Price Indexes in FSU Trade (1990=100)

Sector	1991	1992	1993
Power	1.97	54.31	765.81
Oil and gas	2.48	95.00	1472.5
Coal	2.23	109.00	821.86
Other fuels	2.23	95.00	788.50
Ferrous	2.10	66.89	622.03
Nonferrous	2.34	69.03	559.14
Chemicals	2.06	55.49	499.37
Machinery	2.17	39.91	375.12
Wood and paper	2.55	39.91	319.26
Construction material	2.47	42.11	446.40
Light industry	3.06	29.80	211.61
Food products	2.61	47.55	551.63
Other industry	2.38	48.77	482.79
Agriculture	1.56	14.52	130.71
Other products	2.38	48.77	482.79
Total	2.37	47.41	483.23

Notes

1. For 105 categories of commodities foreign trade (in domestic and foreign prices) was estimated in order to compile the input-output tables for national economy, but these statistics were kept secret until recently to avoid exposing data on production and exports of military related commodities.

2. The valuta ruble was used as a bridge between the domestic ruble and hard currency. The Soviet Bank linked the valuta ruble and hard currency. Links between the valuta and domestic rubles were established for more than 3,000 products and differed for exports and imports. For more detail see Brown and Belkindas, "Who's Feeding Whom? An Analysis of Soviet Interpublic Trade," in *The Former Soviet Union in Transition*, Volume 1, JEC, Congress of the United States, 1993.

3. For detailed explanation on the reasons for publication and methodology of estimations see Brown and Belkindas, 1993.

4. Information previously used by the World Bank (Michalopoulos 1993; World Bank 1993a), has been revised using new information from the countries (Goskomstat reports on foreign trade for various states).

5. This approach seems feasible because the trade with Russia accounts for 70 to 75 percent of the trade of the FSU states, thus largely determining their total interstate trade volumes.

6. To be precise, 1990 trade was reported in foreign trade rubles, which in turn were obtained from U.S. Dollars through multiplying by official exchange rate (R0.59/US\$ at the time). Thus, the reverse operation was done here in order to obtain U.S. dollars from foreign trade rubles.

2

Russian Trade Policy

Vladimir Konovalov

- Macroeconomic Background
- Trade Developments
- Trade Policy with Countries Outside the Former Soviet Union
- Trade Relations with Countries of the Former Soviet Union
- Concluding Remarks

Until 1991 Russia's trade regime provided an air lock between the domestic and world economies. Planners determined resource allocation with scant regard for comparative advantage. On the contrary, they pursued self-reliance within the former Soviet Union. Goods were imported only if they could not be produced locally, and exports were the residual after domestic needs were satisfied. The air lock was maintained by monopoly foreign trading organizations which enforced administratively set prices for trade. These organizations took advantage of a distorted domestic price structure in order to export raw materials that were easy to sell in hard currency markets and used the revenues to subsidize imports of food and machinery. This strategy was completely at odds with the outward orientation pursued by the fastest growing countries over the past thirty years.

An outside observer appearing on the scene in 1991 could make a strong case that reform of the incentives regime was crucial to ensuring that production and consumption decisions reflected opportunity costs (were based on world market prices), so that investment flowed toward activities that were in line with the country's comparative advantage. Achieving this required freeing exports and imports and putting in place a macroeconomic and regulatory environment that encouraged investment.

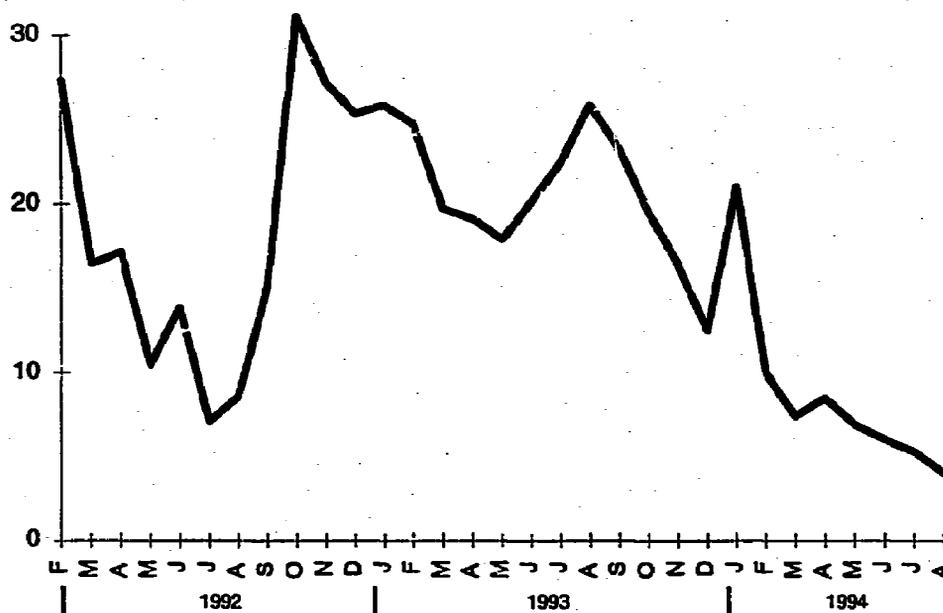
Viewed at any particular time over the past two years, trade policy would appear to be in a state of flux, with considerable uncertainty about overall direction (World Bank 1993). However, looking back it is apparent that progress has been considerable. The exchange rate is freely determined by the market. Average tariffs are about 12 percent, despite enormous pressure for protection by industrial lobbies. Import subsidies were cut from about 25 percent of GDP in 1992 to virtually zero in early 1994. State trading through centralized procurement continues, with diminished coverage, but trading monopolies have been eliminated. Progress has also been made in introducing a regulatory framework typical of that in market economies. For example, a customs law modeled on that of the European Union (EU) was adopted, along with implementing guidelines and procedures relating to customs administration that closely resemble those found in the EU.

Progress in liberalizing interstate trade and eliminating export quotas and taxes has been slower. Official bilateral agreements continued to play a significant role in trade relations with other states of the former Soviet Union. Export controls directed production (mainly resource based) to the domestic market and limited price increases. The

controls stunted exports and reduced the capacity to import. At the same time they introduced massive distortions in resource use that retarded economic development. Recently, some progress has been made in this area as well. As of mid-1994 all non-oil export quotas were abolished and elimination of export quotas on oil was delayed until the use of new mechanisms for access to oil pipelines is clarified.

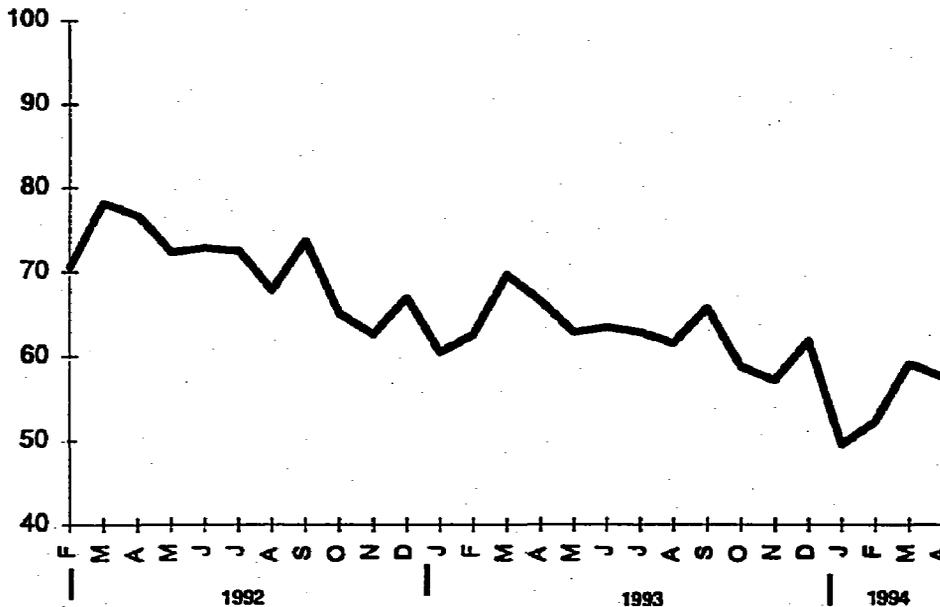
The progress in reform was possible in part because of the protection the undervalued exchange rate afforded to import-competing industries. In the first eight months of 1994 the rate of inflation gradually declined, leading to an appreciation of the real exchange rate. Competitive pressures from imports increased, leading to calls for explicit protection. Tariffs and import policy have now become a central policy variable. The pressure for protection has increased substantially in recent months and has to some extent been accommodated by the government. Tariffs were increased five percentage points on average by a decree of mid-March 1994, much of the increase reflecting substantially higher protection for three powerful industries: motor vehicles, agriculture, and defense. But countervailing forces were effective in raising opposition to the proposed increase, and implementation of the high-

Figure 2.1 Inflation, 1992-94
(CPI, month on month percentage change)



Source: World Bank calculations

Figure 2.2 Real GDP Index, 1992-94
(1990 average = 100)



Source: World Bank calculations

er tariffs was delayed until July. The government's ability to withstand protectionist pressures will be a key test of its resolve to maintain an open trading system.

Despite these reforms in the incentives regime, little restructuring has taken place. Perhaps the most important reason for the delay is that many enterprises are only now beginning to confront hard budget constraints. Early reforms emphasized price adjustment. The challenge for the government in 1994 and beyond is to start the process of structural change by facilitating the movement of labor and other resources to more productive activities. The authorities will have to resist pressures for higher tariffs and for the imposition of nontariff barriers. Rapid accession to the GATT and the new World Trade Organization (WTO) will help to lock in liberal trade policies. Equally important is further progress in eliminating entry and exit barriers that slow restructuring and the reallocation of factors of production, including inward foreign direct investment.

Macroeconomic Background

The Russian Federation has initiated an unprecedentedly broad, complex, and difficult process of economic reform. And it has done so starting from a posi-

tion that was decidedly unfavorable (World Bank 1992). In macroeconomic policy the government has faced the challenge of establishing a consistent strategy involving trade offs between bringing down inflation quickly through significant and consistent financial tightening and cushioning the drop in output through a more gradual adjustment process.

The reform started from a position of severe monetary overhang and distorted domestic prices. Price liberalization led to massive inflationary pressures as the authorities were unable to hold to a tight monetary policy as uncompetitive industries lobbied for cheap credits (figure 2.1). Since the liberalization of prices at the start of 1992 monthly inflation has fluctuated between 5 and 30 percent. At times in the past two years the whole economic system has been threatened by collapse through hyperinflation. However, by mid-1994 there were signs that the government was winning in the fight against inflation. More restrictive policies had brought the rate of inflation down to about 5 percent.

The breakup of the former Soviet Union and the central planning system has also led to a massive collapse in output (figure 2.2). In mid-1992 industrial output stood at less than 70 percent of its 1984 level. Output stayed relatively stable during the final

months of 1992 and the first half of 1993, but then began dropping again in the third quarter of 1993. For 1993 as a whole real GDP declined by about 12 percent, following a decline of 19 percent in 1992. Early indications suggest a continuing drop in GDP through early 1994.¹

For the purposes of this chapter, a key factor to understand is the relationship between relative prices, exchange rates, and trade policy. When Russia began its economic reforms, its price structure was severely distorted. Under central planning prices for raw materials and energy were suppressed in order to provide cheap inputs for industry. The prices of food (such as bread) were controlled largely for social reasons. When the authorities released domestic price controls in early 1992, the exchange rate appeared to depreciate excessively in real terms, in the sense that a large difference emerged between market exchange rates and the implied purchasing power parity rates. In part, this wedge reflected macroeconomic instability in Russia and the continued underdevelopment of monetary and financial institutions. The asset demand for dollars was particularly strong because of uncertainty (political and economic) and highly negative real interest rates in Russia. The authorities attempted to slow the pace of change in relative prices by maintaining interventions on external

trade. Specifically, continued distortions in the price structure were supported by volume and price controls on the main export commodities, energy and raw materials. At the same time the authorities tried to keep the volume of imported goods such as food, medicine, and industrial inputs at existing levels. The attempt to do so as the exchange rate depreciated rapidly led to massive import subsidies.

In nominal terms wholesale prices diverged considerably from world prices for the main product groups that entered export and import trade (table 2.1). These price differences are a summary measure that capture the effects of trade controls. For example, export quotas direct the output of exportable goods to the domestic market, driving down domestic wholesale prices. Export purchasing power parity was 171 rubles to the dollar in January 1993, significantly lower than the benchmark interbank market exchange rate of 555 rubles to the dollar.

On the import side, subsidies to various products also have the effect of reducing wholesale prices in domestic markets (offset to some extent by the tariffs and excise duties on imports). The implied purchasing power parity rate on imports of 376 rubles to the dollar reflects that impact (table 2.1). There are two important conclusions to be drawn from these estimates. First, that volume controls and taxes on exports are the key distortions in the trade regime

Table 2.1 Implied Purchasing Power Parity for Exports and Imports (January 1993)

All exports	171	All imports	376
Portland cement	40	Meat, chilled	265
Coal	288	Vegetable oils	186
Crude oil	168	Coffee	1,261
Oil products	212	Tea	722
Natural gas	51	Wheat	175
Nitrogenous fertilizer	217	Barley	178
Wood	163	Sugar	647
Wood products	46	Alcoholic spirits	296
Ferrous metals	112	Cigarettes	467
Copper	214	Medicaments	108
Nickel	284	Plastics and plastic products	279
Aluminum	305	Clothing	487
Lead	422	Footwear	427
Zinc	284	Steel	100
Light vehicles	812	Computers and televisions	554

Source: Institute of Market Forecasting at the Ministry of Foreign Economic Relations of Russia.

Table 2.2 External Trade, 1990-93

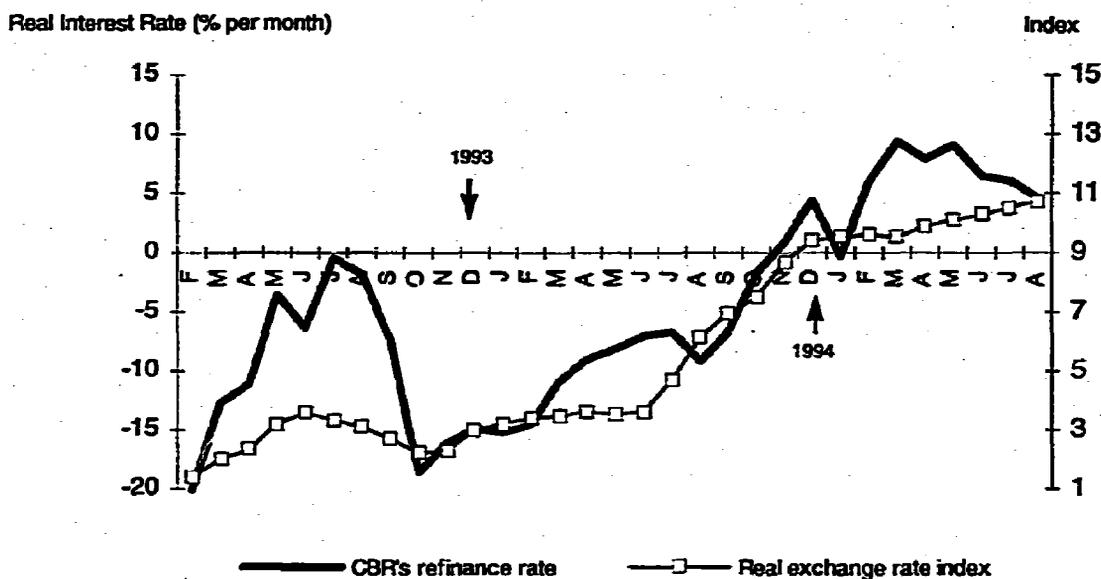
	1990	1991	1992	1993
<i>In Millions of Current US Dollars</i>				
Total Exports	207,527	161,671	52,554	59,652
Former Soviet Union ^a	126,627	108,571	10,954	15,752
Rest of world ^b	80,900	53,100	41,600	43,900
Total Imports	196,941	128,433	46,446	43,646
Former Soviet Union	114,041	83,333	9,246	10,546
Rest of world	82,900	45,100	37,200	33,100
Trade Balance	10,586	33,238	6,108	16,007
Former Soviet Union	12,586	25,238	1,708	5,207
Rest of world	-2,000	8,000	4,400	10,800
<i>Percentage Distribution</i>				
Total Exports	100	100	100	100
Former Soviet Union	61.0	67.2	20.8	26.4
Rest of world	39.0	32.8	79.2	73.6
Total Imports	100	100	100	100
Former Soviet Union	57.9	64.9	19.9	24.2
Rest of world	42.1	35.1	80.1	75.8

a. Derived from country data and World Bank staff estimates reported in national currencies using official/commercial exchange rate for 1990 and 1991, and annual average market exchange rate for 1992 and 1993.

b. ROW - countries outside the former Soviet Union; based on country data reported in US\$.

Source: World Bank calculations

Figure 2.3 Real Interest and Exchange Rates



Source: World Bank calculations

and should receive the highest priority in reform. Second, the large variability in purchasing power parity estimates indicates the need for more uniformity in the trade regime (including fewer exemptions).

It was apparent that real appreciation of the ruble would be helpful for reforms in the trade

regime. A stable and more realistic exchange rate would lead to reduced pressure for export controls and taxes and import subsidies. As it turned out, the recovery in the value of the currency has been one of the major accomplishments of the reform program. The real exchange rate has steadily appreciat-

Table 2.3 Output and Exports of Selected Commodities in 1992 (Whole Year) and 1993 (First Three Quarters)

Item	Unit	Exports to									
		Output		Rest of World		Former Soviet Union Countries		Total Exports		Percentage to rest of World	
		1992	1993 ^a	1992	1993	1992	1993 ^a	1992	1993 ^a	1992	1993
Crude oil	mln. tons	393	260	66.2	60.1	75.5	36.4	141.7	96.5	47	62
Natural gas	bln. cu. m	640	455	88.9	66.1	106.4	64.2	195.3	130.3	46	51
Coal	mln. tons	337	227	17.3	14.5	15.8	6.1	33.1	20.6	52	70
Ferrous metal rolls	mln. tons	47	33	2.2	2.9	4.6	1.6	6.8	4.4	32	65
Timber	mln. cu. m	164	93	9.9	8.6	6.4	2.1	16.3	10.7	61	80
Paper	ths. tons	3,607	2,206	286.5	341.6	795.6	243.4	1082	585.0	26	59
Passenger cars	thousands	963	718	395.7	198.3	81.5	24.5	477	222.8	83	89
Trucks	thousands	646	432	13.9	9.1	104.9	48.6	118.7	57.7	12	16
TV sets	thousands	3,641	2,991	80.2	10.3	174.1	89.2	254.3	99.5	32	10
Radios	thousands	4,016	2,248	28.7	50.4	383.1	94.2	411.8	144.6	7	35

a. First three quarters of 1993.

Source: Roskomstat and Statistics Committee of CIS.

ed since early 1992 (figure 2.3), a turnaround that can be largely attributed to renewed confidence in the ruble, brought about partly by positive real interest rates and greater availability of domestic assets (such as real estate). Consequently, the demand for foreign currency as a store of value has declined. The ratio of market exchange rates to purchasing power parity estimates for consumer goods has declined from a factor of about 7 to slightly more than 2 over the period 1992 to 1994, an indicator that the currency is much less undervalued than early in the reform period. Purchasing power parity ratios are notoriously difficult to estimate, but these numbers indicate that considerable adjustment has taken place on traded goods in Russia.

Several administrative measures through the early part of 1992 also helped to strengthen the exchange rate, from unification of the exchange rate and elimination of the foreign exchange surrender tax to expansion of the room for market forces. The reforms eliminated a detrimental export tax that the Central Bank of Russia had been imposing on exporters by way of a multiple exchange rate. The multiple exchange rate regime had social costs well beyond the efficiency losses generally associated

with taxation: it discouraged exports and the repatriation of earnings and it encouraged barter transactions. Foreign exchange markets were permitted to function more freely, without imposing direct costs on producers and the broader social costs associated with barter trade.

Trade Developments

The dissolution of the USSR in late 1991 converted traditional interstate relations into international trade. Russia's trade with the other countries of the former Soviet Union was supposed to be subject to the same trade regulations as with the rest of the world. But since there were no customs borders, it was impossible to unify the trade regimes immediately. Distorted prices, the lack of customs borders, and the extended use of barter trade and distorted prices made assessing trade flows with the former Soviet Union problematic. Partly for this reason the official balance of payments so far reflects only third-country trade. An attempt to consolidate the balance for total trade is made in table 2.2.

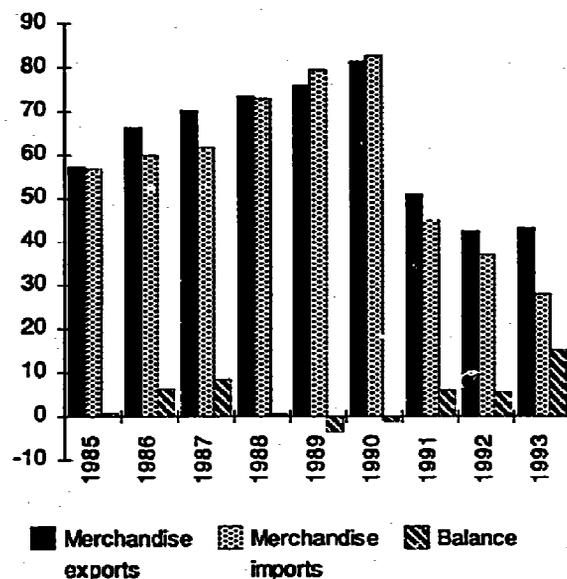
Total trade has collapsed alarmingly since 1990, apparently due to reduced trade with the former Soviet Union. An important part of this contraction

is a valuation problem in the sense that official exchange rates were used to convert ruble-based trade into dollars in 1990 and 1991, while much depreciated market exchange rates were used the following two years. That makes it necessary to consider trends in the underlying volumes of trade with the former Soviet Union (table 2.3). Trade volume has declined, but not as much as the trade values suggest.

Russia's trade statistics are sketchy and imprecise, but it is apparent that within collapsing overall trade Russia is increasingly directing exports toward third countries, particularly raw materials (including oil and gas), which account for about two-thirds of the total volume of exports. Exports of crude oil to third countries were more than 60 percent of the total in 1993, up from 47 percent in 1992. This trend is also apparent for some manufactured goods, such as cars, trucks, and radios. However, goods such as TV sets are struggling to hold third-country markets, and their proportion of sales to countries of the former Soviet Union are increasing. In general, the reduction in trade for individual commodities exceeds the decline in output.

About 60 percent of total trade (exports plus imports) with third countries is in hard currencies. Documentary collection, letters of credit, and other

Figure 2.4 Trends in International Trade, 1985-93
(Billions of U.S. dollars)



Source: World Bank calculations

Table 2.4 Russian Trade with Rest of World
(US\$ billion)

	Exports		Imports	
	1992	1993	1992	1993
Total trade	41.6	43.9	37.2	33.1
Barter and clearing accounts	17.1	21.1	9.4	10.2
Foreign exchange trade	24.5	22.8	27.8	23.3

Source: Goskomstat and IMF.

internationally recognized methods of payments have always been common for trade with the rest of the world (except in recent years, when arrears problems of the Russian government and enterprises made prepayment and payment on delivery more widespread). Trade with the former Soviet Union countries is still ruble or barter based. A large part of that trade is subject to bilateral agreements, mainly obligatory and indicative lists for bilateral deliveries, although enterprise-to-enterprise arrangements also exist and have been expanding.

Trends in Third-Country Trade

Trade with the rest of the world reached a high point in 1990 and has collapsed since then (figure 2.4). Exports have been cut in half and imports have fallen by 70 percent. Exports of manufactured goods by Russia to third countries declined from an estimated US\$17 billion in 1990 to a little less than US\$10 billion in 1993. The largest decline occurred in the machinery and transport equipment sector (from US\$13 billion to some US\$5 billion). Imports declined even more, leading to growing surpluses on the trade account.

Although these surpluses may improve Russia's ability to repay debt in the short term, they reflect unhealthy developments in the trade account. Raw materials constitute a large part of Russia's exports and have held up better than other sectors. Such exports are relatively price inelastic and do not require much in the way of marketing or trade finance. Manufactured exports, however, have been severely disrupted, reinforcing declines in output and profitability. The massive fall in imports is linked both to the fall in demand for industrial

Table 2.5 Concentration Ratio of Exports
(percentage of total exports)

Commodities	Russia	United States	Canada	Brazil	Korea	India
Top three	50	18	25	21	17	28
Top five	59	25	35	30	25	35
Top ten	70	37	50	44	39	50

Note: 1992 for Russia; 1987-88 for other countries.

Source: Roskomstat, UNCTAD

Table 2.6 Product Structure of Trade with Rest of World, 1992 and First Three Quarters 1993
(US\$ million)

	Exports				Imports			
	Value		Percent		Value		Percent	
	1992	1993	1992	1993	1992	1993	1992	1993
Total	37,610	26,434	100.0	100.0	32,027	12,093	100.0	100.0
Foods and agricultural raw material	1,185	862	3.2	3.3	9,204	3,359	28.7	27.8
Timber (unprocessed)	548	530	1.5	2.0	5	9	0.0	0.1
Mineral fuels and electric energy	21,349	15,133	56.8	57.3	541	188	1.5	1.6
Crude oil	8,545	6,454	22.7	24.4	0	0	0.0	0.0
Oil products	4,171	2,703	11.1	10.2	267	142	0.8	1.2
Natural gas	7,479	5,289	19.9	20.0	20	1	0.1	0.0
Ores, minerals and metals (in primary forms)	3,902	2,240	10.4	8.5	461	375	1.4	3.1
Uncut diamonds	1,361	428	3.6	1.6	0	0	0.0	0.0
Aluminum (unprocessed)	1,234	819	3.3	3.1	0	1	0.0	0.0
Manufactured goods	10,626	7,669	28.3	29.0	21,815	8,163	68.1	67.5
Iron, steel, other metal products	2,763	2,827	7.4	10.5	1,168	585	3.7	4.8
Timber (processed)	550	415	1.5	1.6	41	9	0.1	0.1
Chemicals (mostly fertilizers)	2,529	1,824	6.7	6.9	2,302	831	7.2	6.9
Pharmaceuticals	16	9	0.0	0.0	942	199	2.9	1.6
Cellulose, paper and paper products	353	314	0.9	1.2	392	92	1.2	0.8
Textiles and clothing	260	121	0.7	0.5	4,140	1,527	12.9	12.6
Machinery	3,815	2,071	10.1	7.8	12,128	4,565	37.9	37.8
Other	340	85	0.9	0.3	701	355	2.2	2.9

Note: The totals in this table understate actual trade (as shown in aggregate in earlier tables). Roskomstat can only provide a product breakdown for the lower amount shown here, and there is no basis on which to distribute the remainder.

Source: Roskomstat.

inputs following the collapse in output and, more recently, to steep increases in real import prices stemming from the elimination of import subsidies and the imposition of various trade taxes (tariff, value added taxes, and excises). Expanding third-

country trade is critical to Russia's attempts to halt the slide in output and living standards.

In the first half of 1994 both exports and imports grew at about 10 percent over the same period in 1993. On the export side the change has

been the result of increasing physical volumes, as the terms of trade have moved against Russia. Estimates of imports are more uncertain since a significant share is unrecorded (a product of so-called shuttle traders importing food and consumer goods). Although the trade balance is likely to remain in surplus, Russia's balance on the current account is likely to become negative. That prospect underlines the importance of maintaining the reform momentum—restrictions on imports and exports will lessen the contribution of the trade sector to economic recovery. While it is too early to project the capital account, it appears that disbursements of new money will remain low, maybe at around the 1993 level of US\$5 billion. But if stabilization is successful, capital flight should level off, easing the pressure on the capital account. The overall balance, however, is likely to deteriorate.

Barter trade has always been a major part of foreign trade by centrally planned economies, but it is now also undertaken by private enterprises in Russia because of the very limited availability of trade finance. Major losses of resources are associated with barter-based trade, and enterprises' flexibility in searching out new and expanding markets is being significantly impaired by this practice. The problem is becoming increasingly severe. A significant shift away from trade based on payments and credits into barter trade occurred over the past two years (table 2.4). Between 1992 and 1993, the share of barter in total trade with third countries increased from 41 percent to 48 percent for exports and from 25 percent to 31 percent for imports. Virtually all (registered) trade within the former Soviet Union is based on barter arrangements.

Commodity Structure

Russia's exports are based on a narrow range of products, as reflected in a high concentration ratio compared to that in many other countries (table 2.5). The top three commodities (natural gas, crude petroleum, and petroleum products) account for half of Russian exports, compared with 18 percent for the United States, 21 percent for Brazil, and 28 percent for India. The top five commodities (the three listed above plus road motor vehicles and alu-

minum) account for about 59 percent of Russian exports—almost double the percentages of other countries. The top ten commodities (the above plus iron, fresh fish, nickel, fertilizers, and natural abrasives) account for about 70 percent of Russian exports as compared to 37 percent in the United States, 44 percent in Brazil, and 50 percent in India.

A further breakdown of trade based on Roskomstat data outlined in table 2.6 provides some indication of the product structure in trade. (These numbers understate total trade as shown in the balance of payments, but they are the best available.) Almost 70 percent of Russia's exports are raw materials, and 97 percent of imports are manufactures and food products. Exports of manufactured goods totaled at least US\$7.7 billion in the first three quarters in 1993, about the same as in the previous year. The three main manufactured exports were iron and steel products, machinery, and chemicals (mainly fertilizers). Cars and related spare parts account for about half of machinery exports. Other important products include steam boilers, trucks, and graders. Motor vehicles, defined broadly to include cars, trucks, tractors, graders, and associated parts, account for more than three-quarters of total machinery exports. Certainly the low level and range of manufactured exports suggest that there are benefits to diversifying the export base. So does the fact that manufactured goods account for more than two-thirds of imports (with machinery and transport equipment alone accounting for 34 percent). Food and agricultural raw materials (29 percent) are the next largest items in Russia's imports. The relative share of these commodity groups has increased in the past three years.

Trade Policy with Countries Outside the Former Soviet Union

Russia was very isolated when it embarked on reform in late 1991. Since then the government has done much to introduce the administrative framework typical of market economies. A strategic choice was made to use the European Union as a model for the Russian Federation's trade policy framework. Since mid-1992, Russia has developed a customs code and tariff schedule and imposed

value-added taxes on imports. After initial attempts to regulate trade with ex-Soviet partners through bilateral agreements and quantitative controls, the focus has now shifted to harmonizing trade policies applying to the former Soviet Union and third-country trade. The manufacturing industry in Russia was not protected by the usual barriers on imports because an undervalued exchange rate protected domestic output, and because extensive export controls kept raw material inputs cheap. Offsetting these factors was a policy of large-scale import subsidization, estimated to be some 17.5 percent of gross domestic product (GDP) in 1992. The government took great strides in eliminating these distortions as it abolished both import subsidies (early 1994) and export controls on non-oil products (July 1994). The government has announced that export controls on oil and oil products will be eliminated in January 1995.

Institutional Reform

Two federal laws form the legislative base for Russia's import regime, the Law on the Customs Tariff and the Customs Code. The laws were developed in close consultation with customs experts from the European Union. Import tariffs are established by decree. The Customs Code establishes fifteen customs regimes, including provisions for export facilitation mechanisms, such as duty waivers and rebates, on imported inputs used in export production, bonded warehouses and outward processing trade, and free trade zones. Customs classification is based on the Harmonized Commodity Description and Coding System (Harmonized System), which was adopted in January 1992.

Russia is in the process of acceding to the GATT. Russia became an observer to the GATT in 1990, requested accession in June 1993, and presented the GATT Secretariat with a memorandum describing its trade policies in February 1994. The memorandum will be the basis for interested GATT contracting parties to pose questions concerning Russian trade-related policies. GATT membership will bring many benefits. It will become more difficult for Russia's trading partners to subject Russian

exports to quotas, discriminatory tariffs, and arbitrary antidumping or countervailing duty actions. GATT membership guarantees Russian exporters nondiscriminatory treatment and access to GATT's dispute settlement rules. GATT membership will also help the government resist pressures for protection by making it costly to pursue certain types of trade policies.

Centralized Trade

The state has gradually reduced its role in direct trading activities, albeit less rapidly than envisioned by the government in 1993. This trade is a remnant of the system of cross-subsidization used under the former planning system. In brief, monopoly foreign trading organizations set prices for traded goods. In effect, the foreign trading organizations took advantage of a distorted domestic price structure in order to export raw materials that were easily sold in hard currency markets (they required little marketing). Revenues from such transactions were used to subsidize imports of food and machinery.

Something akin to this system was preserved following the collapse of central planning. In third-

Table 2.7 Export Quotas for State Needs 1993, 1994
(as have been initially approved)

Item	Unit	Volume/Value		
		1993	1994	1994/1993 %
Total	billion. doll.	15.4	9	58
Electrical energy	billion. Kw/h	4.7	2.5	53
Oil and gas condensate	mln. tons	20	25	125
Diesel fuel	ths. tons	45	38	84
Fuel oil	ths. tons	6,000	6,345	105
Gasoline	ths. tons	275	275	100
Jet fuel	ths. tons	30	30	100
Marine fuel	ths. tons	1,080	1,000	92
Aluminum primary	ths. tons	100	350	350
Copper refined	ths. tons	50	60	120
Nickel	ths. tons	40	50	125
Cellulose	ths. tons	190	90	47
Technical assistance	mln. doll.	1,300	990	76
Average				114

Source: Ministry of Foreign Economic Relations

country trade export quotas are set aside for state needs so that the government purchasing agent, Roscontract, buys exportable goods on the domestic market at less than world prices.² Centralized trade accounted for about 40 percent of third-country exports in 1993 and is expected to account for 20 percent in 1994. The "profits" made on this procurement were initially used to finance centralized imports, which were in turn initially massively subsidized. Subsidies have been eliminated (see below), and the profit from centralized exports are used to service external debt and provide revenue for the central budget. Centralized trade has been a major distortion in the trading system and an impediment to further reform. In particular the profits from centralized trade have induced certain interests to lobby against price liberalization. Also, centralized trade is not subject to import and export taxes, which results in considerable variability in incentives.

The total value of centralized exports approved for 1994 is some \$9 billion, about two-thirds of the approved level for 1993, while the number of products subject to centralized exports has dropped from thirty-three in 1993 to fourteen in 1994 (table 2.7). Energy and fuels dominate. The most notable changes in 1994 have been the elimination of coal, fertilizers, and timber from the list and the addition of natural gas. Volumes on remaining goods have generally increased as the number of goods included has dropped. Quotas are sometimes modified during the course of the year, since centralized trade is an easy way for the authorities to obtain more budgetary revenue.

Import Policies

Import Subsidies. Import subsidies used to account for a large share of government expenditure. A carryover from the price-equalization mechanism that was part of socialist trade, import subsidies were used to isolate domestic users from differences between domestic and world prices. Until mid-1992 import subsidies were a component of a system of multiple exchange rates aimed at providing for basic import needs for final consumption (mostly food) and for ensuring that intermediate inputs for selected sectors and enterprises were pro-

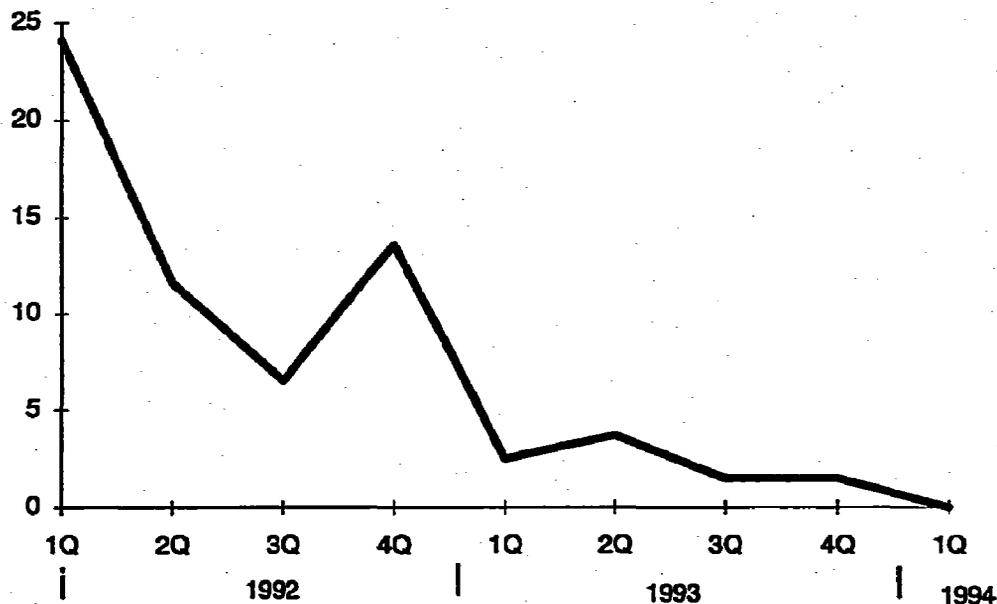
vided at subsidized prices. In mid-July 1992, the transparency of the system was improved by the replacement of multiple exchange rates with a uniform rate (determined by the interbank auction) and direct budgetary subsidies, calculated as import coefficients. In effect, the subsidy coefficients maintained multiple exchange rates on the import side.

The import subsidies were a major fiscal burden and were estimated to account for almost 25 percent of GDP in early 1992. Subsidy coefficients varied from 61 percent on food products to 90 percent on food processing equipment. Some 55 percent of subsidies went to industry, and 45 percent to food products (and their inputs). Import subsidies were financed through taxation of exports and external borrowing. As discussed earlier, rapid depreciation of the ruble and the unwillingness of the authorities to pass on the resulting cost increases to end users determined the extent of the subsidies. Over time, however, the import subsidies became unupportable and they were first reduced and then abolished on January 1, 1994—a major change in the incentives regime (figure 2.5).

Licensing. Imports of goods into Russia are relatively free of quotas and licensing. Licensing is used largely to protect public health (industrial waste and certain chemicals) and licenses are administered by the Ministries of Agriculture and the Environment and apply to only some 3 percent of imports. The customs authorities require quality certification for almost half of total imports (reputable foreign certificates are accepted). The procedures are not intended to protect local industry by delaying imports.

Tariffs and Excise Duties. The main interventions on the import side are various taxes (customs duties and excise). During the early part of 1992 most imports were tax exempt, except for a minor administrative surcharge of 0.15 percent. The basic duty structure was introduced in July 1992, with a base rate of 5 percent (with relatively few exceptions, such as beverages at a higher rate of 25 percent). The tariff schedule comprised four columns depending on the source of imports: least developed countries (zero rate); developing countries (half the basic rate); most-favored-nation (MFN)

Figure 2.5 Trend in Import Subsidies, 1992-94
(percent of GDP)



Source: World Bank calculations

countries (basic rate); and non-MFN countries (twice the basic rate). The customs duties applied to about three-quarters of Russia's imports and were about 4 percent on average (import weighted).

The tariff schedule has been changed substantially three times since mid-1992, and these frequent changes have led to confusion and uncertainty among importers. The net result of the changes has been a significant increase in the variability of duty rates, which now range between 0 and 100 percent. The Law on Customs Tariffs stipulates a ceiling tariff duty of 100 percent of the customs value of a good. The average import-weighted duty rate increased to about 11 percent in late 1992, declined about 8 percent in mid-1993, and then increased to 12 percent in mid-1994. The granting of exemptions at both the product and enterprise level added to the variations in the import structure. A step in the right direction was taken with the new Law on Customs Tariff of January 1, 1994, which abolished enterprise-specific exemptions.

The most recent changes in the customs tariff were implemented on July 1, 1994, (following a

decree of March 1994), a response to considerable protectionist pressures and fiscal concerns. They resulted in substantial increases for some products and greater product differentiation. Particularly affected by the recent increases are cars (from 25 percent to 40-46 percent), integrated boards and chips and some electronic goods (from 5 to 60 percent), weapons (from 15 to 100 percent), and several types of machine tools (from 5 to 25 percent). The main basic rates of the new customs tariffs are zero percent for pharmaceuticals; 1 percent for oil products; 1 to 10 percent for plastics, chemicals, and noncotton yarns and fabrics; 5 to 10 percent for agricultural products (although some rates are much higher, such as 20 percent for sugar, 30 percent for cigarettes, and 100 percent for spirits); 10 percent for fertilizers; 10 to 20 percent for footwear and clothing; 20 to 25 percent for wool and raw cotton and zero to 20 percent for machines and equipment (although some items are as high as 60 percent).

Excise duties ranging between 10 and 400 percent are levied on certain products (luxury goods, tobacco, cars, and alcohol). Although declared rates

for some goods are higher for imports than for domestic goods (alcohol, cigarettes, cars), actual rates for most products are higher for domestic goods because the base used for tax collection is less favorable for domestic goods.³ Most imports are also subject to a 20 percent VAT.⁴ The March 1994 decree on tariffs noted earlier stipulates that excise taxes (both rates and the base on which they are collected) will be harmonized for foreign and domestically produced goods.

Export Policies

Export quotas. From 1992 to mid 1994 export restrictions were the single most important intervention in the trade regime. Although the government recently announced the future elimination of these restrictions, their effect on relative prices and trade patterns lingers. Exports from Russia were subject to a range of quantitative and licensing controls including quotas, licenses, export registration, and special export controls on military technology. Export quotas applied to most energy and other raw materials, which accounted for about 70 percent of total exports. The quotas and licensing requirements were intended to ensure that goods remained available in domestic markets. Limiting the amount of domestic production that could be exported. Such controls kept the domestic prices of these goods lower than they otherwise would have been, reducing the profitability of industries with export potential and boosting the profitability of industries that relied on artificially cheap inputs. No constraints applied to exports of manufactured goods, and all exports are exempt from VAT and excise taxes.⁵

The quotas were based on assessments of material balances (the difference between projected domestic consumption and production) undertaken by the Ministry of Economy. In effect, the quotas perpetuated the practice under the centralized regime of exporting only goods that were in excess of domestic needs. In periods of price liberalization, export volumes were increased. The Ministry of Foreign Economic Relations handled the distribution of most export quotas as follows: 50 to 55 percent to Roscontract, 30 percent to enterprises, 10 to 12 percent to regions, and 3 to 5 percent for sale

through auctions. Exports produced by joint ventures and commodities produced under subcontract agreements were not subject to quotas.

The magnitude of export quotas can only be deduced *ex post* from the official trade statistics. Distribution of quotas was undertaken administratively, and although they were not published, historical performance was one of the more important criteria determining quota distribution. Given the enormous profits to be made, it is not surprising that quotas were subject to intense rent-seeking efforts. Profits were greatest where the price differences were largest (and the quotas most restrictive). Some quotas—and their foreign exchange earnings—in export regions were assigned to local authorities (in part, as a form of economic transfer intended to lessen demands for greater local or regional autonomy). A small portion of the quota was sold on the commodity exchange. While this amount allowed for some flexibility for distributing a share of the quotas to new entrants into exporting, the effect was limited by the small volumes.

Export controls have led to enormous efficiency losses. As mentioned earlier, in January 1993 the domestic price of exports implied an exchange rate of 171 rubles to the dollar, when the market exchange rate was 555 rubles per dollar (see table 2.1)—an implicit export tax of more than 200 percent. Low domestic prices of energy maintained through export taxes encouraged domestic consumption, discouraged production, and reduced exports. The lack of investment in oil production is clearly related to the low domestic prices maintained by export controls. And, by reducing foreign exchange earnings, the controls have also lessened the capacity of the economy to pay for imports. Moreover, such tight controls led to a significant appreciation of the exchange rate.

A decree of May 23, 1994, eliminated quotas and licensing on all non-oil exports and services as of July 1, 1994, except those subject to international obligations. Controls on oil are expected to be eliminated in January 1995 (the delay is due to difficulties in designing and implementing new mechanisms of access to the oil pipelines). The elimination of export restrictions will have wide-ranging ramifications for the economy:

Table 2.8 Export Taxes as of End 1993

Item/(unit)	Quantity	Value (US\$ million)	Share in overall exports (%)	Export price \$/unit	Tax Rate	
					ECU/unit	\$/unit
Fish and products (tmt)	431.0	525.0	1.7	1,218.1	0	0
Iron ores (tmt)	5,377.9	125.8	.4	23.4	0	0
Coal (tmt)	16,208.1	530.6	1.7	32.7	0	0
Crude oil (tmt)	67,713.5	7,115.0	22.7	105.1	30.0	33.9
Petroleum products (tmt)	29,514.2	2,824.4	9.0	95.7	n.a	n.a
Gasoline	n.a	n.a	n.a	n.a	40.0	45.2
Gasoil	n.a	n.a	n.a	n.a	30.0	33.9
Oil fuel (mazut)	n.a	n.a	n.a	n.a	8.0	9.0
Natural gas (million m3)	73,881.0	5,705.3	18.2	77.2	18.0	20.3
Ammonia (tmt)	2,342.1	184.8	.6	78.9	2.0	2.3
Methanol (tmt)	704.0	57.0	.2	81.0	3.0	3.4
Synthetic rubber (tmt)	121.0	106.0	.3	876.0	65.0	73.5
Nitrogenous fertilizers (tmt)	3,742.9	270.5	.9	72.3	5.0	5.7
Phosphoric fertilizers (tmt)	114.7	13.5	0	117.7	4.0	4.5
Potassium fertilizers (tmt)	2,122.2	140.8	.4	66.3	3.0	3.4
Logs and timber (thsm3)	9,060.6	540.9	1.7	59.7	8.0	9.0
Processed timber (thsm3)	2,528.5	371.9	1.2	147.1	7.0	7.9
Plywood (thousand m3)	236.0	74.5	.2	315.7	0	.0
Cellulose (tmt)	594.2	148.2	.5	249.4	15.0	17.0
Paper (tmt)	352.9	85.4	.3	242.0	15%a	36.3
Cotton fabrics (thousand m)	97,314.0	40.4	.1	.42	0	0
Pig iron (tmt)	1,710.1	174.5	.6	102.0	0	0
Ferroalloys (tmt)	213.1	123.1	.4	577.7	16.0	18.1
Aluminum (tmt)	1,107.1	961.9	3.1	868.8	70.0	79.1
Machinery and equipment	n.a	2,295.6	7.3	n.a	15%a	n.a
Total	n.a	22,415.1	71.4	n.a	n.a	n.a
Overall exports	n.a	31,409.8	n.a	n.a	n.a	n.a

a. Military equipment and aviation technics.

Source: World Bank estimates.

- *Higher energy prices on the domestic market.* Resource-based industries will be encouraged to expand production and redirect sales to export markets. In the short run the potential to expand exports may be constrained by transport capacity, but this obstacle should be overcome in the medium term. Consumers will be encouraged to economize on the use of energy and raw materials, thereby increasing efficiency. Industrial enterprises, particularly the most energy-intensive activities (such as fertilizers and chemicals), will be forced to accelerate restructuring.
- *Further strengthening of the exchange rate through higher export proceeds.* The resultant increase in imports will con-

tribute to economic recovery and growth. In effect, the previous export restrictions represented a substantial tax on import activities through lowering of the exchange rate. A higher exchange rate will improve the prospects for much needed restructuring of the industrial sector by reducing the cost of capital equipment imports. However, it will lead to increased external competition for domestic markets;

- *Greater transparency and less rent-seeking activities.* The system of export restrictions was a major source of rent seeking, as producers and middlemen tried to bribe officials to obtain quotas or to evade customs controls. The rent-seeking activity

was on such a scale that it undermined respect for administration.

- *An unclear, but potentially large fiscal impact.* The budget will benefit from increased excise tax revenues in the short run. However, that gain will be offset by a loss in revenues from centralized exports as the difference between domestic and world prices narrows. There may also be a loss in revenue if profit taxes from the industrial sector fall. Moreover, the authorities will be under enormous pressure to increase subsidies to certain sectors. These pressures should be resisted since the purpose of a realignment in relative prices is to force a restructuring of the economy and a much needed improvement in the efficiency of energy use.

By shrinking the gap between domestic and export prices and taking away Roscontract's privileged quota position, the elimination of export quotas will severely reduce the potential for the authorities to profit from distorted relative prices and thereby hasten the elimination of centralized trade. In the short run domestic prices will probably remain below world prices because of export taxes, suppressed domestic demand (falling output and ability to pay by industrial enterprises), and transport and pipeline constraints to exporting. As transport constraints are eased, export taxes will become the main wedge between domestic and world prices. The authorities have recently announced that centralized trade for non-oil products will be eliminated in 1995. The position with respect to oil products is not yet clear, but given the elimination of quotas the authorities will need to switch to other forms of revenue.

Export taxes. Export taxes are also applied to certain natural resources and semiprocessed commodities, to keep prices low on the domestic market and to raise revenue. Export taxes were introduced in January 1992 and have been changed numerous times since then in response to changes in the exchange rates and in the relationship between domestic and world prices. (The structure of the

export taxes as of end 1993 is shown in table 2.8.) Most taxable goods were subject to levies quoted in ECUs per ton. The ad valorem equivalent tax rates ranged from 1 to 80 percent. Oil and gas, which accounted for about 40 percent of total exports, were subject to rates of 34 percent and 20 percent.

Two important factors have altered the effects of the formal export tax structure. One was the surcharge applied on all barter trade and on some ruble and joint-venture trade; the other is evasion and exemptions. The stated purpose of the surcharge was to penalize exporters who avoided the (implicit) foreign exchange surrender taxes. The surcharge had grown progressively higher, rising from 15 percent in early 1992 to 50 percent in early 1994. The surcharge on barter trade was eliminated in early 1994 as part of a package of currency reforms (notably that exporters were no longer required to surrender export earnings to the Central Bank of Russia). Exemptions granted to oil exports and to all deliveries of goods for state needs were largely responsible for collection rates during 1993 as low as 22 percent. In addition exporting regions withheld export taxes, partly because they needed the revenues to provide local services. Under the recent package of reforms export taxes will become the main instrument influencing relative prices in Russia. Export taxes are an area in which the government could move more boldly in reform because there is ample scope to cut tax rates, a move that could be introduced in parallel with an overhaul of energy taxes in general. The government has decreed that export taxes will be eliminated at the end of 1995.

Strategic exports. Some important categories of goods (mainly raw materials) may be exported only by registered exporters (a form of nontariff restriction). About 200 foreign trading organizations and larger enterprises are entitled to export the listed goods. All other exporters of these goods must work through registered exporters. The stated objectives of this practice are to exercise control over the hard currency activities of exporters and revenue collection and to "protect" small exporters who are supposed not to know how to transact in international markets. The latter exporters are sup-

posed to be responsible for the selling of Russian raw materials too cheaply on the world market. Such behavior has been motivated more by the large difference between domestic and world prices for many of these products than by ignorance. The large profits to be made in exports have attracted many small exporters who can still earn healthy profits by selling at what appear to be relatively low prices in world terms.

There is no justification for using exporter registers to control the number of exporters once quotas are lifted. Domestic prices will move toward world levels, and export activity will tend to settle down as profit margins are reduced to normal levels. Controlling the numbers of exporters will inhibit evolving market structures and foster greater concentration of industry. Exporters should be registered only to help ensure the collection of export taxes in the short term; all interested parties should be registered as a formality. Once export taxes are lifted, the export register should also be scrapped.

Trade Relations with Countries of the Former Soviet Union

The disintegration of the former Soviet Union has contributed to a severe decline in trade and is an important reason for the subsequent collapse in output. Previously the various countries were tightly bound together as trade within the former Soviet Union absorbed an unusually high proportion of total trade, even when compared with other regional trading blocs. Only Russia had a significantly different trading pattern, not only because it was the best endowed, but also because Moscow was the seat of the ministries that controlled trade. The breakup of the former Soviet Union seriously disrupted interstate trade. The Soviet economy had been largely closed to the West, and the former republics had little alternative but to trade with each other or with other command economies in the eastern bloc or with socialist economies such as Cuba and Viet Nam. The highly militarized Soviet economy required cooperation in arms production and also contributed to a large proportion of interstate trade. Finally, in the Soviet Union's "hub and spoke" economy, which was run from Moscow,

political considerations, guided the geographic distribution of enterprises, not economic efficiency. To enforce economic dependence, there were often only a few single-source suppliers spread among several of the former republics. These artificial trading patterns are now drastically changing and the former Soviet Union countries are all turning to the outside world.

Payments Problems

Problems with the monetary and payments system helped bring about the collapse of interstate trade. During the first half of 1992 only Russia could print rubles, but all the central banks in the ruble zone could expand the money supply by creating credit in rubles. In the absence of monetary coordination, this quickly gave rise to a free rider problem, because monetary restraint by some central banks could be exploited by others that were able to expand their money supply independently. This arrangement fueled inflation, impeded efforts to stabilize the ruble, and posed difficulties for trade and payments.

Russia accumulated a significant trade surplus with other countries during 1992, a consequence of traditional structural relationships within the Soviet Union and the relatively larger upward adjustment in the price of oil, Russia's main export. To stem the outflow of goods and to control the amount of credit extended to the other countries, Russia established a network of correspondent accounts for the central banks of the countries to monitor all bilateral transactions. Credit limits were imposed on these accounts after July 1992. When a country exceeded its limit, the Russian central bank would refuse to clear payments orders (such as checks) of enterprises in the debtor country, meaning that Russian exporters would not be paid for the goods they shipped to that country. This move accelerated the introduction of independent currencies throughout the region. Matters were exacerbated by the dramatic decline in the efficiency of the banking system once Gosbank, the central bank of the former Soviet Union, was dissolved. It began to take two to three months to clear payments orders—a risky business in an environment of high inflation.

The former republics were not able to adjust quickly to the shifting terms of trade and began to run up large debts with Russia despite the credit limits. By late 1993 net trade debt to Russia amounted to 1,500 billion rubles (Russian enterprises' arrears amounted to 1,500 billion rubles, while other countries owed Russia 3,000 billion rubles), most of it for shipments of Russian fuel and energy. In mid-1993 the Russian government stopped issuing technical credits (these had been granted on a case by case basis, without any specific limits or terms of repayment). All the negative balances on correspondent accounts in the Central Bank of Russia were transformed into government-to-government debt. Repayment periods and interest charged (typically LIBOR plus 2 percent) were determined for both accumulated debts and new credit lines. Most countries lacked the resources to repay the debt, so the terms and conditions of repayment became a contentious political issue. One solution that was pursued was asset-debt swaps. The first, with Ukraine, gave Russia shares in the Lisichansk oil refinery as partial repayment of the Ukrainian debt.

Recent Developments in Payments Mechanism

Gradually a number of countries in the former Soviet Union began to introduce their own currencies. The introduction of new currencies considerably changed the incentive structure that led to credit limits being imposed through the central bank correspondent accounts. In particular, central banks with independent currencies cannot create noncash

rubles. Enterprises that wish to import from Russia must first acquire Russian rubles. For these countries, Russian rubles must be obtained through exporting to Russia or by obtaining credit from Russia (or the country can use assets acquired through trade or credit with other countries or donors to purchase Russian rubles). Thus, there is no need to force all trade transactions through the correspondent accounts of the central bank of Russia. Over time, the importance of the central bank correspondence accounts declined and commercial banks were allowed to deal directly with one another.

Various initiatives were put forward to improve the payments system. One, the proposal to establish an Interstate bank, seemed well on its way in 1992, but then progress stalled (see comment by Gros to Chapter 11). The Interstate Bank was never created in part because no individual country had a large enough incentive to push for it, least of all Russia, which was running a surplus with all the other countries.

Private commercial banks have met some of the need, becoming much more active in settling payments across countries of the former Soviet Union. They have done this through a network of correspondent accounts and through Western banks, largely in Europe. As a result, active exchange markets have developed among the various countries. Commercial banks are able to process transactions through their correspondent accounts in a matter of days, compared with two to three months on transactions through Central Bank of Russia clearing

Table 2.9 Russian Regulatory Regime for Trade with Other Countries of the Former Soviet Union

Type of trade	Export licensing and quotas	State obligations	Exports		Export licensing and quotas	State obligations	Trade taxes (exports and imports)
			Exports	Imports			
Obligatory list goods	No	Yes	No	No	No	Yes	No
Indicative list goods	No	No	Yes	No	No	No	Yes
All other goods	No ^a	No	Yes	No	No	No	Yes

a. An exception is that goods not on the indicative lists, but which are subject to licensing to third countries, are also subject to licensing in interstate trade.

Source: World Bank

mechanisms. In addition, traders have circumvented payments problems by moving cash across borders (reportedly in large suitcases) or by resorting to barter arrangements. All these channels involve large transaction costs, however, and even today the commercial banking system is not efficient enough to support a full recovery of interstate trade. Consequently, the lack of an effective payments system remains a bottleneck that will be overcome only as the commercial banking system develops.

Trade Regime

The most significant trade barrier has been the widespread use of export licenses and quotas. Although most of these restrictions on non-oil products were recently eliminated, they have heavily influenced the evolution of trading patterns in the countries of the former Soviet Union. These controls were imposed in reaction to two developments.

One was the lack of monetary coordination within the ruble zone, which meant that each country had a strong incentive to import goods and pay for them in rubles, which their central banks could create independently. Countries responded by imposing quantitative limits on exports. The other impetus for export controls was the wide variation in the pace of price liberalization among countries,

which resulted in significant price differences for a number of products. Many prices, notably for energy, were still well below the world level. Without export restraints, these products would be exported to world markets or to other countries where prices were higher.

On the import side, there were few formal restraints on imports from other countries of the former Soviet Union, but competition from abroad was weak in most sectors because an undervalued ruble provided very high implicit protection against hard currency imports. In addition extensive foreign exchange subsidies are available but only on non-import competing products. The regulatory environment between Russia and other countries of the former Soviet Union is outlined in table 2.9.

State trading through bilateral arrangements. In an effort to deal with trade problems between the countries of the former Soviet Union, countries resorted to many of the features that characterized trade under central planning. By March 1992 an extensive network of bilateral trade agreements had been signed that divided trade into "obligatory" and "indicative" trade. Trade not under the agreements was to be enterprise-to-enterprise based.

Obligatory list trade was conducted on the basis of intergovernmental barter agreements covering the most important products traded between

Table 2.10 Fulfillment of Intergovernmental Agreements between Russia and Other Countries of the Former Soviet Union, 1993

CIS States	Stipulated by contracts			Actually filled			Percentage of fulfillment			Exports minus Imports	
	Total	Import	Export	Total	Import	Export	Total	Import	Export	By contract	Fulfilled
Azerbaijan	955	454	501	65	25	40	7	6	8	47	15
Armenia	446	208	238	60	12	48	13	6	20	30	36
Belarus	3,692	1,841	1,851	2,184	1,092	1,092	59	59	59	10	0
Kazakhstan	2,195	1,103	1,092	580	212	368	26	19	34	-11	156
Kyrgyz Republic	266	133	133	129	64	65	49	48	49	—	1
Moldova	526	252	274	185	93	93	35	37	34	22	0
Tajikistan	206	103	103	17	—	17	8	—	17	0	—
Uzbekistan	2,630	1,220	1,410	1,471	735	736	56	60	52	190	1
Ukraine	7,670	4,319	3,351	2,458	1,229	1,229	32	28	37	-968	0
Turkmenistan	14	7	7	12	6	6	87	87	87	0	0
Total/average	18,599	9,640	8,959	7,163	3,468	3,695	39	36	41	-681	227

— not available

Note: Table excludes natural gas shipments

Source: Institute of Market Forecasting

the countries—such as energy products and raw materials—much as had occurred under the former CMEA. These commitments obligate the country to fulfill the contract, and maximum allowable prices are specified for many products. Although an effort was made to roughly balance this portion of the trade by assigning prices and adjusting volumes, Russia accumulated large interstate trade surpluses as prices were realigned. For indicative list trade countries agreed to provide export licenses for all enterprise-to-enterprise negotiated contracts up to the quota amounts specified. The trade took place only if the enterprises agreed on the terms of the sales, including price and credit conditions. Indicative lists covered some 1,000 to 1,500 products, including a wide range of machinery and agricultural and consumer products.

All remaining products were to be freely traded at the enterprise-to-enterprise level. Moreover, products could be traded in multiple ways; in particular, oil was traded in all three categories. However, the majority of trade in value terms was in the first two categories.

These bilateral agreements did not resolve the myriad trade and payment problems. It was unclear how and how frequently trade imbalances should be settled—convertible currency, rubles, and additional shipments of goods have all been proposed as a means of payment. Governments were not very successful in fulfilling their obligatory trade agreements, largely because the continuation of price controls reduced incentives to export (table 2.10). As shown in the table, these agreements were to cover the bulk of Russia's total trade with former Soviet Union countries. In the event, the average fulfillment ratio was only 39 percent and actual trade under the agreement was valued at only US\$3.7 billion (out of total trade of US\$27.2 billion). Actual fulfillment of contracts varied considerably by country from 7 percent (with Azerbaijan) to 87 percent (with Turkmenistan). At the same time, the system of state orders had either broken down or become less effective. As a result, enterprises that either did not find it profitable or that lacked the necessary inputs, often did not supply the agreed-upon quantities. More fundamentally, as

long as trade was conducted on the basis of bilateral pacts, it was governments rather than markets that determined the allocation of resources.

Obligatory list trade became less important over time as Russia diverted raw materials to more lucrative third country markets, and the number of products covered by obligatory lists fell over time. As of early 1994 they applied to only 30 products. Moreover, the foundations of the system were undermined by the recent decree abolishing export quotas and licensing (except on oil products). This will align domestic and world prices on the Russian market, lessening any margin for cross-subsidized trade through government-to-government agreements. Policymakers should move boldly to eliminate the remaining controls on interstate trade, and no new obligatory agreements should be signed once the current contracts expire at the end of 1994.

Supply Response

During 1992-1993, the focus of the government's main policy changes was in the area of price reform. This resulted in large changes in the incentive structure facing Russian firms and consumers as domestic prices began to converge to world levels. It is still too early to determine what effects price reform has had on the structure of Russian industry. Until late 1993 it appeared that the impact of price liberalization on industry structure and employment was quite limited, even though measured industrial output has dropped dramatically. On an aggregate level, industrial output fell by 16 percent during 1993 after having fallen by 18 percent in 1992. Output declined further in the first quarter of 1994. The largest declines in output during 1993 were registered in the machine building, metal working, and petrochemical branches, with reductions of more than 40 percent. The dismal output performance reflects the inefficiency and uncompetitiveness of much of Russian industry. Russia inherited a highly concentrated and capital intensive industry, much of which was geared toward the production of military hardware. About half of all enterprises were engaged in heavy industry,⁶ accounting for over three-quarters of total industrial employment.

There has been some adjustment by Russian firms, but on the whole much less restructuring and resource reallocation has occurred than is needed. Many enterprises have altered their output mix. This has been the case in particular for firms engaged in defense-related production. Arms procurement by the government fell by about one-third in 1992, and fell further in 1993. While the output of the defense industry has fallen substantially as the result of procurement cutbacks, the proportion of total output produced by firms in the military-industrial complex has fallen even more due to diversification away from military production. The share of defense-related output is estimated to account for only one quarter of total production of such enterprises. But much more is required. Many of the enterprises in this sector, as well as many other parts of manufacturing, need to undergo very significant retooling, restructuring, downsizing, or closure. Despite the significant fall in industrial output in the last few years, the Russian economy is still over-industrialized. For the economy to move toward a more appropriate structure and for economic growth to occur, further drastic reductions in both output and employment shares of the industrial sector will be inevitable. Moreover, changes in the sectoral structure of industry will also be required. Russian industry remains overly specialized in producer goods, especially machinery and equipment, while the consumer goods industry is severely underdeveloped.

The weak supply response to the changes in the incentives regime that occurred during 1992-93 is largely related to the legacy of central planning, which closed Russian enterprises off from international competition. Bureaucratic control of prices and domestic resource flows resulted in a vertically integrated and highly concentrated production structure. Domestic competition was severely constrained. Enterprises were expected to increase their production capacity, output, and employment; there was little emphasis on productivity and efficiency. The result is that many Russian enterprises are uncompetitive by international standards. They remain greatly overstaffed, and are much more energy-intensive than their foreign competitors.

Their technology, plant, and equipment are largely obsolete. Since planning was done in terms of physical inputs and output, there has been little regard for financial reporting and control. Central planning also eliminated the need for sales and marketing departments and strategic product development. These functions are crucial for successfully operating in a market environment. Moreover, many of the larger enterprises have traditionally provided their employees and their families with a wide array of social services, including housing, health care, education, transportation, and cultural, recreational, and sports facilities. Employees are often locked into this community-enterprise system in the sense that the firm provides all these social services as well as employment. For that same reason local authorities try to maintain the status quo as long as possible, to avoid having to take on these social functions, which they lack the resources to finance.

Both central and local governments provided directed credits to enterprises, which allowed them to continue to operate production facilities and maintain their social services and further delayed restructuring. Firms also provided substantial credit to each other, whether voluntarily or by accumulating arrears. Until mid-1992 payment flows went through branches of the State Bank, which acted as remitting and collecting agents for seller and usually lent funds to debtors. After mid-1992 the combination of price liberalization, macroeconomic instability, and greater enterprise autonomy led to a breakdown of the bank-guaranteed payments system. In the absence of effective bankruptcy procedures, firms responded by granting each other credit. Interenterprise arrears became huge. The growth of interenterprise credit and continued directed credits from government significantly reduced the pressure on firms to take the drastic actions that the change in economic environment demanded.

During 1993 and especially in 1994 budget constraints became firmer as the government pursued its commitment to lower the budget deficit and inflation. The challenge facing the economy is to manage the process of restructuring that has become unavoidable. Unless enterprises and factors

of production are allowed (and encouraged) to enter alternative economic activities, not even hard budget constraints, a more stable macroeconomic situation, and more liberal trade policies will be enough to bring about the reallocation of resources needed to restart economic growth.

Privatization has already changed the way enterprises operate. More than 99,000 enterprises have been privatized since early 1992. By mid-1994 almost half the labor force was employed by non-state enterprises, which accounted for more than 60 percent of total production.

The biggest remaining impediments to restructuring and a healthy supply response are excessive local government regulation of business, too much concentration in input and output markets, inadequate infrastructure, and too many changes in tax policy. Underdeveloped real estate markets are also a problem, although the situation is improving.

Local governments often impose a variety of licensing requirements on businesses in their jurisdictions related to health and safety standards, prudential supervision of services, environmental regulations, zoning restrictions, and so on. The number of official bodies that impose and enforce licenses and standards is often large. In many cases licensing is simply a method of taxing enterprises. Firms may also be subject to price controls or restrictions on trade and profit margins. Both federal and local governments frequently confer preferential treatment on incumbent firms that increases barriers to entry. Examples include direct subsidies, low-interest credit, tax exemptions, low rates for or special access to utilities, and loose enforcement of licensing or related regulations.

The high concentration of Russian industry confers considerable market power on suppliers and buyers. A firm that has been privatized, developed a business plan, obtained funds to upgrade its production technology, and found a market niche may suddenly be confronted by a significant increase in the price for a crucial intermediate input or raw material from a monopoly suppliers. The issue here is one of local market power. Trade and entry are usually quite feasible in principle; what is needed to increase competition are regulatory barriers to entry

and elimination of and enforcement of the competition law.

Infrastructural inadequacies are another impediment, especially in utilities, housing, transportation, communications, and storage and distribution. Public utilities are generally inefficient and provide low quality service. They also have great market power and considerable discretion in pricing. Inadequate supplies of power or water, poor quality, and in many cases, discriminatory pricing favoring incumbents, typically impede the startup of new manufacturing enterprises. Housing shortages and high costs are a problem for worker mobility, making the geographical reallocation of labor difficult. Transportation is another bottleneck that may affect new investment. Roads are often of poor quality, forcing enterprises to locate along a railway line which reduces efficiency. Railways are monopolies, with limited rolling stock, lack of specialized equipment, and frequent breakdowns and delays. Communications are also inadequate. Telephone and related services are of low quality, preventing data communications. Storage, warehousing, and distribution are often of low quality and inefficient, resulting in high wastage rates.

Turning to a specific constraint of development of export-oriented production, exports of manufactured products would benefit greatly from quality upgrading through greater use of foreign know-how and technology and better knowledge of export market requirements. Marketing of Russian products used to be the domain of state foreign trade organizations, or was simply not an issue because exports were determined by government-negotiated trade agreements. Russian enterprises consequently lacked overseas marketing capability and knowledge. International trading activities were liberalized in 1992, and Russian firms no longer need to use the services of specific foreign trading organizations. Russian manufacturers now have the choice of engaging the services of a trading company, or establishing direct links with foreign buyers. Although several foreign trading organizations have adapted well to the new environment, in many instances Russian producers may need to establish direct links with foreign buyers if they are to win

export orders. Such direct interactions may be needed to allay the concerns of buyers about the quality and reliability of Russian supplies.

To sell on foreign markets, Russian enterprises must produce goods that are attractive to foreign buyers, and they must deliver them on time. In most instances that will require substantial restructuring of firms. Foreign collaboration may be especially fruitful in this connection, by providing Russian enterprises with managerial know-how, technology, and information on foreign markets. Foreign direct investment in manufacturing activities remains very limited, however. Until political and economic uncertainty are reduced, nonequity forms of foreign investment (subcontracting or technical or marketing agreements) may be all that foreign investors are willing to consider in the short run. Ultimately, attracting foreign investment requires macroeconomic and regulatory stability. So far, though the trend in policy has clearly been in the right direction, there has been a great deal of variability in the formal rules and in the way they are applied. Uncertainty remains the greatest constraint on the inward flows of investment that are crucial for the development of an efficient manufacturing sector.

Concluding Remarks

Trade policy and foreign exchange regime management play crucial roles in ensuring that producers confront the correct price structure when contemplating new investment. This applies to both existing public enterprises and the newly emerging private sector. In order to increase the efficiency of production, the prices of exports and imports should be brought in line with world prices. This process is rapidly taking place in Russia. This has significantly changed relative prices in Russia, and in the process created both winners and losers. The authorities should refrain from cushioning enterprises from these changes, for example through credit subsidies. Subsidies and soft budget constraints are undesirable precisely because they reinforce price distortions and defer restructuring.

Macroeconomic stabilization can reinforce and facilitate important improvements in Russia's trade policies. Stabilization and increased credibility of

macro policy would lead to continued real appreciation of the ruble and thereby reduce the pressure for certain trade interventions, particularly on the side of exports. At the same time, changes in trade policies need not await stabilization and related external financial support. These policies tend to reduce supply of foreign exchange and increase its demand, thereby making the stabilization effort more difficult. Experience also suggests an environment of macro-economic stability, a competitive and reasonably stable real exchange rate, and currency convertibility are essential preconditions to a strong trade performance in the longer term.

Experience has shown that protection aimed at easing the costs of adjustment could be provided through moderate tariffs that preferably do not vary significantly by sector, or at least have a narrow range, and could decline over time as the economy becomes more fully integrated in international trade. Most developing countries that have made an effective transition from a heavily protected environment while sustaining a strong export performance have imposed modest tariffs. In Russia's case there is scope to introduce a more uniform and lower import tax regime. In this regard a lower tariff ceiling of 30 percent could be introduced. Importantly, policymakers should resist changing the tariff structure as the currency strengthens with stabilization, ensuring that enterprises are exposed to world competition. Likewise, most exemptions to import duties should be abolished (particularly for centrally procured goods). For those imported goods subject to an excise tax, the general principle should be for the rates to be the same on imports as their domestically produced substitutes.

The long-run, first best policies for trade with the countries of the former Soviet Union are relatively clear. The overarching need is to move away from state controlled trade to a market oriented system that facilitates enterprise-to-enterprise trade. According to respondents in a World Bank survey, political interventions are one of the main barriers in the way of interstate industrial cooperation. To quote one company director "... the state mixes politics and economics and very often economic relations become the basis for political bargaining and

an instrument of pressure. Once the politicians come to an agreement we can solve all the problems with our partners in the republics.”

Efficient trade would be facilitated by the establishment of currencies that are convertible on current account. This applies equally to the other countries of the former Soviet Union that establish their own currencies as to Russia. It would also be desirable in the long run to develop a trade regime that is as free as possible from nontariff barriers on either exports or imports, and that would allow unregulated enterprise-to-enterprise trade. Tariffs that apply would be low and relatively uniform. More generally, in the long run it would be best to unify the trade regime; that is, there would be no difference in the treatment of countries that were part of the former Soviet Union and those that were not.

Notes

This chapter draws on *Russia: Joining the World Economy* (World Bank 1993), which was based on the work of an economic mission led by Vladimir Konovalov and comprising David Tarr, Yung Rhee, Alexei Kireyev, Sergei Stankovski and Linda Goldberg.

1. For a variety of reasons, official statistics tend to overstate the actual declines in GDP. The most important is the undervaluation of the newly emerging private activities in the services sector.

2. Roscontract, which evolved from the former marketing arm of state planning systems, is the main procurement agent for the government for exports under state needs. The agency has close relations with state-owned enterprises and has extensive regional distribution offices, warehouses, and wholesale stores. These facilities are also used for domestic trading activities. The agency employs about 500,000 workers.

3. For imports the tax rate applies to the customs value, while for domestic goods the tax is applied to the selling price (the tax-inclusive producer price).

4. Most food products, medicines, and certain clothing, footwear, and furniture items are exempt from the VAT.

5. Crude oil and natural gas exports are subject to excise taxes.

6. Heavy industry includes electric power, fuels, metallurgy, chemicals and petrochemicals, machine building and metalworking, wood products, and construction materials.

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Comment on "Russian Trade Policy"

Daniel Gros

Konovalov provides a thorough and detailed analysis of Russian trade policy. Few would quarrel with the chapter's main points—the need to abolish the restrictions on trade dating from the Soviet era and to make further progress in liberalizing exports. But instead of pointing out areas of broad agreement, I want to explore some issues more deeply than Konovalov does. Let me illustrate this immediately.

The chapter begins with the comment that until 1991 Russia's trade regime "provided an air lock" between the domestic and world economies. The implication is that the economy was basically closed before 1992, when a liberal trade policy opened it to the world. Konovalov destroys the case for his own main thesis, however, by showing that trade was cut in half between 1990 and 1993.

The mention of the increased importance of barter trade is also difficult to reconcile with the main thesis that Russia's foreign trade is now more market determined. If barter trade is viewed as a holdover from the Soviet era, it needs to be explained how the increase in barter trade is compatible with more liberalized trade.

The superficial explanation for the development of Russian trade that is often offered is that only trade with the former COMECON countries and with developing countries collapsed, whereas trade with industrial countries only declined by about 20 percent (see Christensen 1994). This really is not an explanation at all. The central European

COMECON countries experienced the same collapse of trade among themselves and with the former Soviet Union, yet they were able to expand trade with the West by so much that overall trade increased. This illustrates a fundamental difference between Russia and the other transforming economies that needs to be explained: in the other formerly socialist countries liberalization led not only to a reorientation of trade, but also to an increase in total trade, not a decline as in Russia.¹

The question that should have been addressed is whether Russian trade policy had anything to do with this difference in performance. I will return to this question after a brief discussion of two other points that are missing from the paper: the Lerner symmetry theorem and an evaluation of the welfare costs of Russian trade policy.²

The Symmetry Between Export and Import Tariffs

Konovalov gives high marks to Russia for its liberal import policy and then discusses the various restrictions on exports as though the two were unrelated. Yet as the Lerner symmetry theorem states, a uniform ad valorem tax on exports is equivalent to a uniform ad valorem tax on imports. This equivalence is especially important to note in Russia's case because the size of its export taxes is extraordinary.

Konovalov's figures for early 1993 show that the domestic price of exports implied an exchange rate of 171 rubles to the dollar while the market exchange rate was 555 rubles per dollar. That yields an implicit export tariff of more than 200 percent just one year after the Russian economy was supposedly opened to international trade.

Another equivalence theorem that needs to be mentioned is that an export tax plus an import subsidy is equivalent to a nominal appreciation of the exchange rate. In other words the exchange rate for 80 to 90 percent of trade was in reality 50 percent of the market rate as long as large import subsidies were being paid in 1992.

Russia's trade regime did not consist of uniform ad valorem trade taxes, so the conditions for equivalence were not completely fulfilled. However, the export taxes did apply to over two-thirds of exports, so it would be possible to apply the theorem approximately. The next step should be to investigate the lack of complete equivalence.

The Lerner symmetry takes on a crucial dimension if one considers that the welfare losses caused by a tariff are a convex function of the tariff rate. Import tariffs of 10 to 20 percent hardly seem worthy of much attention considering that the implicit export tariff was possibly over 200 percent. In this case the welfare loss is quadratic in the tariff rate. The welfare losses from an export tariff with 200 percent are 100 times larger than the losses from an import tariff of 20 percent.

The Welfare Cost of Trade Restrictions

Can one go beyond this simple, comparative statement? Given the size of the distortions it would have been useful to provide at least a rough estimate of the welfare costs of Russian trade policy (import subsidies in 1992 and export taxes in 1992 and 1993). It is notoriously difficult to estimate welfare costs precisely, but in this case a rough approximation would be enough. The easiest way to get an order of magnitude of the welfare cost is to concentrate on the demand side because it is much more difficult to make any assumption about the supply elasticity. That means that the following calculation probably underestimates the true welfare loss.

Concentrating on the loss of consumer surplus requires only an assumption about the demand curve. I already mentioned the general properties of a linear demand curve, namely that the welfare loss is quadratic in the tariff rate. However, linear demand curves are regarded as a useful approximation only for small changes, and in this case we are working with tariff rates in excess of 100 percent. It might be better then, to work with a conventional constant elasticity demand curve, which allows the welfare cost of trade policies to be calculated as a function of the elasticity of demand—if one has one additional piece of information on the position of the demand curve (and the tariff rate).

Import Subsidies

Konovalov provides this information on the budgetary cost of import subsidies, which was 25 percent of GDP in 1992. This information is useful because it provides a theoretical upper bound. In the case of import subsidies the consumer surplus is higher with the subsidy. It follows that the welfare loss must be lower than the budgetary cost if (and only if) one assumes that revenue collection did not cause any distortion (that is, if the government had been able to levy lump sum taxes). However, this was clearly not the case in Russia, so the estimated welfare costs of import subsidies are clearly an understatement.

The welfare loss from an import subsidy of 100 percent (a subsidy that lowers domestic prices to half of the world price) is between 4.7 percent and 12 percent GDP, depending on the elasticity of demand chosen (see annex to this comment). Even the lower number is certainly large by conventional standards of the size of the welfare loss triangle. The welfare gains that would have resulted from elimination of the import subsidies paid out in 1992 might have helped make the reforms more popular.

Given that the import subsidies (and the export taxes) affected such a large part of the economy, the partial equilibrium approach used here is clearly inadequate. It might be useful to follow the simple general equilibrium model presented in Gylfason (1994) to get a sense of the general equilibrium effects.

Export Restrictions

Information on export tariff revenues is not available. Most of the potential export tax revenues were not actually collected. An educated guess about the size of the energy sector in the Russian economy would be one way around the missing information. Another way would be to estimate the export tax revenue that would have resulted if the government had been able to collect the difference between world market price and domestic price. This would be a useful avenue for further research.

Most export restrictions were on energy-related products. Thus another way to get a sense of the cost of the export taxes and quotas on energy products would be to use previous estimates of the welfare costs of the underpricing of energy in the former Soviet Union (see, for example, Gros and Jones 1991). This estimate can take as its starting point (for Western market economies) various econometric studies that suggest that the price elasticity of the demand for energy is about 0.5.³ The welfare loss (consumer surplus only) from an implicit energy export tax of 150 percent (the 200 percent implicit tax adjusted for a 25 percent transport cost) is thus about 50 percent of each unit of consumption. With the value of Russian energy production at about \$180 billion, the welfare cost of underpricing energy could be as high as \$90 billion,⁴ which is more than double the annual value of Russian exports and a very large proportion of 1992 GDP. This point estimate is clearly too large to be believable, but it shows that the policy of keeping the domestic price of oil and gas to a fraction of the world market price was extremely costly in standard welfare terms. More work needs to be done to reliably estimate welfare losses, but the crude estimates indicate that the cost is likely to be very large.

As an aside it is worth noting that the missing export revenues, in their own right, were probably a crucial element in the failure of stabilization. From the point of view of standard welfare analysis it does not matter whether the government or the private sector collected the surplus. But, there is evidence that in some cases the difference between world and domestic prices was wasted. In a private conversation, former Minister of Foreign Economic

Relations Sergei Glaziev argued that much of the potential revenue was not collected because companies that promised to undertake some of the more uneconomic activities, such as producing electricity that is sold for 1 percent of the world market price, did not have to pay the export taxes. In that case the welfare loss would definitely be higher. Konovalov mentions that apparently only 22 percent of the export tax revenue was collected in 1992. It would be interesting to know how much the total export tax collection should have been and to compare it to the budget deficit.

Disappointing Supply Response

Let me now return to the fundamental point: Why did Russia perform so badly in trade-related measures (export and import growth)? If one takes the data presented in chapter 2 that show a tremendous drop in exports, one could even ask: Why is Russia less open now? Considering that the Russian data are so unreliable, one is tempted to argue that the drop in trade is simply due to underreporting after 1992 and an overvaluation of transferable ruble trade in the base period. This argument suggests the need to look to other sources. The directions of trade statistics of the International Monetary Fund (IMF) would be one good source because the data are based on import statistics of the industrial countries and should be less affected by the split up of the Soviet Union. Its main drawback is that it contains no information on Russia's share in imports of the industrial countries before 1992.

The experience of Poland and other Central European countries provides a useful benchmark. Their exports to the West increased by about 50 percent, although these countries had a smaller real depreciation (and higher wages in dollar terms). Why?

Trade policy was the main culprit behind the weak supply response of exports. The big difference between Russia and the successful Central European exporters is the composition of exports. Russia's exports are dominated by raw materials and energy. In 1992 mineral fuels accounted for 57 percent of Russian exports to countries outside the former Soviet Union, manufacturing for only 28

percent. This implies that Russia's overall export performance depends less on the competitiveness of its manufacturing industries than on factors that determine supply and domestic demand for energy and raw materials. Low domestic prices of energy (maintained through export taxes) encourage domestic consumption, discourage production, and so reduce exports. For commodities as highly tradable as oil and gas, trade policy is crucial because it determines domestic prices. The continuous decline of oil production in Russia is attributed to exogenous factors, such as exhaustion of fields. Industry estimates, however, view lack of investment as the main reason for the output decline in oil and inadequate investment must surely be related to the low domestic prices maintained through export restraints. If Russian producers anticipated (correctly) over the last two years that the export restrictions would gradually be reduced and that the domestic price would rise (in real terms), they had every incentive to keep the oil underground.⁵ Eliminating domestic price controls, as planned, might thus induce a large supply response.

The reported figures for oil exports from Russia must also be adjusted for the fact that a lot of oil (and other raw materials) escapes through other countries of the former Soviet Union (mainly the Baltics and Ukraine). If the reported (re)exports of raw materials from these countries were added to Russia's exports, it would show that Russian exports of raw materials have held up better than the numbers used so far would suggest.

As for stimulating exports of manufactured goods, that cannot be achieved by trade liberalization in Russia since an increase in domestic energy prices will further shift exports away from manufacturing as dollar wages will probably increase. Neither would I agree that Russian enterprises are to blame for the poor export performance in manufacturing because they did not have the will to export, were not privatized, or some similar argument. In Poland the export boom came from state-owned enterprises. A low exchange rate and hard budget constraints should be sufficient to create an export boom in manufactured goods. This is not to say that privatization is not important. The compar-

ison with Poland shows only that a lack of privatization does not alone explain the poor export performance of Russia. The absence of a hard budget constraint in 1992 (and part of 1993) must also have played a major role (in addition to the differences in trade policy).

Trade and Payments with the Other Countries of the Former Soviet Union

Trade with the rest of the former Soviet Union continues to play a major role in the Russian economy. However, Konovalov encounters the same problem I have encountered in this area. For most of 1992 and 1993 change has been constant, and almost none of the official measures has been implemented on the ground. It is almost impossible to describe this mess in a coherent way.

From my own work as an adviser in a number of CIS countries, it seems that in 1992 and early 1993 Russia's official trade policy toward the rest of the CIS remained completely ineffective. The state-to-state trading agreements were not implemented, and the existence of tariffs or quotas for exports or imports was irrelevant since there were no customs borders.

This lack of customs controls is an important point that is not mentioned in the chapter. Without such controls Russia could not enforce any trade restrictions. The re-exports of raw materials from the Baltics and other countries of the former Soviet Union were the most visible sign of this lack of control, and deserve attention, if only because they were one of the fix-points for Russian trade policy over the last two years.

The chapter also briefly mentions difficulties in the payments area and the attempt to create a multi-lateral payments mechanism among CIS central banks through the creation of the Interstate Bank. This is a complex subject that merits more thorough analysis (see my comment on chapter 11). I fully agree with Konovalov's conclusion that private commercial banks have become much more adept at resolving the payments problems. In my own view the Interstate Bank project has been overtaken by events and is no longer really needed, though in 1992 or 1993 it would have made sense to create a

payments mechanism such as the one embodied in the Interstate Bank.

Annex: Calculation of the Welfare Loss from Import Subsidies

The starting point is a conventional constant elasticity demand function for imports. Supply is not considered because many imported goods do not really have close substitutes that are manufactured in Russia, and it is difficult to make conjectures about the elasticity of supply of the raw materials Russia exports. However, the commission of supply implies that the following calculations provide a lower limit for the welfare losses.

Demand is thus given by:

$$(1) P = A Q^{-\beta} \quad \beta > 0,$$

No specific assumption about β needs to be made at this point. However, the discussion will be limited to the case β greater than one, which implies that the elasticity of demand is assumed to be below one.

As an aside I want to note that it should be possible to get a rough approximation of the short-run elasticity of demand from the available trade data. Experience has shown that as the import subsidy was reduced, consumption of imports fell substantially. The elasticity should thus be quite high.

The starting point for all welfare calculations is the consumer surplus (CS), which is given by:

$$(2) CS = A \int Q^{-\beta} dq = A Q^{1-\beta} / (1-\beta) - QP$$

The loss of welfare from a tariff is equal to the loss of consumer surplus (the difference between the consumer surplus under free trade and with the tariff) plus the tariff revenue. Denoting the quantity consumed under free trade by Q_{FT} and the quantity consumed with the trade restriction (tariff or subsidy) by Q_T , and using the demand equation, the loss of consumer surplus can be written as:

$$(3) \text{ Loss of CS} = CS_{FT} - CS_T = A [Q_{FT}^{1-\beta} - Q_T^{1-\beta}] / (1-\beta) - A [Q_{FT}^{1-\beta} - Q_T^{1-\beta}] \\ = [\beta / (1-\beta)] A [Q_{FT}^{1-\beta} - Q_T^{1-\beta}]$$

The absolute values of the loss of consumer surplus are difficult to interpret unless they can be measured in an international unit or related to another measure of the Russian economy. For the following it will be easiest to measure the welfare loss as a ratio to national income, Y . The loss of consumer surplus can then be rewritten as:

$$(4) \text{ Loss of CS} / Y = [\beta / (1-\beta)] A Q_T^{1-\beta} [(Q_{FT} / Q_T)^{1-\beta} - 1] / Y$$

The ratio Q_{FT} / Q_T has to be equal to $T^{1/\beta}$, where $T \equiv (1 + t)$ is one plus the ad valorem tariff rate. This term can thus be deduced from estimates of the implicit tariff.

The term $A Q_T^{1-\beta} / Y$ can be calculated from the information on the budgetary cost of the import subsidies or the potential export tax revenues. The cost of the import subsidies is given as 25 percent of GDP. This implies $P_w Q_T (T-1) = 0.25 Y$, where P_w is the world market price, which is here assumed to be given because Russia is a small economy in terms of trade flows (Russian exports and imports are about as large as those of Belgium). The domestic price is given by T times the world price $P = P_w T$. Substituting in the demand curve (which implies that $A Q_T^{1-\beta} = P_w T$) leads to:

$$(5) A Q_T^{1-\beta} / Y = 0.25 [T / (T-1)] = 0.25 (1+t) / t$$

The welfare loss (as a proportion of national income) can then be written as:

$$(6) \text{ Welfare loss} / Y = 0.25 \{ [[\beta / (1-\beta)] [T / (T-1)] [T^{(1-\beta)/\beta} - 1] - 1 \}$$

To solve the equation one needs to have an estimate of T and of β .

For the case of the import subsidies, a T below 0.5 (corresponding to an import subsidy of over 100 percent) should be appropriate since the value of imports (at world market prices) was more than 50 percent of GDP in early 1992 (and the cost was about 25 percent of GDP). With $T = 0.5$ inserted in the equation, the bracketed terms on the right side of equation 6 collapse to: $-[\beta / (1-\beta)] [2^{-(1-\beta)/\beta} - 1] + 1$.

The following table shows the value of this expression for selected values of β and the welfare loss as a proportion of GDP under the assumption that the budgetary cost of the subsidies was 25 percent of GDP:

β	$\beta/(1-\beta)[2-(1-\beta)/\beta - 1] + 1$	Welfare cost as percent of GDP
2	0.2	4.3
1.00001	0.3	7.7
0.5	0.5	12.5

These three values could be interpreted as a low elasticity case ($\beta = 2$ implies an elasticity of demand equal to one-half), a medium elasticity ($\beta = 1$) and a high elasticity ($\beta = 0.5$ implies an elasticity of demand equal to two).

An interesting special case is $\beta = 0.5$, which causes the right side of equation 6 to collapse to $0.25*(T-1)$. In this case the welfare loss is linear in T , which is in apparent contradiction to the usual convexity of the welfare loss. However, this result is due to holding tariff revenue constant. Equation 6 just says that for $\beta = 0.5$ the welfare loss is linear in the tax rate that yields 25 percent of GDP.

As discussed in the text, the real loss of welfare was probably much higher since the Russian government collected little revenue. The triangles calculated here clearly understate the true welfare losses of Russian trade policy.

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Notes

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- At least if one compares 1992 or 1993 to 1991 or 1990.
- One other minor comment is that it is not clear which purchasing power parity the author is using. All the author says is that the measure is subject to considerable uncertainty. He might usefully have referred to Koen and Meyermans (1994) for a detailed presentation of different purchasing power parity exchange rates, including one based on the price of a hamburger in Moscow.
- The welfare loss (loss of consumer surplus) from energy export taxes that lower the domestic price is equal to one half times the proportional difference in price times the proportional change in quantity times the value of initial consumption. As mentioned above, Konovalov finds that the world market price for energy goods was more than three times the domestic price. This suggests an export tariff of 200 percent. Even conceding that part of the price difference, say 25 percent is due to transport costs, the implicit tariff is 150 percent. This implies that the loss of welfare for each unit of consumption is equal to $0.5 * 1.5 * 0.73 = 0.54$.
- This is based on Gros and Jones (1991) who show that for the world market value of overall energy consumption was about \$240 billion in the former Soviet Union. This would imply a welfare loss equivalent to about \$130 billion. Russia accounted for about two-thirds of overall energy consumption in the former Soviet Union.
- If the observed decline in production results from a decision by producers to keep the oil in the ground to sell it later at a higher price, the welfare loss for Russia might be limited. For an exhaustible resource like oil, it does not matter how much is pumped out in each period, but that whatever is extracted is used efficiently.

Comment on Chapter 2

The Origins of Russian Trade Policy

Sergei Glaziev

The Russian Federation's economic relations with the rest of the world during the early 1990s were shaped by an array of macroeconomic problems: falling output of energy and other raw materials,

declining industrial output, and rapidly rising inflation. These and other destabilizing forces hurt the performance of Russian exporters and importers. In addition, the federation faced the rupture of existing economic ties with producers, regions, and former Soviet republics.

Under central planning foreign trade was conducted on the same basis as internal production and distribution. The foreign trade balance, measured in quasi-physical indicators, was determined by the difference between internal production and consumption. The regime balanced internal production and consumption according to central plans; exports and imports were regulated through direct state orders, which were issued through foreign trade organizations based on internal requirements.

The dismantling of central planning started with the adoption of the Law on State Enterprises in 1987, which liberalized the state sector. State enterprises were allowed to trade on their own and were given responsibility for a wide range of other activities, including research and development and management of labor, productivity, and profitability. Multiple exchange rates and licenses for foreign trade operations were introduced to smooth the transition and to avoid the spontaneous outflow of

resources, which was a threat because of the huge gap between internal and external prices.

The new regime was more complicated and less stable than the orthodox central planning system. The system of multiple exchange rates resulted in distortions similar to those of the previous regime, with the gap between market and official exchange rates stimulating black market growth and boosting imports of subsidized goods.

This regime began to collapse in 1991, when the countries of the former Soviet Union declared their sovereignty and started their struggle with Soviet central authorities for their economic rights. Foreign trade was central to the drive for independence. Republican authorities started issuing licenses to their domestic companies, allowing them to exploit price differences and to conduct very profitable export operations. In exchange for the licenses companies were expected to deliver consumer imports for domestic consumption. After the failure of the military coup d'état in August 1991 the process accelerated, and in November 1991 both central and republican authorities lost control of the trade balance and foreign revenues, plunging the system into chaos.

The new Russian government began to liberalize all spheres of economic activity, but structural

obstacles, especially the huge gap between internal and external prices, hampered its efforts. After more than seven decades of isolation from world markets and international competition, the government feared that rapid liberalization of foreign trade would lead to drastic changes in relative prices that would undermine the competitiveness of domestic companies, which would be unable to adjust to skyrocketing prices of energy and raw materials. The cost of these shocks, the government believed, would have severely outweighed the benefits that could be realized from foreign trade.

The disruption in interstate trade was another obstacle to reform. Trade with the other former republics accounted for more than half of Russia's foreign trade. This trade was conducted in internal prices because of the concern that exposure to market prices would destroy the long-term ties between enterprises in the former Soviet republics. The collapse of CMEA trade was seen as a cautionary example of the threat of liberalization.

The authorities also worried that rapid liberalization would lead to capital outflows and excessive foreign competition in the internal market. For all these reasons, total liberalization of foreign trade was viewed as too risky. Some restrictions and specific regulations would be needed to ease the transition. Tariff and non-tariff measures could be used to dampen price shocks. Currency controls would be needed to avoid huge capital outflows. Export credits and guarantees to finance export of sophisticated goods would be provided. A mechanism for maintaining import levels and generating currency reserves for the government had to be established.

Controls on Exports or Imports?

The government had to choose between export or import restrictions or a mixture of both to protect domestic output and consumption. Macroeconomic instability and the lack of internal competition were arguments against the use of import restrictions. The chaotic rise of prices after price controls were relaxed made the calculation of rational import tariff impossible. Policymakers also worried that import restrictions would play into the hands of vested interests, who would take advantage of such

restrictions at the expense of consumers. Experience the world over has shown that import restrictions are easy to introduce but difficult to remove, as entrenched interests would lobby hard to retain them. Import restrictions can also impair the competitiveness of the national economy.

This knowledge sparked interest in a second option: restricting exports of energy and raw materials. This option offered some protection from foreign competition without giving rise to powerful rent-seeking groups that would lobby against removing the restrictions. Export restrictions benefit downstream users at the expense of export-oriented producers, unlike import restrictions, which benefit producers of import-competing products. Consumers are generally too disorganized to effectively defend export restrictions while exporters tend to press for their removal.

Export restrictions have natural limits; they should not exceed the rent revenues caused by either natural or structural advantages. Kept under these limits, export restrictions do not block exports (which continue to be profitable), while keeping the prices of energy and raw materials comparatively low. In that way, export restrictions, promote the competitiveness of manufacturing industries and benefit the state budget at the same time. If the restrictions surpass these natural limits, vested-interest groups will protest and send a strong signal to lower the restrictions—an automatic adjustment mechanism that keeps export barriers from rising too high.

The Export Regime

After choosing export restrictions over import restrictions, the authorities had to decide whether to use export tariffs or quotas. In theory the two types of restrictions would have the same economic impact. Tariffs were better, however, because they resulted in fewer market distortions and administration costs. The export tariff could also partly substitute for an import tariff, since the main threat to competitiveness was a rise in energy and raw material prices, that could have bankrupted the manufacturing industry. The introduction of the export tariff created favorable conditions for the gradual adapta-

tion of the national economy to world prices, permitting tariff barriers to be lowered gradually as well.

Foreign trade was regulated through three mechanisms: an export tariff for protection of the home market against too rapid an exposure to world prices and foreign competition, the limited use of export controls for strategic raw materials, and a compulsory surrender requirement for half of all foreign exchange proceeds.

The export tariff applied only to 150 commodity items, including certain raw materials, fuel, ferrous and nonferrous metals, chemicals, timber products, foodstuffs, aviation engineering products, and military equipment. Ad valorem duties, calculated on the customs value of the dutiable goods, applied to most covered exports. The highest rates were levied on iodine (30 percent) and propylene (40 percent). Specific duties, calculated on the unit weight or quantity of the dutiable goods, were also applied to some goods. The highest specific duties were levied on silver ore (64,000 ECU per ton) intermediate goods and germanium (33,600 ECU per ton) and certain rare metals (21,000 ECU per ton). Specific duties on most goods were below 100 ECU per ton.

The government planned to gradually decrease the export tariff rates as manufacturing enterprises adjusted to the higher prices for raw materials and energy. The initial plan was to lower the average tariff from 25 percent in the beginning of 1992 to zero at the end of 1995. Between 1992 and 1994, the government reduced the export tariff several times, lowering it to an average of one-third its original level.

Quotas were retained on some energy and raw material exports even after the introduction of export tariffs, largely because of concerns about the effectiveness of the export tariff.

Quotas are set by the Ministry of Economy on the basis of supply and demand forecasts. The quotas are distributed among producers by line ministries and, for some commodities, by regional authorities under the direction of the Ministry of Economy. In 1992 a new category of export quotas was introduced for distribution through tenders, so

as to generate federal budget revenues. The quotas went to enterprises that promised to turn the larger export revenues over to the budget after covering the cost of the purchase and delivery of the goods.

The largest share of the quotas was distributed by the line ministries. Regional administrations distributed quotas for some specific goods, such as timber. A small portion of the quotas were sold through auctions. The plan was to gradually expand the share of quotas sold through auctions and to phase out the quotas by early 1993, except on primary energy resources.

Removing export quotas, however, proved more difficult than anticipated. The industrial ministries and the Ministry of Economy pushed to continue quantitative controls and administrative control over the allocation of quotas in order to induce enterprises, to supply resources to the domestic market to meet the requirements of the ministries—for instance, to deliver fuel to agricultural enterprises and to cities that were insolvent. With liberalization of the state sector in 1987, liberalization of internal trade in 1991, and liberalization in 1992, the power to distribute export quotas became the major instrument of control over enterprises.

Auctions, which removed the discretionary element from quota allocation, never became an important instrument of quota distribution. Quotas sold at auctions were based on current supply and demand conditions in the corresponding commodity exchanges. In 1993 about ten auctions took place, generating 9.5 billion rubles in revenue for the state. More than 500 companies participated. For most of them the auctions offered their only chance to export. The companies that purchased quotas at auctions were generally more successful and efficient than their privileged competitors, who obtained the quotas free of charge.

The export restrictions were designed not only to regulate internal prices and influence firm behavior but to generate revenues for the government. Export tariffs and state exports accounted for about 28 percent of budget revenue. Additional revenues came from the forced sale to the government of 50 percent of energy and raw materials export revenues at the 40 percent of the market exchange rate.

That requirement was abolished in the middle of 1992.

To control capital flight and force the repatriation of export revenues from the sale of strategically important materials, export registration was introduced for those commodities. The list included crude oil and processed oil products, gas, electric power, cellulose, nonferrous metals, certain mineral fertilizers, grain, soya and sunflower seed, fish and crustaceans, caviar, and spirits. In addition ores for the production of ferrous metals, wood, rare metals, rough and sawn coniferous lumber, and wooden slippers were also classified as strategically important items after January 1, 1994.

Licenses are issued only to enterprises registered at the Ministry of Foreign Economic Relations. To qualify, firms must be selected by a special committee of the Ministry. Export quotas are also required. The foreign currency proceeds of the sale of strategically important raw material exports must be deposited in assigned bank accounts.

Thus Russia had established a dual export regime in 1992. Exports of energy and raw materials were regulated through tariff and nontariff methods. They were subject to currency controls and, in the first half of 1992, had to sell 40 percent of their export earnings at an exchange rate that was equivalent to an additional 20 percent export tax. Exports of all other goods (except dangerous products such as weapons or drugs) were free of restrictions. These export measures were designed to reduce the risk of foreign trade liberalization, avoid the bankruptcy of manufacturing industries, and maintain the competitiveness of final goods. The export barriers were gradually lowered as enterprises adjusted to the higher relative prices of energy and raw materials and to the appreciation of the ruble.

The Import Regime

Import policy was far more liberal, in large part because a greatly undervalued ruble increased the price of imported consumer goods and protected local producers against foreign competition. Between 1992 and 1993 the ruble began to appreciate, rising to about ten times its original value and

reducing the competitiveness of domestic industry. In response, import restrictions grew in importance. The first import tariff was introduced in mid-1992, mainly for fiscal purpose. It was a moderate 5 percent tariff on all goods. Later, as the ruble appreciated, tariffs were increased and differentiated. The tariff was raised to 15 percent on final goods and 25 percent on luxury goods. Tariffs on energy and raw materials remained the same or were reduced. New tariff rates are calculated within the framework of existing tariff legislation, with a maximum tariff of 100 percent of the customs value of the goods. The average weighted tariff rose from 5 to 7 percent to 13 to 15 percent.

Initially, a value-added tax (VAT) was levied on domestic production but not on imports. To reduce the distortions created by this differential taxation, the relevant laws were amended to include imports after February 1, 1993. The VAT is now set at 20 percent for foreign and domestic goods. The VAT on imports is calculated on the customs value of the goods plus any import and excise duties.

Trade with the Countries of the Former Soviet Union

One of the most difficult aspects of foreign trade liberalization for Russia has been liberalizing trade with other countries of the Commonwealth of Independent States (CIS). At first, trade was conducted in internal prices, which meant that Russian exports were undervalued and imports were overvalued. The total amount of subsidies Russia granted to the CIS countries through price distortions reached about US\$10 billion, or 6.5 percent of GNP. Maintaining trade with the CIS countries was vital to the stabilization of the Russian economy, because of the strong links between Russian companies and consumers and producers in other Soviet republics that had been forged over decades. Immediately switching foreign trade with CIS countries to world prices would have caused huge adjustment costs.

Another problem was administrative. So many Russian companies had partners in the CIS countries that processing export requests would have been impossible without severely interrupting trade.

A transitional mechanism was required. The mechanism worked out by the Ministry of Trade and Resources was simple and it was a boon to those who controlled it. The ministry positioned itself as an intermediary that would arrange bilateral trade between Russia and other CIS countries through special intergovernmental agreements. The volume of mutually supplied goods was calculated in world prices to keep trade balanced. The agreements fixed the quantity of goods that each country was obliged to deliver. In practice the ministry got the right to buy a certain amount of goods at domestic prices and to exchange for a certain amount of goods that Russia needed. The goods were then sold, as specified in the agreement, in the internal market at domestic prices. This large-scale barter trade was inappropriate to the new economic situation, and the Ministry of Foreign Economic Relations criticized it sharply. But the government decided to go ahead, and the Ministry of Trade and Resources got the right to trade and to control the trade within CIS simultaneously.

This dual system of foreign trade with different regimes for foreign trade within the CIS and the rest of the world could not work efficiently. Huge re-exports of Russian raw materials through transactions with CIS countries started immediately. No reliable information about the trade balance between Russia and CIS countries is available because of registration methods used by the local divisions of the Ministry of Trade and Resources.

To normalize trade relations with CIS countries, negotiations were started on free trade agreements, and by mid-1992 such agreements were signed with almost all CIS countries. In the fall of 1992 the Ministry of Trade and Resources was transformed into the state commercial organization, Roscontract, and lost its regulatory power over foreign trade. Not until January 1, 1993 was a unified procedure established for export licensing and the setting of quotas for exports and imports. Following international practice, a single government body, the Ministry of Foreign Economic Relations, was assigned authority for issuing import and export licenses. The licensing regime is based on schedules of goods subject to license and a uniform sys-

tem for setting and allocating quotas and issuing licenses.

Shifts in the Structure of Trade

Trade volume decreased in 1992-93, despite the liberalization. Several factors accounted for the drop in Russia's overall trade:

- Continuing disruption of the traditional economic links among enterprises within Russia and between them and their foreign trade counterparts.
- Elimination of previously state-financed export activities (particularly in machinery and equipment).
- Dismantling of the centralized distribution of hard currency reserves to pay for imports and settlements on interstate bank credits.
- Liberalization of export and import operations for all economic entities.
- Continuing changes in Russia's trade regulations (introduction of value-added taxes and excise duties on imported goods, new export and import tariffs).
- Delays in signing of interstate foreign trade agreements for 1993.

The situation has been aggravated by declines in the auction of major export items and an absence of effective controls over customs, taxes, and financing of foreign trade deals. Poor control over credit creation and monetary policy has also exacerbated the problem.

The shocks from internal macroeconomic imbalances outweighed the positive influence of foreign trade liberalization. The first signs of a positive response in manufacturing exports in 1993 were not supported by export promotion measures, and the gains disappeared again until the end of the year. Producers of sophisticated goods need government assistance and promotion (export credits and guarantees, information services, political support) to realize their competitive advantage in export markets. New instruments of trade finance are

urgently needed. The system of Russia's transportation infrastructure needs attention as well.

Several actions are needed to raise the quality of Russian products to meet international standards. A system of certification and control over export-oriented production is needed that will be accepted by foreign customers. Information services for foreign trade operations need to be developed, to make information available on prices in various markets, on potential foreign partners, and the like. Some positive changes have already taken place. Foreign trade has become more efficient and diverse. Russian foreign trade has diversified geographically. Trade with the United States, Germany, Canada, the United Kingdom, France, Spain, Sweden and Finland is improving noticeably. Exports to China have increased considerably in recent years, as has

trade with the Asia-Pacific region (Republic of Korea, Hong Kong, Singapore, Taiwan (China), Philippines, and Thailand).

The first positive shifts in 1993 were the result largely of the adaptation of some enterprises to the new conditions introduced by foreign trade liberalization. The disintegration of important technological links in the production of sophisticated products has increased the prices of Russian products and resulted in a loss of competitiveness on both international and home markets. The crucial task now is to develop an effective, unified industrial and foreign trade policy, that will strengthen the scientific and industrial sectors, spur the export of highly processed goods, and define a new competitive organizational structure for industrial production.

3

Ukraine: A Trade and Exchange System Still Seeking Direction

Françoise Le Gall

- The Economy Today
- Output and Prices
- External Trade
- Trade Regime
- Export Regime
- Import Regime
- Bilateral Agreements
- Exchange and Payments System
- Reform Issues

The trade and exchange system in Ukraine is still steeped in the economic patterns inherited from the former Soviet Union. It has been searching for a middle road somewhere between the "blind" capitalism of the West and the "mummified" command economy of the socialist east. Its story is one of too little reform, not too much, of a system built on static planning mechanisms and administrative controls at a time of great economic change and of policies that have seriously hampered economic recovery. Reform of the trade and exchange regime would boost economic performance, but it is only a part of an overall program of stabilization and reform.

This chapter covers the trade and exchange regime of Ukraine through June 1994. In late October 1994, the government expressed the intention to implement a far-reaching economic program reform that includes an overhaul of the trade and exchange system along the lines recommended in this chapter.

The Economy Today

A review of recent economic developments, particularly of underlying macroeconomic and structural problems and external shocks to the economy, shows how much the collapse of trade has contributed to the economic decline of Ukraine. Economic conditions, already difficult at the time of independence in August 1991, worsened dramatically thereafter, dam-

aged by both government policy—especially the absence of a coherent macroeconomic stabilization and structural reform program—and external shocks, such as the collapse of trade with the former Soviet Union. The result has been a large and continuous drop in output, high and variable inflation, and a serious deterioration in the balance of payments.

The economic environment has provided few incentives for economic agents to respond efficiently to market signals (including changes in the external terms of trade) and to business opportunities at home or abroad. High inflation has eroded confidence in the future, making people and firms reluctant to save and invest. Decisions about resource allocation have been made more difficult by wide swings in relative prices, which distort the information content of prices. Notwithstanding a recent tightening of bank credit, most state enterprises continue to operate under soft budget constraints. Rather than adjust, enterprises have tended to accumulate payments arrears under the expectation that domestic arrears will be monetized by the central bank (or that creditors such as energy suppliers will be compensated by the government) and that external arrears (notably to Russia) will be consolidated into state debt.

Output and Prices

Real GDP contracted by roughly 15 percent in 1993, bringing the cumulative fall in output since 1989 to 40 percent.¹ This trend accelerated in the first months of 1994 as industrial production declined by almost 35 percent during January-July compared with the same period in the previous year. Particularly hard hit have been metallurgy, machine building, and construction materials, all energy-intensive and facing shrinking markets for their products.

The disintegration of long-established supply and customer links, both within Ukraine and with other countries of the former Soviet Union, has hurt many industries. Frequent disruptions in the supply of energy and raw materials have led to growing shortages. With domestic production meeting only about half the country's energy needs, Ukraine relies heavily on imports mainly from Russia and,

to a lesser extent, Turkmenistan. These energy supplies have been cut off intermittently as Ukraine has allowed payments arrears to mount. The declining fortunes of one industry or enterprise often have a ripple effect throughout the economy because of the rigid specialization inherited from socialist days.

Shocks on the demand side have had an impact as well. Specialized markets have dwindled, most notably military equipment, which accounted for as much as 10 percent of GDP in 1990 and no doubt a substantial share of exports to the former Soviet Union. Recently, new signs of waning demand have emerged, a consequence of a large fall in real wages—they shrank by half between December 1992 and December 1993—and the stringent credit policy of late 1993 and early 1994.

Inflation reached almost 5,000 percent in 1993 (up from 1,210 percent in 1992), and varied considerably from month to month. It spiked in January, June, September, and December as the government adjusted the administered prices of energy, food, and transport and communications to reflect increasing costs. While the underlying rate of inflation steadied in the first half of the year, by October and November prices were rising 50 percent a month. The hyper inflation-like increases came on the heels of a massive expansion in credit during the summer months. With demand flagging badly in the first quarter of 1994, inflation fell markedly, reaching 5.7 percent in March.

These price developments have not been adequately captured by Ukraine's three principal exchange rates: the official rate, the rate established at the foreign exchange auctions of the National Bank of Ukraine (which are subject to administrative restrictions of varying intensity), and the parallel market rate in Kiev. All three rates do give some indication of domestic inflationary pressures. The parallel market exchange rate increased from an average of 3,002 karbovanets (krb) to the U.S. dollar in April 1993 to krb 32,871 in December 1993 and krb 47,731 in May 1994 (table 3.1). On a real basis, however, the parallel market exchange rate appreciated by 64 percent between April and December 1993 and by another 19 percent in the first five months of 1994. The evolution of the auc-

Table 3.1 Dynamics of Karbovanets Exchange Rates, 1993-94

Date	Nominal exchange rate (Krb/US\$)			Monthly change (percent)			CPI Change	Real exchange rate (April 1993=100)			Ratio of official to market rate
	Official	Auction	Market ^a	Official	Auction	Market		Official	Auction	Market	
1993											
Jan	727	878	n.a.	14.6	n.a.	n.a.	73.2	65.9	n.a.	n.a.	n.a.
Feb	973	1,284	n.a.	33.9	46.2	n.a.	28.8	51.0	67.3	n.a.	n.a.
Mar	1,616	1,899	n.a.	66.1	47.9	n.a.	22.1	65.7	77.2	n.a.	n.a.
Apr	3,002	3,002	3,002	85.7	58.1	n.a.	23.6	100.0	100.0	100.0	100.0
May	2,999	2,999	2,939	-0.1	-0.1	-2.1	27.6	78.3	78.3	76.7	102.0
Jun	3,656	3,658	3,388	21.9	22.0	15.3	71.7	55.6	55.6	51.5	107.9
Jul	4,589	4,589	3,858	25.5	25.5	13.9	37.6	50.7	50.7	42.6	118.9
Aug	5,970	14,007	6,935	30.1	205.2	79.8	21.7	54.2	127.2	63.0	86.1
Sep	5,970	16,460	11,615	0.0	17.5	67.5	80.3	30.1	82.9	58.5	51.4
Oct	5,970	22,833	19,407	0.0	38.7	67.1	66.1	18.1	69.2	58.8	30.8
Nov	6,194	31,150	26,303	3.8	36.4	35.5	45.3	12.9	65.0	54.9	23.5
Dec	12,608	25,317	32,871	103.6	-18.7	25.0	90.8	13.8	27.7	35.9	38.4
1994											
Jan	13,000	25,000	37,911	3.1	-1.3	15.3	19.2	11.9	22.9	34.8	34.3
Feb	13,000	31,422	37,416	0.0	25.7	-1.3	12.6	10.6	25.6	30.5	34.7
Mar	14,000	41,139	39,253	7.7	30.9	4.9	5.7	10.8	31.7	30.3	35.7
Apr	14,000	42,000	44,242	0.0	2.1	12.7	6.0	10.2	30.5	32.2	31.6
May	15,100	42,000	47,731	7.9	0.0	7.9	20.0	9.2	25.5	28.9	31.6

Source: World Bank calculations

a. Kiev parallel market

tion rate and the official rate tells the same story, but in even starker terms (figure 3.1). Another indicator of developments in the real exchange rate, the monthly wage in the state sector in U.S. dollars, fluctuated throughout the period April 1993-March 1994, but around a rising trend. Converted at the parallel market exchange rate, this monthly wage increased from an average of \$12 in the second quarter of 1993 to \$21 in the first quarter of 1994 (table 3.2).

Loose financial policies are to a large extent responsible for the high inflation. Monetary policy has generally played the passive role assigned to it under the Soviet system. Total bank credit rose 19 percent a month during January-May 1993, a somewhat slower pace than in 1992, but then rose to 40 percent a month between May and September. Most of the increase represented government support to state enterprises (and collectives), especially in coal and agriculture, indicating that monetary policy was being used to circumvent budgetary constraints. This option became more difficult to exercise at the end of 1993, as the central bank imposed strict limits on credit (they were relaxed somewhat by April 1994).

The state budget deficit, which had been as wide as 18 percent of GDP in 1992, fell to 3.5 percent of GDP (cash basis) in 1993. One-shot measures accounted for much of the reduction. Revenue increases came almost entirely from the taxation of inflationary gains, which contributed to the serious decapitalization of enterprises. Spending cuts were largely ad hoc, leaving some items untouched (price subsidies) and slashing others down to bare bones (investment). In addition, taking expenditure arrears (mainly on salaries) into account put the deficit at 7 percent of GDP on a commitment basis.

Progress on structural reforms has been slow, proceeding in fits and starts. In 1992 and 1993, the government moved to liberalize a number of prices (nonessential consumer goods), but reimposed a wide range of controls thereafter, from administered prices on a few key items (energy goods and municipal services) to limits on retail profit margins and margins on some individual commodities and requirements for advance notification and approval of prices on goods produced by "monopolies", and local authorization for selected price adjustments.

Table 3.2 Changes in the Average Wage (state sector)
(in karbovanets and U.S. dollars, 1993-94)

Date	Nominal wage (karbovanets)		Real wage (karbovanets)		Nominal wage (US\$)		
	Amount	Change (%)	Amount	Change (%)	Official	Auction	Market ^a
1993							
Jan	15,175	-24.4	115.0	-56.4	20.9	17.3	n.a.
Feb	19,240	26.8	113.2	-1.6	19.8	15.0	n.a.
Mar	23,070	19.9	111.2	-1.8	14.3	12.1	n.a.
Apr	25,653	11.2	100.0	-10.1	8.5	8.5	8.5
May	30,420	18.6	92.9	-7.1	10.1	10.1	10.4
Jun	58,266	91.5	103.7	11.6	15.9	15.9	17.2
Jul	72,000	23.6	93.1	-10.2	15.7	15.7	18.7
Aug	80,736	12.1	85.8	-7.9	13.5	5.8	11.6
Sep	196,600	143.5	115.9	35.1	32.9	11.9	16.9
Oct	240,188	22.2	85.2	-26.4	40.2	10.5	12.4
Nov	307,200	27.9	75.0	-12.0	49.6	9.9	11.7
Dec	793,000	158.1	101.5	35.3	62.9	31.3	24.1
1994							
Jan	763,396	-3.7	82.0	-19.2	58.7	30.5	20.1
Feb	760,099	-0.4	72.5	-11.6	58.5	24.2	20.3
Mar	845,990	11.3	76.3	5.3	60.4	20.6	21.6

Source: World Bank calculations

a. Kiev parallel market

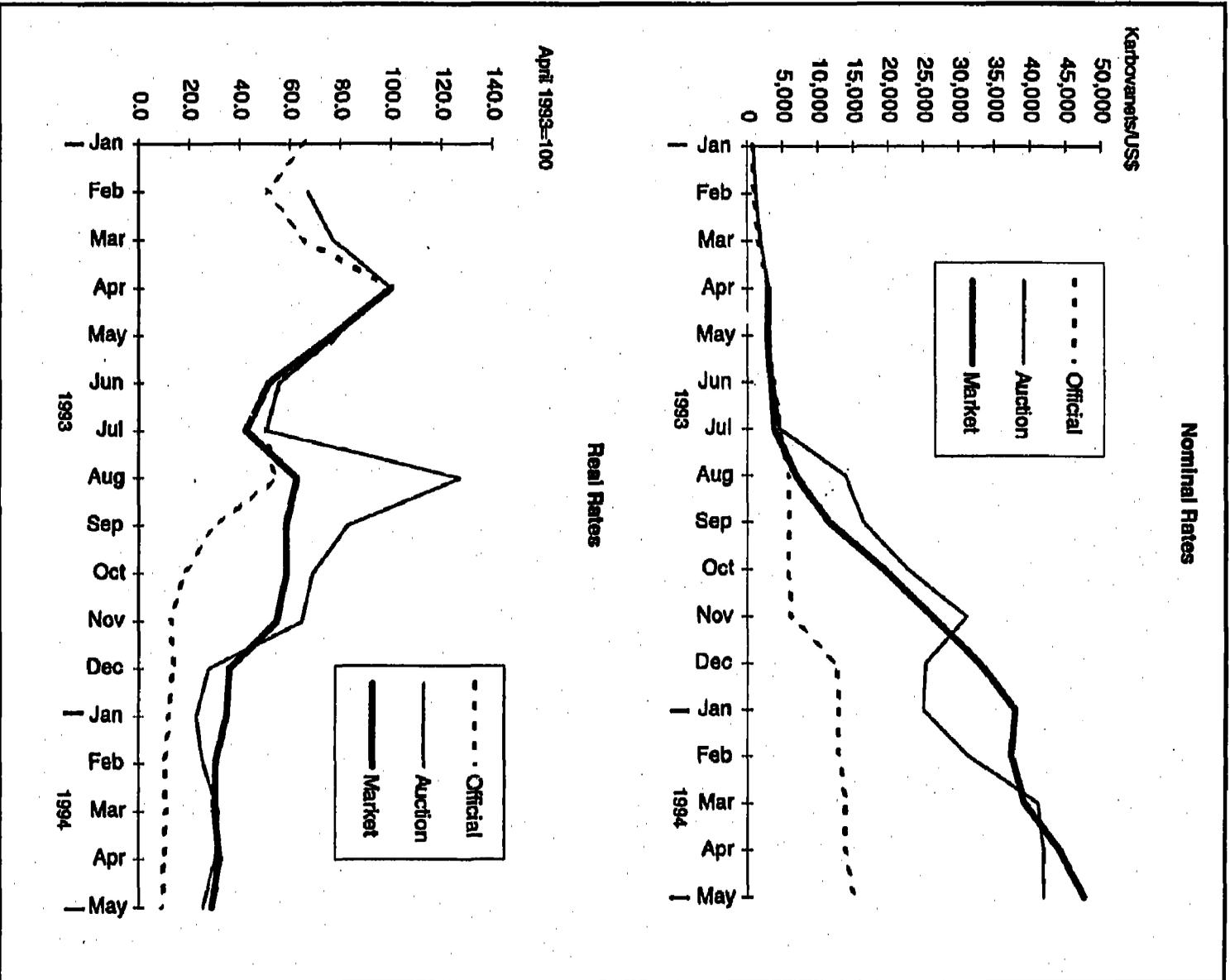
n.a. Not applicable

The state order system (discussed later) has remained important for major products (600 groups of commodities in 1993, accounting for about half of turnover in these goods), attenuating the impact of price signals. Large monopolies continue to dominate the distribution system and other sectors. Some municipalities have begun to privatize small enterprises and retail outlets, but the impact of these local initiatives has been slight. In early 1994 the central government announced its intention to accelerate the privatization of medium-scale and large enterprises as well.

As for the private sector, businesses are being constantly buffeted by changing rules and discretionary decision-making. Cumbersome registration and licensing procedures and a shortage of commercial real estate impede the entry of new businesses into markets. These problems of economic restructuring are compounded by the lack of factor mobility. In sum, little of the economy (including the agricultural sector) is in private hands at this stage.

Resistance to fundamental change in economic policymaking has come from several quarters. Analysts of the political economy of Ukraine have pointed to the officials and politicians who favor "gradualism" and "state guidance" over the unchecked laws of the market, and to state enterprise workers, fearful of losing their jobs. Some have also noted the emergence of a class of rent-seekers, who depend on an economy caught somewhere between state planning and the marketplace (see comment by O. Havrylysyn). Among them are directors of state enterprises and agricultural collectives, heads of trade groups, and managers of new private commercial entities formed as spinoffs from state enterprises. For example, if under conditions of relatively easy access to bank credit and of controls that keep domestic prices below market levels, economic agents can obtain the financing to buy raw materials and a license to export, the opportunities for quick returns are plentiful. Moreover, these profits, whose size is obscured through underin-

Figure 3.1 Nominal and Real Exchange Rates, 1993-94



Source: World Bank calculations

voicing of exports, are often kept abroad because of inflation and restrictive foreign exchange regulations. Total capital flight was estimated at roughly \$3 billion in 1992-93.

External Trade

The shifting pattern of Ukraine's external trade reflects such disparate influences as the breakup of the Soviet Union; lax macroeconomic policies that have supported soft budget constraints and high inflation; myriad price controls that sidestep the root causes of inflation and prop up a skewed structure of relative prices; and a complex and restrictive trade and exchange regime. Because these shifts in trade patterns have come about somewhat haphazardly rather than through structured changes, specifying these trends in quantitative terms is a risky business; for that reason, the numbers must be viewed as rough estimates (see appendix to chapter 1).

In the picture of Ukraine's trade that can be pieced together from the data, three developments stand out: a sharp contraction in trade volumes, a

substantial worsening in the terms of trade, and a modest shift in trade away from the former Soviet republics toward the rest of the world (table 3.3). At the micro level, these trends are not always as clear-cut. The decline in trade volumes, whatever the magnitude, may in part be accounted for by products for which demand has slowed, an adjustment that is critical to the transition process (see chapter 4). Also, some share of external trade has been channeled to the domestic market. Notwithstanding the decline in trade, there appears to have been an increase in foreign economic activities by smaller, privately owned companies.

The level of trade fell significantly during 1990-93, both with the former Soviet Union and with the rest of the world. Export and import volumes with the former Soviet Union suffered following the disintegration of the central planning system and the contraction in demand, exports dropping by 71 percent and imports by 52 percent. The collapse of the market for military equipment hurt exports, while the collapse of the interrepublic payments

Table 3.3 Trends in Ukraine's External Trade, 1990-93
(millions of current U.S. dollars and percent)

	1990	1991	1992	1993
<i>Value</i>				
Total exports	78,337	58,098	11,262	11,969
Former Soviet Union ^a	64,947	49,598	5,262	5,669
Rest of World ^b	13,390	8,500	6,000	6,300
Total imports	81,990	72,517	11,925	13,885
Former Soviet Union	66,083	61,217	6,425	9,185
Rest of World	15,907	11,300	5,500	4,700
Trade balance	-3,653	-14,418	-663	-1,915
Former Soviet Union	-1,136	-11,618	-1,163	-3,515
Rest of World	-2,517	-2,800	500	1,600
<i>Percentage distribution</i>				
Total exports	100	100	100	100
Former Soviet Union	82.9	85.4	46.7	47.4
Rest of World	17.1	14.6	53.3	52.6
Total imports	100	100	100	100
Former Soviet Union	80.6	84.4	53.9	66.1
Rest of World	19.4	15.6	46.1	33.9

a. Figures for trade with the former Soviet Union are derived from country data and World Bank staff estimates reported in national currencies using official or commercial exchange rate for 1990 and 1991 and annual average market exchange rates for 1992 and 1993.

b. Rest of the World refers to countries outside the former Soviet Union; figures are based on country data reported in U.S. dollars.

scheme impeded all trade. In trade with the rest of the world, export volumes fell by 51 percent and import volumes by 69 percent. The production and supply of exports were affected by the breakdown in central planning, the absence of market institutions to support external trade, and continued weakness in trade with Eastern Europe following the collapse of the CMEA. Imports fell as incomes and output shrank and foreign exchange was in extremely short supply. In contrast to the general slide in trade, there has been a tremendous expansion in barter which may have accounted for more than half of total exports by early 1994.

As the prices of energy imports (mostly from Russia) moved toward world levels², Ukraine's terms of trade with the former Soviet Union deteriorated. Despite a large drop in energy import volumes, the share of gas and oil imports in current prices shot up from 7.5 percent of total imports in 1990 to 29 percent in 1993, or from 10 percent to about 43 percent of imports from the former Soviet Union. Though substantial, the contraction in the volume of energy imports was smaller than that in real GDP, and in both 1992 and 1993 the energy intensity of the Ukrainian economy increased, a reflection of the lack of structural adjustment in industry.

The direction and composition of trade also underwent a number of changes. In 1991 inter-public trade accounted for more than four-fifths of total trade; by 1992 one half of all trade was with countries outside the former Soviet Union. To some degree, this shift was an illusion, a reflection of the valuation effect of the sharp real depreciation of the ruble against hard currencies. (The ruble was the domestic currency until Ukraine pulled out of the ruble zone in November 1992.) In 1993 the former Soviet Union's share in total trade climbed to almost 60 percent.

Russia is Ukraine's single most important trade partner in the former Soviet Union, a legacy of its position as the principal market for Ukraine's exports to the former Soviet Union and a reflection of the growing importance of energy in Ukraine's imports. According to partial data, Ukraine continues to trade heavily with its former partners in

Eastern Europe (Bulgaria, the Czech Republic, and Slovakia), but it has also found new markets for its exports—mostly raw materials—in Asia (China).

Changes in relative prices and a collapse in investment demand throughout the former Soviet Union appear to have influenced the composition of Ukraine's trade. Machine-building and consumer goods have shrunk as a share of exports to the former Soviet Union while ferrous metals have expanded. There are indications that raw materials and metals also have increased as a proportion of exports to the rest of the world. Trends on the import side are more difficult to gauge. Oil and gas products dominate imports from the former Soviet Union, but account for very little of the imports from the rest of the world. Beyond that the picture is murky. Little information is available on whether the bulk of imports from the rest of the world consists of consumer goods or equipment and spare parts.

Trade Regime

Trade policy has been cast within the vestiges of central planning, with its emphasis on supply of goods that exist to this day in Ukraine. A key feature of this approach is administrative control of domestic prices (and the consequent isolation from world prices) which is considered necessary to protect living standards by ensuring that basic goods and services are available at low prices and to support state enterprises by providing inputs at low prices. And because the resulting domestic prices are often lower than world prices, producers have a strong incentive to sell abroad.³ The authorities, concerned that domestic shortages will become more severe, have focused trade policy on measures to neutralize the pressures arising from the disparity in domestic and world prices. From this perspective, exports are essentially a means of financing the minimum required level of imports.

Though there have been many changes to the trade regime in the past three years (boxes 3.1 and 3.2), the system remains highly intricate and limiting, characteristics that often work in favor of the new class of rent-seekers. At times, the changes have been little more than tinkering, and at others,

Box 3.1 Status of Foreign Trade and Exchange Regime, June 1994

<i>Exports</i>	
Export tax	Nons.
Quotas	Cover 104 goods or about 30 percent of total export value; obtained through state orders, state contracts, or at quota auctions.
Licenses	For goods under quota.
<i>Import restraints</i>	
Tariffs	Initial standard rates of zero to 50 percent, with most in the 0 to 10 percent range. Some food and alcohol products, tobaccos, furs and leather, and jewelry are subject to rates ranging from 60 to 350 percent; imports of manufactured goods not produced locally are exempt.
Licenses	Restricted to a few goods on safety and environmental grounds.
<i>State trading</i>	
Major partner countries	Former Soviet Union (mainly Russia), Bulgaria, Czech Republic, Slovakia, Hungary, Romania, Turkey, Iran, Mongolia.
<i>Major commodities traded under agreements with countries of the former Soviet Union</i>	
Exports	Ferrous and nonferrous metals, chemical products, machine-building products (for example, combines, motors, pumps, cables, locomotives), fibers and textile threads, meat and dairy products, sugar, vegetable oil, salt.
Imports	Petroleum and natural products, wood products, rolled ferrous metals, chemical products.
<i>Foreign exchange regime</i>	
Surrender requirements	40 percent of foreign exchange earnings to be surrendered to the government at the official rate (krb 16,500 per U.S. dollar and krb 8.6 per ruble as of June 8, 1994) and allocated by the Tender Committee (at the official exchange rate for priority imports); 10 percent of earnings to be surrendered to the National Bank of Ukraine at an administered rate of krb 25,000 per U.S. dollar for the building up of official reserves; remaining 50 percent may be kept in foreign exchange accounts or sold at weekly auctions.

measures tilting toward trade liberalization have been taken together with measures representing greater control. For example, while detailed quotas were being specified for exports, legislation adopted in late 1992-early 1993 initiated the move to a framework that would view the world outside Ukraine as a single entity; in principle at least, a number of trade regulations apply uniformly to the former Soviet Union and the rest of the world.

Export Regime

Export regulations distinguish between goods that are considered vital to the economy (agricultural

and industrial inputs) and those that are not (manufactures). In the former case, a strict system of controls, anchored by licenses, and variously consisting of quotas, a special regime, and export taxes, has sought primarily to maintain domestic supplies, though some quotas have been imposed in response to EU restrictions on products from Ukraine (selected threads, yarns, and fabrics). A presidential decree of May 5, 1994, has substantially narrowed the scope of export controls. In the latter case, formalities are much less onerous, with no license being required. However, for all goods, the foreign exchange regime presents the main obstacle to

exporting. Exporters are required to surrender half of their export earnings at a fixed exchange rate that is much lower than the market rate.

Quotas. The system of export quotas applies to major agricultural commodities, raw materials, and intermediate goods. The quotas are determined as part of the material balances drawn up by the Ministry of Economy together with the branch ministries; in this exercise, the overall volume of exports (and imports) is derived from estimates of output and consumption of priority goods. Export quotas, which are used principally to fulfill bilateral trade arrangements (discussed later), are then allocated up to the level established in this way. In concert with the Ministry of Economy, the branch ministries allocate the quotas to the enterprises—generally those under their control—that sign state contracts and state orders; a very limited share of the quotas is available through auctions.

The list of products subject to quotas has changed on several occasions, getting shorter each time. Under legislation adopted on December 17, 1993, the quota list covered 240 goods equivalent to almost two-thirds of total export value. The decree of May 5, 1994, removed more than one hundred products from the list, which now covers about one-third of total export value.

Under the system of state contracts introduced in 1993, an enterprise agrees to deliver to the state a commodity for export meeting set specifications and quantities. The government, for its part, undertakes to allocate critical inputs to the enterprise through its centralized allocation system.⁴ The government guarantees payment for the final product and finances the purchase (at the domestic price) through the state budget. The export earnings are channeled to the foreign currency account of the Ministry of Finance at the State Export-Import Bank of Ukraine. This system is increasingly being used for exports to countries outside the former Soviet Union and has become the sole source of hard currency in the budget.

Under a state order, an enterprise is directed to supply a commodity to an enterprise outside Ukraine within the context of bilateral agreements. Although price is negotiated directly between the seller and the

(foreign) buyer, the government can bring pressure to bear on the process; it has close links with large state enterprises, and in the final analysis, the price is approved by the Ministry of Foreign Economic Relations (see section on licenses). The exports are paid for through normal banking and interstate clearing channels. As with state contracts, the government offers—though it cannot always deliver—a variety of incentives to the producing enterprise, including preferred access to critical inputs, tax breaks, subsidized credits, and customs privileges.

Firms can also purchase export quotas at auctions organized by the Ministry of Foreign Economic Relations since April 1993. While this mechanism provides an opportunity for increasing the share of new entrants in exporting, its effect has been limited by the small volume of quotas up for auction. According to the directives that first set up the auctions, lists of commodities and amounts to be auctioned were published in the mass media twenty days before the auction. The asking price (in U.S. dollars) started at the level of the export tax and was gradually reduced until the lot was sold or the state's reserve price (reportedly, half the export tax) was reached. Quota payments were in karbovanets at the central bank exchange rate of the day. After administrative costs of the auction were covered, any remaining revenues were channeled to the budgets of the local administrations in the areas where the quota purchasers resided. Quotas could be resold freely, with any profits going to the enterprise. New directives of February 7, 1994, changed the quota allocation system to cover only unused regional and enterprise quotas rather than a set amount and barred firms from selling quotas. That changed again in the decree of May 5, 1994, which specified that a set share of the total quota was to be earmarked for sale at the auctions; a new mechanism for determining the auction price (given that export taxes have been abolished) was not elaborated.

"Special Regime." A special regime was introduced in December 1992 for exports of strategic products. One year later, the list was pared down to coal, ammonia, ethylene, benzol, methanol, mineral fertilizers, and ferrous metals. Exports of these

Box 3.2 Stages in the Evolution of the Foreign Trade and Exchange Regime, 1992-94

Exports		
Export taxes	January 11, 1993	Export taxes set at 5 percent (for manufactured goods) to 30 percent.
	May 20, 1993	Permission given to export goods under quota by paying an export tax, usually 30 percent.
	December 26, 1993	All export taxes eliminated.
Quotas	March 22, 1993	Comprehensive quotas covering 390 products published.
	December 26, 1993	Quota coverage reduced to 285 goods, or about 60 percent of export value, but quotas become binding as export taxes are abolished.
	May 5, 1994	Scope of quotas narrowed to 104 goods, or 30 percent of export value.
Special regime	December 26, 1992	Exports of strategic goods placed under special regime requiring approval of Cabinet of Ministers.
	December 26, 1993	List of strategic goods shortened; export restricted to five authorized organizations in each sector.
	May 5, 1994	Special regime abolished and replaced by quarterly auctions of quotas.
Licenses	January 1993	Licenses applied to all exports except manufacturers.
	May 5, 1994	Licenses required only for goods exported under quota; one-year limit on general licenses removed.
Imports		
Tariffs	January 11, 1993	Tariff structure adopted, with standard rates of between zero to 50 percent, mostly in the zero to 10 percent range.
	June 23, 1993	Selected goods exempted from import tariffs.
	May 3, 1993	Tariffs raised on certain goods (60 to 100 percent for food products, 200 to 350 percent for alcohol, 200 percent for tobaccos, 150 percent for furs and leather).
Quotas	December 26, 1993	Quotas introduced on meat, milk, and dairy products, foodgrains, fats, sugar, machinery and equipment, and ferrous metals to go into effect on March 1, 1994.
	March 4, 1994	Moratorium imposed on quotas.
	May 3, 1994	Quotas formally eliminated.
Foreign exchange regime		
Surrender requirements	September 22, 1992	Surrender requirement reduced from 100 percent to 50 percent, and compensated at central bank auction exchange rate.
	August 12, 1993	Official exchange rate fixed by Cabinet of Ministers and National Bank of Ukraine introduced and applied to 50 percent compulsory surrender requirement; adjusted at intervals starting at krb 5,970 per U.S. dollar in August 1993 and reaching krb 16,500 in June 1994.
	January 1, 1994	Surrender requirement modified, with 40 percent of foreign exchange earnings to be surrendered to government at official rate and 10 percent to the National Bank of Ukraine at an administered rate (krb 25,000 per U.S. dollar); remaining 50 percent to be kept in foreign exchange accounts or sold exclusively to the central bank at the administered rate.
	February 25, 1994	50 percent of foreign exchange not surrendered may be sold at auctions.
Foreign exchange markets	September 22, 1992	Weekly auctions of U.S. dollars by National Bank of Ukraine initiated; administrative restrictions apply.
	March 16, 1993	Weekly U.S. dollar auction expanded from 6 to 40 banks.
	April 16, 1993	Weekly auctions of Deutsche marks and Russian rubles established.
	July 21, 1993	Ukraine Interbank Currency Exchange auctions replace central bank auctions.
	November 9, 1993	Ukraine Interbank Currency Exchange closed.
	February 25, 1994	Central bank auctions of U.S. dollars, Deutsche marks, and Russian rubles resume; Ukraine Interbank Currency exchange reopens for auctions of Belarus ruble and Kazakh tenge.

commodities required the approval of the Cabinet of Ministers upon the recommendation of an inter-ministerial commission. In 1993, enterprises wishing to export strategic goods were subject to elaborate screening covering everything from date of establishment and ownership of the enterprise, to current economic activities, financial records for the previous two years, and the balance sheet approved by the State Tax Inspectorate. In 1994, the regulations were initially amended so as to strengthen control over export prices and hard currency earnings. Thus only five organizations in each sector—selected by the branch ministries from a list of twenty organizations kept by the Cabinet of Ministers—had the right to export under the special regime; most of them were state foreign trade organizations. Subsequently, the decree of May 5, 1994, abolished the special regime, replacing it with a system of quarterly auctions of quotas. The quotas are to be sold at auctions in which any organization may participate. At the same time, however, enterprises cleared to export strategic goods could no longer choose to pay a 30 percent tax that freed them from the quota limits (see discussion of export taxes, below).

Licenses. Licenses are used to control export quantities and prices. Until recently, they spelled out the lowest acceptable price for the export goods established by the Ministry of Foreign Economic Relations, taking into consideration world prices. Now, they incorporate the actual contract price, though it is still subject to government approval. All exports except manufactures used to require licenses, but as of May 1994, licenses are required only for exports of commodities under a quota. Requests for licenses must be handled within thirty days of application to the Ministry of Foreign Economic Relations. A general license is issued for exports under state contracts and state orders and may also be issued to firms by an independent decision of the Cabinet of Ministers. Otherwise, single licenses only are awarded for specific transactions. Licenses may be denied if the required documents are not properly presented or registered, the goods would be exported at a price below that established by the ministry, or the quota on the good has been exhausted.

Export taxes. New export taxes ranging from 5 to 30 percent went into effect in January 1993. The rates were in principle set so as to capture half of the difference between domestic and world prices. Because domestic price controls, combined with the real depreciation of the karbovanets, had left many prices well below their world market level, the rates were expected to allow ample profits. A few of the tax rates (selected fertilizers, ferrous metals, tires) were reduced in May 1993, reportedly because of complaints by some exporters that the rates were too high.

In the past, these export taxes, though a serious burden on exporters, injected some flexibility into the quota system. Instead of seeking to obtain an export quota, enterprises and traders could export goods subject to the quota regime by paying an export tax, usually assessed at 30 percent. In 1994, all export taxes were eliminated, but the quota system was maintained. As a result, the quotas have become binding on exports.

Import Regime

Imports come under a simpler regime than exports, perhaps because domestic industries receive considerable protection from a highly depreciated exchange rate and chronic shortages of foreign exchange. In January 1993, an import tariff structure with a relatively narrow and modest set of rates was adopted. There were no nontariff barriers except for the requirement that products meet safety and environmental standards. This system came under some strain at the end of the year, when quantitative restrictions were briefly put on the books, but overall, it has retained a fair part of the original outlines. More damaging, perhaps, are current foreign exchange arrangements that cross-subsidize key imports (energy, agricultural inputs). This mechanism shields state enterprises and agricultural units from market-based prices, thereby contributing to the misallocation of resources in the economy.

The import tariff does not draw a distinction overall between the rest of the world and the former Soviet Union. In the initial legislation, most goods carry tariffs of zero to 10 percent. A small number

of goods are subject to tariffs of 15, 20, or 30 percent (for example, the 30 percent tariff applies to certain fabrics and textiles), and the tariffs on some alcohol and tobacco products are 50 percent. Preferential tariffs (normally zero) are extended to goods from least developed countries as classified by the Generalized System of Preferences and from countries that enter into a "customs agreement" or create a "special zone" with Ukraine. Concessional rates (often 2 or 5 percent) apply to goods from countries with which Ukraine has negotiated most favored nation trading status—the new states of the former Soviet Union and twenty nine countries located primarily in Western Europe and North America, as well as developing countries that do not qualify for preferential rates. Goods imported in operations fulfilled under state contract or state order are exempted, as are a variety of raw materials and intermediate goods (many of them are likely to be under some form of state control). Tariff exemptions for imported inputs increase the effective rate of protection for final goods, and thus tend to induce a shift to these goods; they also have a negative effect on fiscal revenue.

The decree of May 3, 1994, eliminated tariffs on a large number of manufactures that are not produced domestically. At the same time, import duties were increased on a variety of consumer goods and foodstuffs.⁵ Tariffs on some food products were raised from 10 or 20 percent to rates between 60 percent (sunflower seed oil) and 100 percent (boiled sausage), and those on alcohol and spirits from 20 or 50 percent to 200 percent (beer and wines) and 350 percent (vodka); duties on tobacco were raised by 4 to 200 percent. As a result of these changes the tariff structure has no doubt become more widely dispersed, reflecting the special interests of certain industries and enterprises.

Import quotas were introduced on paper, but not in practice. A December 1993 resolution of the Cabinet of Ministers placed quotas on an array of goods (meat, milk and dairy products, foodgrains, fats, sugar, machinery and equipment, and ferrous metals and parts thereof), an arrangement that took effect on March 1, 1994. Three days later, a moratorium was issued on import quotas, and two

months later, the decree of May 3 formally eliminated import quotas. In addition, import licenses for goods subject to quota and for a variety of other products were abolished. Licenses were retained only for a few goods, to meet safety and environmental concerns.

Bilateral Agreements

A network of bilateral agreements has been put in place in an effort to rebuild trade links with the other states of the former Soviet Union and Eastern Europe and to ensure a supply of critical inputs to domestic producers. It also dovetails with the system of export controls, in particular quotas, that is used to fulfill Ukraine's obligations under the agreements.

In 1993 and 1994, Ukraine signed bilateral agreements with the fourteen other states of the former Soviet Union; it has similar arrangements with several countries in Eastern Europe (including Bulgaria, the Czech Republic, Hungary, Romania, and Slovakia) and the developing world (India, Iran, Mongolia). These arrangements account for the bulk of Ukraine's trade. The agreement with Russia is the most important. The 1993 agreement with Russia is typical of such agreements except that it covers more products than the others. The bilateral arrangements include three categories or lists: obligatory, indicative, and enterprise-to-enterprise.

The obligatory list is a descendant of the planned interrepublic flows and transfers of the Soviet Union—many of the same agencies and staff are involved. The obligatory list, or intergovernmental barter, specifies the most critical commodities in trade between Ukraine and Russia. Exports from Ukraine, covering 140 product categories, come mainly from machine-building and metal working, the chemical and petrochemical industries, non-ferrous metallurgy, and agriculture. Imports are more concentrated, consisting of 75 product categories, mainly petroleum and gas products and chemical goods. Each country is obligated to fulfill this part of the agreement. Ukraine does so through a variety of arrangements (basically anything that works), mainly state orders and state contracts. Obligatory list trade is supposed to balance; the two

countries negotiate prices and volumes in advance with the objective of balancing trade—in other words, a sort of mini-clearing system. Prices are denominated in U.S. dollars and are supposed to approximate world prices. In practice, some prices are negotiated; for example, energy products imported from Russia and sunflower oil exported to Russia have been priced below world levels. Recently, the import prices of energy products have been rising rapidly, and oil prices were close to world levels by the beginning of 1994. It is quite possible that the prices of Ukraine's export goods have increased more slowly.

Indeed, the estimates in table 1.9 suggest that by 1993 Ukraine's terms of trade vis a vis other countries in the former Soviet Union had deteriorated by 11.2 percent. This compares to a hypothetical deterioration of 13.8 percent that would have been expected if 1990 trade was conducted at world prices. This would support the conclusion that by 1994 the bulk of the terms of trade adjustment had occurred, that trade was basically at world prices and net subsidization by the major trading partner, Russia, had ended. On the other hand, evidence regarding the prices on which obligatory list trade between Russia and Ukraine was to take place in 1993, suggests that, at least on that portion of the trade, some Russian subsidies continued. As a result of the terms of trade shift, in 1994 Ukraine accumulated large arrears on its trade with Russia, and Russia consequently reduced deliveries of oil.

The indicative list covers more commodities: 229 groups of exports and 40 groups of imports. These commodities also reflect the patterns of trade that prevailed in the Soviet Union. The indicative list specifies the maximum amount or quota that will be licensed for export to each country; there is no state obligation to supply the amounts listed. Each government undertakes to license exports up to the quota amounts provided that agreements are reached at the enterprise-to-enterprise level. Individual enterprises are responsible for the terms of the sale, including price and credit arrangements.

All remaining products may be freely traded between enterprises. Products can be traded in more than one list; for instance, oil is traded in all three cat-

egories. But most of the trade in value terms between Ukraine and Russia is in the first two categories.

In addition to bilateral agreements, Ukraine has signed free trade agreements with Belarus (1992) and Russia (June 1993). Under the agreement with Russia, goods are to trade at world prices, free of export and import taxes. Trade in key commodities, such as energy and petrochemicals, machine-building products, and sugar, is excluded, covered in a separate waiver. The agreement also specifies that trade can be halted if there is a severe domestic shortage of a good or a severe balance of payments deficit. The free trade agreement does not apply to the system of bilateral trade, so probably covers only 10 to 15 percent of the flows between Ukraine and Russia. (Some Ukrainian officials estimate that it applies to less than 5 percent.)

Though these bilateral arrangements were developed to alleviate trade and payment difficulties among the new independent states, they have fallen considerably short of their goal. Trade targets are frequently unmet, partly because price controls reduce export incentives and partly because the system of state orders is weakening and firms lack critical inputs. A more general problem is the uncertainty about how to settle trade imbalances.

In May 1993 Ukraine and Russia signed an agreement covering 1.05 trillion rubles (R) of debt incurred by Ukraine to Russia during 1992 and the first quarter of 1993; this debt was converted into a US\$2.5 billion state debt.⁶ Russia extended an additional credit of R.250 billion in 1993 to pay for gas imports; this debt was transformed into a state debt of US\$203 million. Throughout 1993, Russia intermittently cut off gas supplies to Ukraine because of debt arrears. But, with the trade deficit mounting, these are at best stop-gap measures. There has been some discussion that Ukraine might lease some oil and gas facilities to clear its debts to Russia.

Exchange and Payments System

Ukraine's external trade has been seriously impaired by a complex set of exchange regulations and a breakdown in the payments system with the former Soviet Union. The primitive foreign exchange surrender requirements, which tax exports

and cross-subsidize imports, represent the major hurdle to stronger export performance.

Foreign Exchange Surrender Requirements

Though restrictive overall, the administrative control of the foreign exchange system has at various times been loosened or tightened. With the introduction of the foreign exchange decree of February 5, 1992, high taxes on exporters and the full surrender of foreign exchange were imposed. Some months later—against a backdrop of great strain in the financial policies of the countries of the former Soviet Union evident in Russia's decision in June to bar foreign entities from obtaining foreign exchange on the Moscow Interbank Currency Exchange and in Ukraine's withdrawal in November from the ruble zone—the National Bank of Ukraine began its own weekly auctions of U.S. dollars in September. The central bank established official exchange rates for the karbovanets against the Russian ruble and the U.S. dollar; exchange rates for the banking system were determined separately on the interbank market. Although these rates were all market based in principle, there were important divergences in practice between the official and banking rates, and even greater spreads between these rates and the parallel market rates. Enterprises responded to this system of high taxes, multiple exchange rates, and negative real interest rate by keeping their export earnings abroad or engaging in barter trade.

In response to these developments, a new foreign exchange decree in March 1993 substantially liberalized the exchange system. Firms still had to repatriate all their foreign exchange earnings to domestic commercial bank accounts, but they only had to surrender half the proceeds (less any amounts needed to service foreign loans or repatriate profits) to the interbank auction within five days of repatriation. The foreign exchange surrendered was blocked at an account in the firm's commercial bank and sold within five days at the interbank auction, and the karbovantsi thus generated were transferred to the enterprise.

Later in the year, the government again changed course, and over a period of several months it introduced administrative controls designed to accumu-

late more foreign exchange to pay for imports of oil, gas, and lumber. Under regulations issued on August 12, 1993, 50 percent of hard currency and ruble earnings⁷ had to be converted and deposited in the Prominvestbank (the government's agent bank) at a fixed exchange rate set by the Cabinet of Ministers (krb 5,970 to the U.S. dollar).⁸ In addition, the Ukraine interbank currency exchange, which had replaced the central bank auctions, was closed in November. Under new directives in January 1994, 40 percent of foreign exchange earnings were to be surrendered to the government at the official rate (krb 12,610 to the U.S. dollar as of December 2, 1993)⁹ and 10 percent to the central bank at an "administered" rate (krb 25,000 to the U.S. dollar as of December 29, 1993). Firms could keep the remaining 50 percent of their export earnings in foreign exchange accounts or sell them exclusively to the central bank at the administered rate. At the end of February 1994 controls were once again relaxed. The central bank foreign exchange auctions were resumed, and retained foreign exchange earnings may be sold at the auctions. The National Bank of Ukraine remains the only seller at the auctions, however, and buyers may bid only on the basis of pre-selected import contracts. The Ukraine interbank currency exchange also reopened its doors, but only for auctions of the Belarus ruble and the Kazakh tenge.

The foreign exchange arrangements have a direct bearing on the import regime. The Tender Committee, a group of twelve government representatives established in November 1993, meets weekly to allocate the foreign exchange surrendered to the government to imports of key commodities; these generally cover energy supplies (imported by the State Oil and Gas Committee), lumber, and agricultural inputs, i.e. imports that do not compete with domestic production. In effect, the committee decides which imports to subsidize by providing foreign exchange at the official exchange rate.

Interstate Payments System

For the most part, the interstate payments system has been in disarray since the breakup of the

Soviet Union. During 1992, interstate trade was settled in rubles. All payments were channeled through correspondent accounts at central banks. Delays of up to two to three months in clearing payments orders and Ukraine's withdrawal from the ruble zone made a new form of settlement imperative. Starting in November 1992, payments were cleared through correspondent accounts at commercial banks; after January 1993, the correspondent account at the Central Bank of Russia was used only for importing key commodities, such as oil and gas, under intergovernmental agreements.

Since the end of 1992, Ukrainian commercial banks have been able to maintain correspondent accounts in rubles (and in karbovantsi since February 1993) in Russian commercial banks, and Russian commercial banks have been allowed to open correspondent accounts in karbovantsi in Ukrainian commercial banks. A Ukrainian enterprise wishing to buy Russian goods (say, at a price of 1 million rubles) can go to a Ukrainian bank to get rubles. The bank will negotiate the karbovanets price of 1 million rubles with a Russian bank or attempt to buy the rubles at the foreign exchange auction of the National Bank of Ukraine. If the price is acceptable, the Ukrainian importer initiates a payment order that allows the Russian exporter to be paid in rubles through the Ukrainian bank's correspondent account with the Russian bank.

These channels offer greater flexibility and speed in trade activities than previous arrangements. A few of the larger banks in Ukraine and Russia maintain multiple correspondent accounts for this purpose and claim to be able to process transactions in three days. However, the underlying markets remain weak, and there are reports of long delays in obtaining rubles in Ukraine. The Russian ruble is classified as a "first currency" and is subject to the same surrender rules (at a rate of krb 7 per ruble) as convertible currencies under the foreign exchange system. Reflecting the strong demand for rubles, the auction exchange rate depreciated from an average of krb 1.6 per ruble in January 1993 to krb 17.6 in December 1993 and krb 20.5 at the end of April 1994.

Overview of the Trade and Exchange System

The costs of the government's economic policies are high even when measured against the government's own objective of reducing adjustment costs during the transition. The combination of unrestrained financial policies and limited structural reforms have fueled high rates of inflation without preventing a massive decline in output or eradicating unemployment (which is simply hidden). Trade and exchange restrictions have failed to ensure price stability, provide adequate supplies of goods to industries and consumers, or stabilize the exchange rate on a sustainable basis. These policies have kept the economy largely divorced from the international price structure and ill-prepared to adjust production in response to changes in relative prices, such as higher oil and gas prices. And by isolating the economy from technological progress abroad, these policies have hurt the country's competitiveness. All this has made it more difficult to expand exports and undertake efficient import substitution. The consequence has been large trade deficits and economic imbalances.

Almost three years after independence, the external regime reflects many of the old premises of the Soviet era, despite innumerable amendments intended to modify the traditional system. The government has abolished the registration requirement for traders, given enterprises a more direct role in foreign trade, reduced the number of exports subject to quotas, allowed price incentives to exert a greater influence on trade patterns, and begun to apply uniform regulations to trade with the hard currency area and countries of the former Soviet Union. Despite the numerous changes—which, by their very number and frequency, generate uncertainty among traders and their foreign partners—the trade regime retains its reliance on administrative controls.

Several features of the external regime stand out. First, the trade regulations exist in large part to bolster domestic price controls. On the export side, quotas artificially direct output to domestic markets, keeping domestic prices down in the short run and supporting industries that rely on cheap inputs of agricultural goods, raw materials, and intermediate

goods. On the import side, tariffs protect inefficient domestic producers by keeping prices high enough for them to survive. Second, governments rather than markets determine a significant portion of trade flows through quantitative restrictions, state contracts, state orders, and bilateral agreements. These interventions prop up the traditional system of trade and reduce the effectiveness of market forces. Third, those mechanisms also benefit companies (mostly state enterprises) with close links to the government and its administration, at the expense of small-scale and private sector activities and at an additional cost in resources devoted to unproductive rent-seeking activities associated with trade controls (lobbying, smuggling, and evading tariffs). Fourth, the array of quantitative controls discriminates against exports.

Current foreign exchange arrangements hurt all exports (including manufactured goods and those undertaken by the private sector), limit transactions that are settled in hard currency and rubles, encourage barter trade, and spur capital flight. The use of multiple exchange rates whereby exporters receive less than the market exchange rate on the 50 percent of foreign exchange that they are obliged to surrender is a form of taxation. High inflation and delays in settlement add to the burden. As a result, much less foreign exchange is available at auctions now than in late spring 1993, further constraining imports and putting downward pressure on the exchange rate.

Reform Issues

Economic conditions in Ukraine are grave in no small part because of the trade and exchange system. The government needs to move quickly and decisively to turn conditions around. Measures to foster openness in trade could also address some key concerns of the authorities. Liberalizing exports would provide incentives to enterprises to maintain production and employment at higher levels than they otherwise would be. The additional foreign exchange earnings would expand the capacity of the economy to import, easing domestic shortages. Opening the economy to imports could contribute to generating competitive pressures that would curb the market power of highly monopolized domestic

industries. Hence, the authorities' fear that liberalizing prices and giving more freedom to enterprises will aggravate monopoly exploitation may be overdrawn if trade reform is carried out at the same time. Other gains would come from the transfer of marketing know-how, improved information on product lines, and innovation.

To succeed, trade reform must be accompanied by measures to bring about structural adjustment and stabilize the economy. Just two sets of policy measures are emphasized here, price liberalization and macroeconomic stabilization. The former would bring incentives in line with a more efficient allocation of resources. It would also eliminate the need for administrative controls over trade, which are designed to keep goods flowing to the domestic market. The latter would serve to break inflationary expectations and stabilize the exchange rate at a more realistic level, which would then provide clearer price signals to producers, reduce pressures for export controls and taxes, and facilitate imports. In other words, without strict financial policies designed to reduce the budget deficit and limit credit expansion on a sustainable basis, efforts at liberalizing the trade and the foreign exchange regime would be ineffective, overtaken by an inflationary spiral that would erode Ukraine's competitiveness in the international marketplace and encourage capital flight and the dollarization of the economy.

Trade regulations should be simple and neutral in their impact, i.e. they should avoid benefits that yield different incentives to different producers and traders. Straightforward rules that are easy to understand have the additional advantage of opening up to public view the vested interests opposed to trade reform, which could restrict their maneuvering room, and of enabling reformers to oversee and monitor reforms more easily.

The objectives and strategy outlined above suggest the following policy measures as the core of external reform over the short to medium term:

Foreign Exchange Regime

- Establish an interbank currency market open to all registered banks, with no restrictions on bidding.

- Unify the exchange rate at the market rate. Regarding the overall public finances (including off-budget operations), this move would cause expenditures to rise because the government would have to buy foreign exchange at the market rate, but it would also lead to an increase in revenues because the government would eliminate subsidies on imports and sell its foreign exchange at the market rate. As a general principle, the authorities should avoid efforts to mobilize financial resources through measures that distort trade, relying instead on expanding the resource base by limiting tax exemptions and reinforcing tax administration.
- Eliminate the allocation of foreign exchange through the Tender Committee.

Exports

- Abolish all quotas and licenses for exports in line with domestic price liberalization.
- Improve the mechanism for limiting exports to quota-constrained markets, such as the EU. Instead of export taxes, the government could auction quota rights, which is equivalent to letting competition determine the export tax.

Imports

- Abolish any remaining licenses.
- Provide for any domestic protection in a transparent manner (and on a limited basis) through a uniform and low tariff.

Other Measures

In a second stage, the following complementary measures can be added to the reform agenda:

- Eliminate the state order system, and reduce the number of goods under state contracts to a short list of commodities essential for the government's own needs.
- In transactions with the countries of the former Soviet Union, promote enterprise-to-enterprise trade; limit the coverage of bilateral agreements to a few critical commodities, and within the context of these agreements,

procure the export goods and distribute the import goods through market mechanisms.

In addition, there are issues that will have to be addressed over a somewhat longer period of time. These relate to the growth of trade finance and the role of the financial system in supporting trade, the links between foreign investment and export promotion, the role of the Government in export information and marketing, access to Western markets, membership in GATT, and, in general, the development of manufactured exports.¹⁰

Notes

1. These figures overstate the drop in output since they do not cover the rapidly expanding unofficial economy.
2. Calculations of the terms of trade are sensitive to the choice of base year, and they are seriously compromised by the poor tracking of Ukrainian export prices and the incomplete coverage of trade transactions. As a result, estimates of the deterioration in the terms of trade with the former Soviet Union in 1991-93 vary widely, ranging from about 10 percent to more than 40 percent.
3. Ukrainian officials have stated that a good many domestic prices were actually higher than world prices by end 1993.
4. According to a decree of January 22, 1993, twenty-three groups of commodities are centrally allocated. Enterprises must purchase all other inputs needed to meet state obligations through commercial intermediaries.
5. The new duties are reportedly payable in karbovantsi at the official rate (about one-third of the parallel market rate as of May, 1994) while the imported goods are to be sold at domestic prices calculated at the exchange rate on the parallel market, thereby reducing the impact of the duty.
6. Principal is to be repaid quarterly and in equal amounts over the six years 1994-1999. Interest payments, also quarterly, are at LIBOR (for six-month U.S. dollar deposits) plus one percentage point on the U.S. dollar equivalent of the debt. The penalty rate on debt service arrears is LIBOR plus two percentage points. Debt service may be discharged in convertible currencies or rubles at the exchange rate prevailing on the date of payment, or as equity in real property.
7. A 100 percent surrender requirement on ruble earnings was imposed in August, but was relaxed in practice in October-November 1993.
8. A number of enterprises were exempted from the surrender requirement, adding to the distortions in export patterns. For example, the Government granted an exemption to the tire industry to buy rubber and chemicals abroad.
9. This rate was increased to krb 16,500 on June 8, 1994.
10. In June 1994, Ukraine signed a Partnership and Cooperation Agreement with the EU, which sets out general guidelines for future cooperation, including the prospect of a free trade area.

Comment on "Ukraine: A Trade and Exchange System Still Seeking Direction"

Oleh Havrylyshyn

Le Gall's fine paper provides an early yet comprehensive look at Ukraine's external trade tendencies since independence. It is essentially correct in the judgment that trade policies are the result of a search

for a third way between capitalism and a command economy. Indeed, trade policies are a good example of the crucial tendency in Ukraine's political and economic thinking to define a third way appropriate to Ukraine's "unique" situation. Any student of Ukrainian issues today must become familiar with this tendency, and a good place to gain this familiarity is in a recent edition of *Political Thought*, which devotes special attention to the "third way."¹

Let me make a few detailed comments and suggestions before noting some critical, overlooked issues. I think that the discussion of the ups and downs of the trade regime, the heart of the paper, would have benefited from an accompanying schematic presentation to complement the text—something in the spirit of the "regulation index" that Kaufmann (this volume) attempts. Of course, it will not be possible to achieve the quantification needed for an effective exchange rate type of measure, but there should be some effort to give a flavor of the degree of restrictiveness and protectiveness of the system, and to highlight any specific tendencies.

The discussion of energy prices and terms of trade seems to present a paradox. Energy prices rose about five times faster than other prices, yet energy imports fell less than GDP and energy intensity (necessarily) increased. Le Gall attributes this to a "lack of structural adjustment." Perhaps a different way of putting it is that the government's willingness to increase effective subsidies to energy users (by credit emissions) may have more than compensated for the terms of trade shock.

There is an interesting political economy insight in the comment about how the tariff structure has become more reflective of the interests of specific industries and enterprises. Earlier, Le Gall noted that export protection is more prevalent than import protection, as is typical of the early transition phase. This pattern has been recognized by many writers on the subject, and some of them have predicted that as things settle down, more traditional import-protectionism will emerge. Le Gall's remark about import tariff trends in Ukraine makes a similar point.

Le Gall describes the process of intergovernmental barter between Ukraine and Russia. What terms result at the end of the day from such barter is crucial in determining the effective terms of trade. But the process is far from transparent.

Consequently, it is difficult to be certain about the terms of trade or the effective price of energy and so it is difficult to judge claims that Russia no longer subsidizes Ukraine or, as some Ukrainians claim, that Ukraine could be subsidizing Russia by being forced to accept "prices" for its bartered exports that are much further below world prices than are the prices for energy imports.² I would not have expected the paper to sort out the contents of this black barter box, but then I read the tantalizing phrase "World Bank calculations suggest!" If such calculations are reliable enough to be mentioned, they ought to be explicitly shown in the paper (with appropriate qualifications on range of error, of course). This is too important an issue to not use every piece of available evidence.

Let me turn finally to a more substantive critical comment: the paper does not once mention or even hint at how trade policies may be influenced by the interests of rent seekers, how the accompanying capital flight (which is surely fed, in the main, by such rents) affects the accuracy of trade statistics. This seems an obvious topic for the discussion for two reasons: it follows naturally from the rich economic literature on trade regimes, and it is clearly a major characteristic of all post-Soviet societies, to an extent that may exceed its manifestations in other developing countries. Some quick arithmetic hints at the (possibly) enormous magnitude. The middle range of casual estimates of cumulative capital flight from Ukraine for 1991-93 puts it at \$8-10 billion, or 12 to 15 percent of GDP. Casual estimates for Russia of \$25-30 billion give slightly lower but similar GDP ratios of 10 to 12 percent. Compare these numbers with casual estimates for Mexico in the mid-1980s of about \$20 billion, equivalent, again, to about 12 to 15 percent of GDP; for Argentina the numbers may be as high as 40 percent of GDP.

But in a short three years, Russian and Ukrainian rent-seekers have achieved incomparably more than their Latin American counterparts did in as short a period. Even if these are wildly over-estimated and the annual capital-flight values turn out to be on the same order of magnitude as in Latin America, that is still a big enough Eldorado to

entice potential beneficiaries to lobby vigorously to maintain the trade regime that yields such benefits. Put simply, this means strong lobbying pressures to keep the wedges between world prices and domestic prices large, and to retain the system of licensing that permits these wedges to be exploited. There is, of course, no need for Le Gall to write a second paper on the political economy of Ukraine's trade regime, but this phenomenon ought to at least be recognized in the paper, especially in the few attempts made to explain policies.

Indeed, one such explanation that Le Gall notes is the need to protect the living standards of the population through low prices. This brings me back full circle to my first comment on "the third way." I suggest that the debate on the "third way" is a convenient intellectual facade that allows for the devising of policies that benefit rent-seekers. The fact that rent-seeking elites in many countries around the world have, throughout history, engaged in constructing such facades of "protecting the population" only goes to show that Ukraine is not even unique in its "third way." In fact, Ukraine is not even unique among the formerly centrally planned economies. For most of them today, it may be less instructive to ask "how to reform" than to ask "why are reforms delayed."

There is a beguilingly simple answer: powerful economic elites do not want to reform, because the in-between world after planning and on the way to market capitalism is ideal for them. As central command disappeared, there was a new autonomy for the old Soviet "patriarchs" (directors of enterprises, state-farms, local leaders). At first, their communist background discredited them, and the expected reform measures—privatization, opening up of foreign markets for competition, slashed subsidies—threatened their elite status. In countries where reform measures were quickly undertaken, members of the elite who were not pushed aside were forced to begin to behave roughly like competitive capitalists. In countries that delayed reform, these old elites—along with some newcomers—had time to transform themselves into a new, monopolist-capitalist elite reliant on state financial support and privileges.

The in-between economic arrangement is straightforward. The state provides budgetary subsidies and cheap bank credits allegedly to keep the economy going and people on the job. This arrangement leads to inflation and provides the directorate with continuing patriarchal influence and the funds to engage in side operations (through "commercial" spinoffs from the state factory), such as purchasing cheap titanium, magnesium, or petroleum; obtaining licenses from their old-boy colleagues at the Ministry of Foreign Economic Relations; and selling these commodities abroad at a tidy profit. The result is materials shortages, corruption, capital flight, new affluence for a few, and popular discontent. Popular discontent is partially quieted as patriarchs fulfill their neofeudal obligation, ensuring that workers have jobs and some privileges (health care, vacations, some consumer goods) and are paid enough to survive as before. Discontent nevertheless finds an outlet in workers' behavior: "you pretend even less than in Soviet times to be paying us, and we pretend even less to be working." The result: even more absenteeism, even less productivity, even less production. More worrisome for the future is that new investment in production capacity is not taking place, since commercial trade operations are far more profitable.

Is there a chance that the elites will come to realize that they are killing the goose that lays the golden eggs and become proponents of reform? A slim chance, but only for partial reform, which may not be enough. Consider the three major changes that are needed: financial stabilization, privatization, and market liberalization. At some point, the elites will recognize that excessive cheap credit and subsidies cause inflation, which in the long run hurts even the new capitalists by eating away at the production potential of the economy. Some efforts at fiscal and credit restraint are then likely. Very soon—in some cases already—the new capitalists will see that privatization of even large-scale state enterprises is in their interests because it can, of course, be organized so that they become the major shareholders. Fair or unfair, this would be good for the economy if true competition were allowed to

work, to sort out the efficient capitalists from the inept; in a competitive environment, it often takes only one generation to go from riches to rags. But it's a big if and a questionable one, because allowing competition would mean wholeheartedly pursuing the third change, liberalization. While the rentier-patriarch elites might eventually consider the first two steps to be in their interest, it is a stretch of the imagination to believe they would ever consider in their interest a liberalization that closes the lucrative price wedges and that results in competition in trade that removes their monopolistic privileges.

There are two ways to cut this Gordian knot. One is to establish an economy that is privatized, but monopolized, and highly regulated by government. Were that to happen, we would be likely to see—as we have many times in Latin America and Africa since the 1960s—not a single successful stabilization effort, but rather a series of failed efforts, because the necessary liberalization of market activity is not in fact undertaken. As in Argentina, the crisis may become so deep that eventually societal consensus for full reform and liberalization can be expected. The second, and better way, is through bold political leadership that recognizes the nature of the dilemma and—despite personal political risk—acts quickly to implement liberalization measures that remove the economic incentives and opportunities for monopolistic lobby-group activities.

We should work toward, and hope for, the better scenario, but we should be prepared for the first: the grim reality of a long freeze of the transition process in countries that missed the early opportunity to move forward quickly and, thereby, gave a "new-old" elite the chance to hijack reform and mold it to their own interests.

Notes

1. Political Thought (Politychna Dumka, 2, 1994), is a bilingual publication of the Institute of World Economy and International Relations, Kyiv.

2. The economic logic behind this argument is that Russia, as a monopoly supplier of critical energy, has, of course, the stronger position.

4

A Firm's Eye View of Foreign Trade in Ukraine

Greta Bull

An enterprise-based perspective is useful in understanding the factors influencing the foreign trading regime in Ukraine during a period of rapid change. This chapter presents such a perspective using the results of an extensive enterprise survey conducted in Ukraine in early 1993, interviews with the surveyed enterprises, and observations by the author on institutional development.

The main conclusions of the analysis are:

- The state distribution system is not fulfilling its intended functions of ensuring the delivery of key strategic goods, such as fuel and other raw materials on a competitive basis; nor is it keeping prices stable through administrative price setting; or preventing mafia involvement in the distribution of basic goods, which tends to price vulnerable groups out of the market. As a result, firms are increasingly taking on distribution functions themselves, either directly, by investing in distribution entities, or by contracting with private intermediaries. So many private entrepreneurs are now involved that a large enough number of entrants would be ready to take over to ensure adequate competition were the system to be officially "privatized."
- While there is no disputing a serious drop in trading volumes, the size of the fall has been overestimated

- Enterprise Profiles
- Changes in Distribution Patterns
- The Mafia and Government Licenses
- Patterns of Trade and the Increasing Importance of Unrecorded Transactions
- Expanding Unofficial Trade
- Obstacles to Trade
- Profile of a Successful Producer
- Conclusions and Recommendations

because official government statistics are unlikely to capture smuggling, personal imports, imports of goods of little interest to the Ukrainian government (particularly consumer goods) or the activity of private traders, who have entered the market in the past three years. There are good indications that private firms and black marketeers have increased their trade activity, which suggests that the collapse in trade has indeed been overstated.

- Enterprises considered the breakdown of the banking system as by far the most serious obstacle to trade. Yet, this perceived obstacle was really a symptom of larger problems that reflected the growing divergence between Ukraine's market and that of the ruble zone. Although purely mechanical problems played a part, other significant underlying factors were distorted prices, high inflation, and interenterprise arrears. Other frequently cited obstacles to trade included the inconvertibility of the karbovanets and the instability of the legal system.
- Enterprises responded differently to the changing trade environment. Those that adapted best were more likely than not to be traders, to be small, to produce or trade in consumer and other "light" goods, to be less dependent on interrepublican trade, to receive less direct government support, to make greater use of direct sales and independent distribution networks, to have more extensive contacts with overseas markets, and to have shifted from shrinking Soviet markets to other market areas.

Enterprise Profiles

The survey, conducted in four cities from mid-February to May 1993, covered 341 enterprises: 78 in Kharkov, 114 in Kiev, 75 in L'vov, and 74 in Odessa. Slightly more than half (178) the enterprises were identified as primarily "traders" and the remainder (163 enterprises) as primarily "producers" (see appendix for survey methodology and

selection process). Because the characteristics and behavior of the two groups varied significantly, they are analyzed separately.

The average producing enterprise in the sample employed 580 people and had been in business for a little more than fourteen years. By far the largest enterprise in the sample was a holding company in Kharkov—its primary activity was identified as production—that employed 100,000 people.¹ The average trading enterprise employed 68 people and had been in business for almost three years.

Producers were more likely to be state owned than were traders and were also more likely to be leased or collectively owned,² two common ways of "privatizing" state property in Ukraine (table 4.1). Traders, on the other hand, were rarely state-owned and had greater concentrations of private ownership than did producers.

The sample yielded thirty purely state-owned enterprises, twenty-five of them producers and five traders (table 4.2). These enterprises are referred to as state enterprises under the narrow definition. Seventeen more enterprises (eight producers and nine traders) with mixed ownership forms classified themselves as state enterprises by juridical status. Since the sample of state enterprises was so small, particularly for trading companies, a broader category of state enterprises was determined on the basis of the juridical status of firms. Firms with the juridical status of "state enterprise" or "other" were classified as state-owned since they were likely to share characteristics typical of state forms of ownership such as greater age, larger numbers of

Table 4.1 Ownership Structure of Enterprises in the Sample Population, February-May 1993 (percent of enterprises)

Ownership	Producers	Traders
100% State-owned ^a	15	3
100% privately owned	46	63
100% Collective ownership	10	4
100% Owned by other enterprises	2	5
100% Leased	8	1
Mixed ownership (includes foreign owners)	18	24

a. 100 percent of ownership shares belonged to the state.

Table 4.2 Distribution of Firms by Ownership Type as of February-May 1993

	Producer	Trader	Narrow state	Narrow private	Broad state	Broad nonstate
Number of firms	163	178	30	187	65	274 ^a
Age of firm (years)	14	3	40	2	33	2
Number of employees	580	68	1,940	47	1,348	77
<i>Percentages</i>						
State owned	17	4	100	0	46	1
Privately owned	53	69	0	100	11	74
Leased	9	2	0	0	23	1
Collective	13	5	0	0	16	7
Other	8	20	0	0	4	17
Total	100	100	100	100	100	100

a. Two firms in the sample refused to identify their status.

Source: Author's survey

employees, and high levels of "state," "collective," and "leased" ownership. Enterprises with the juridical status of "joint stock," "cooperative," "joint venture," "limited liability," "small enterprise," "partnership," and "sole ownership" were grouped as nonstate enterprises because they were more likely to be structured as small, privately owned enterprises. These broader categories are generally used in comparing state and nonstate enterprises.

In many instances, there was little distinction between the behavior of producer and state-owned enterprises or between that of traders and nonstate enterprises. In general, then, this report does not distinguish between these groups except when there are significant differences between them.

Major Trading Partners

All survey participants had engaged in trade outside of Ukraine at some point in the last three years, either within the former Soviet Union,³ abroad, or in both market areas. Trade within the boundaries of the former Soviet Union was, not surprisingly, more common, with 92 percent of the sample reporting such trade in the past three years and 62 percent reporting trade with the "far abroad."

All enterprises in the survey reported high levels of interrepublican trade over the past three years.⁴ As expected, enterprises in Kharkov were far less likely to have overseas trading contacts than enterprises in any other city (only 35 percent reported); Odessa enterprises reported just the opposite (figure 4.1).⁵

State-owned producers were more likely to report trade with Russia than were non-state producers; they also reported more extensive contacts with partners in other countries of the former Soviet Union than did the other groups (table 4.3).

Trade with Russia, Belarus, and the Baltics was consistently reported as occurring regularly, while trade with Central Asia and the Caucasus was seen as increasingly unreliable. Although past trading patterns clearly influence current patterns, it seems that enterprises are reorienting themselves toward markets on the basis of proximity, relative wealth, and political stability.

Figure 4.1 Percentage of Enterprises Reporting International Trade by Major City

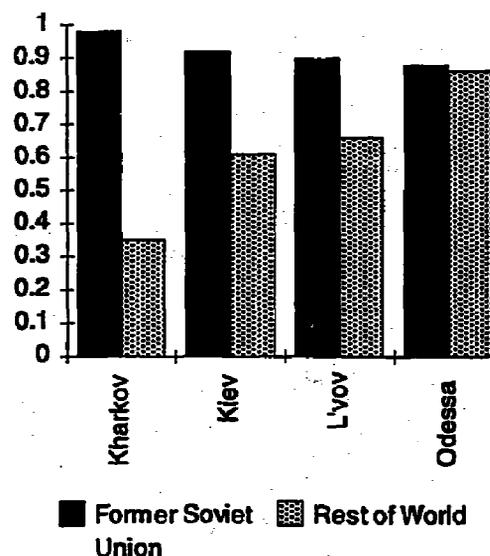


Table 4.3 Primary Trading Partners, 1990-93
(percent)

Trade Partner	Average	Producers		Traders	
		State	Nonstate	State	Nonstate
Russia	89	100	89	89	87
Belarus and Moldova	50	91	48	53	40
Caucasus ^a	22	65	17	21	13
Baltic States	42	80	39	53	32
Central Asia ^b	28	76	29	16	16

a. Georgia, Armenia, and Azerbaijan

b. Kazakhstan, Kyrgyz Republic, Tadjikistan, Turkmenistan, and Uzbekistan

Source: Author's survey

Table 4.4 Goods Traded and Produced
(percentage reporting)

Traders reporting trade in:	%	Producers reporting production of:	%
Consumer goods	82	Consumer goods	68
Services/intellectual property	46	Services/intellectual property	39
Industrial/half-finished goods	36	Industrial/half-finished goods	23
Agriculture	29	Agriculture ^a	6
Equipment	24	Equipment	23
Chemicals/raw materials	23	Chemicals/raw materials	5
Fuels	19	Fuels	2
Wood/paper products	9	Wood/paper products	16
Building materials	19	Building materials	14

a. The low proportion of agricultural activity reflects the urban bias of the sample; most food processing plants are located in rural areas.

Source: Author's survey

Outside the former USSR, the most commonly reported trading partners were European ex-members of the Council for Mutual Economic Assistance (CMEA).⁶ The top five trading partners with the rest of the world for the sample as a whole were Germany,⁷ Poland, the United States, Bulgaria, and the Czech and Slovak Republics. Other top trading partners were Hungary, Austria, Italy, Israel, and China. Overseas trading partners were located as far away as Australia and in as diverse places as Argentina, Gibraltar, Singapore, and Zimbabwe.

Goods Produced and Traded

For traders, the two most commonly traded items were consumer goods (82 percent of traders reported sales) and services and intellectual property (46 percent), both of which are loosely regulated "goods" that do not require high levels of capital investment or long-term cost recovery, making them attractive to small, relatively young trading companies (table 4.4). The next most commonly traded good was industrial and half-finished goods (36 per-

cent). Although traders no doubt purchased some of these goods as production inputs for their own parent enterprise, traders are moving them in such large quantities as to strongly suggest that traders play a significant role at the wholesale level as middlemen for producers. Traders' involvement with chemicals and other raw materials, equipment, and fuels also tends to support this view.

Although it may seem surprising in a country known for its lack of consumer goods, nearly 70 percent of producers reported manufacturing consumer goods. It may be that in recent years production enterprises have shifted at least small parts of their plant to the production of consumer goods, making it more likely that producers would report manufacturing them, no matter how small a share of total production. (Producers were not asked to describe relative proportions of total plant devoted to each item they produced.)

Changes in Distribution Patterns

Some analysts have argued that the state distribution system should be kept in place in a truncated

form until a private distribution system evolves to take its place in order to:

- Help ensure the delivery of key strategic goods, such as fuel and other raw materials, to provide continuity during a difficult transition.
- Help keep prices stable under the system of administrative price setting.
- Keep the mafia out of the distribution of basic goods, to prevent pricing vulnerable groups out of the market.

Our interviews indicate that the state system is not fulfilling these basic functions, particularly at the retail level. In both retail and wholesale trade, firms are increasingly taking on distribution functions themselves, either by investing in new distribution entities or by contracting with private intermediaries. So many private entrepreneurs are involved in distribution now that if the system were officially "privatized," there would be enough entrants ready to take over the state's role and adequate competition to prevent the exercise of monopoly power by any single private company.

Private Alternatives to State Distribution

The anecdotal evidence makes it overwhelmingly clear that the private sector is capable of fulfilling deliveries at the retail level, while the state sector does not appear to be performing as well. The abundance of goods at the local farmers markets, private shops, kiosks, and the bazaar at the Republican Stadium in Kiev⁸ and the nearly empty shelves in state shops speak eloquently of the private sector's performance advantage. "Price stability," implemented through state acquisition of goods at below-market prices and limitations on price markups, has led to shortages and rationing in the state shops. With goods either unavailable or rationed through queuing, the low prices are meaningless. And since state shops are turning increasingly to imported goods supplied by private entrepreneurs they are passing on "commercial" (non-controlled) prices to their customers, regardless of the government's attempts at price control.

At the wholesale level, sales and purchases need to be considered separately. On the sales side, survey interviews suggest that the state system is not functioning competitively. Producers are avoiding the state distribution system when they can either by selling directly to end users (presumably because they get a better price than by selling through an intermediary) or by selling through private rather than state intermediaries (table 4.5). Enterprises reported selling 80 percent of their goods in Ukraine and 73 percent of their goods to other countries of the former USSR directly to end users, either through retail outlets or to other production enterprises. Producers made a surprisingly high percentage (11 percent) of sales in Ukraine directly to consumers through their own shops and kiosks, which suggests growing involvement by producers in retail trade. The remaining goods were sold through intermediaries, both state and privately owned. Enterprises used state intermediaries for 9 percent of sales in Ukraine and 5 percent of sales in other countries of the former Soviet Union and nonstate intermediaries for 11 percent sales in Ukraine and 19 percent sales in other countries of the former Soviet Union.

On the purchases side, the State Committee for Material Resources (SCMR) has privileged access to raw materials through the system of state orders and state contracts, purchasing raw materials (including energy imports from Russia) at below-market prices and distributing them to favored producers at similarly low rates. Despite the privileged position of the state distribution system, an alternative distribution system has emerged, even in the procurement of "strategic goods." Although government-allocated supplies of cheap raw materials are undoubtedly attractive to qualifying enterprises, new entrants to the procurement market could compete with government suppliers in the relatively large market of firms with no access to the cheap raw materials and firms unable to meet their full needs with the limited supplies provided by this system.

Traders appear to be heavily involved in wholesale trading. Thirty six percent of traders report trade in industrial and half-finished goods, 24 percent in equipment trade, 23 percent in chemicals and other raw materials, and 19 percent in fuels.

Table 4.5 Distribution of Enterprise Sales (percent)

	<i>In Ukraine</i>			<i>In other countries of the former Soviet Union</i>		
	<i>Average</i>	<i>Producers</i>	<i>Traders</i>	<i>Average</i>	<i>Producers</i>	<i>Traders</i>
Company-owned store	15	11	18	3	6	0
End user, state	37	46	29	41	52	31
End user, nonstate	29	26	31	32	22	41
Subtotal, direct sales	81	83	78	76	80	72
Intermediary, state	9	10	8	5	5	6
Intermediary, nonstate	11	8	14	19	15	22
Subtotal, indirect sales	20	18	22	24	20	28

Note: Percentages may not total 100 because of rounding
Source: Author's survey

As is the case with sales, producers increasingly diversified their purchasing activities in order to find secure lines of supply as the state distribution system weakened. Fully 85 percent of producers interviewed reported regularly engaging in "trade/commerce" in addition to the production described as their main activity, most likely because trading was becoming essential for ensuring production inputs. Asked for the main reason for declining production, 23 percent of enterprises that experienced such declines blamed "irregular deliveries."

Many enterprises are establishing private affiliates to address key infrastructural needs formerly handled by the state. More than three out of four surveyed firms had at least one investment in another company in Ukraine or in another country of the former Soviet Union, suggesting that enterprises are taking stakes in other firms to help ensure the delivery of inputs (table 4.6). Several producers also reported forming their own trading companies—separate from the firm but with a substantial ownership share—to sell the enterprise's goods and help procure inputs for production and consumer goods for the enterprise's employees. The large investments by producers and traders in retail space (both kiosks and shops) and in trading companies are further evidence of a shift away from the state distribution system.

The Mafia and Government Licenses

That so many enterprises are providing their own distribution services and trading independently suggests that the mafia would have difficulty capturing enough of the market to pose a serious threat

were massive privatization of the distribution and procurement system to take place. Indeed, survey respondents ranked the mafia as one of the weakest obstacles to trade both within and outside the former Soviet Union. Although the mafia is likely to be more of a threat at the retail level domestically, respondents felt that it was a threat that could be handled. A number of survey respondents even remarked that they preferred dealing with the private mafia over dealing with the "government" mafia (bureaucrats responsible for issuing licenses of various sorts), noting that one generally got something for one's payment to the private mafia (protection, retail space, and the like), while payments to the government mafia simply removed an obstacle to productive activity.

The government's role as guarantor of strategic goods creates an environment ripe for corruption. The license conveys an economic rent that provides an incentive to "lobby" government officials. It was widely believed among respondents that the "gatekeepers" for export licenses are generally able to provide comfortably for themselves financially. The alternative to navigating the complicated and expensive foreign trade bureaucracy is smuggling. There was evidence in the survey data that some respondents had resorted to smuggling.

Patterns of Trade and the Increasing Importance of Unrecorded Transactions

According to recent estimates (table 1.2 in this volume), Ukrainian exports (imports) to the other newly independent states in 1993 may have been as

low as 28 (48) percent of their value in 1990 (see table 1.2 above, based on constant rubles); and Ukrainian exports (imports) outside of the former Soviet Union in 1993 only 47 (30) percent of their value in 1990 (table 1.1). Although the results of this survey generally echo these declines, the survey also confirmed that official data are likely to overestimate the decline. First, the enterprise surveys used to estimate interrepublican trade are unlikely to include the private traders that have entered the market in the past three years. The survey results reported here suggest that these are precisely the firms that are experiencing growth under new market conditions. Second, statistics based on customs declarations, which are used to estimate overseas trade, are unlikely to include smuggled goods, personal imports, and imports of goods that have traditionally been of little interest to the Ukrainian government (particularly consumer goods). Trading companies, the most likely to experience increased trade activity in foreign markets, trade overwhelmingly in consumer goods and frequently use personal imports as a means of getting around customs regulations. There were also strong indications in the survey data of increases in black market trade for the entire sample population.

Trade Realignment

Changes in the direction of trade were determined on the basis of two sets of questions. First, enterprises were asked to describe the share of the monetary value of total sales and purchases devoted to four market areas (Ukraine, Russia, other

countries of the former USSR, and the rest of the world). Producers were asked for trade shares at the time of the survey and three years previously; traders were only asked about current trading patterns since most of them did not exist three years ago. Next, enterprises were asked to describe changes in trade activity as measured by changes in the number of sales and purchase transactions in the past three years within three market areas (Ukraine, other ex-Soviet republics including Russia, and the rest of the world). To accommodate enterprises unwilling to discuss absolute levels of sales or purchases, changes in transactions were defined in relative terms: increased by more than 50 percent, less than 50 percent, or remained the same; decreased by more than 50 percent, less than 50 percent, or fell to zero. Although straight value and volume measures would have been preferable to such indirect indicators, high rates of inflation, confusion about which currency units to use,⁹ and the wide variety of goods produced by any single enterprise made providing more concrete data prohibitively costly.

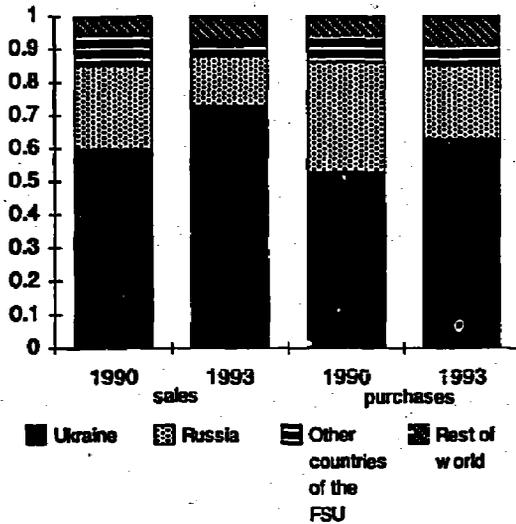
Trade Shares. Trade patterns among the surveyed firms shifted considerably over the first three years of the decade, exhibiting a strong trend away from markets of the former Soviet Union and toward domestic and hard currency markets (figure 4.2). Producer sales to Russia are estimated to have dropped from 25 percent of total sales in 1990 to 15 percent of total sales in 1993, while purchases fell from 33 percent to 22 percent.¹⁰ Trade with other countries of the former USSR besides Russia,

Table 4.6 Investments in Secondary Firms (percent)

	<i>Producers</i>		<i>Traders</i>	
	<i>Ukraine</i>	<i>Other countries of the former Soviet Union</i>	<i>Ukraine</i>	<i>Other countries of the former Soviet Union</i>
Trading companies	20	8	32	17
Retail outlets/kiosks	38	4	46	5
Service enterprises	12	5	14	3
Commercial banks	29	4	20	1
Production enterprises	44	11	23	8
Transport	5	2	6	2
Joint ventures	26	0	26	0

Source: Author's survey

Figure 4.2 Percentage of Producers' Trade by Market Area, 1990 and 1993



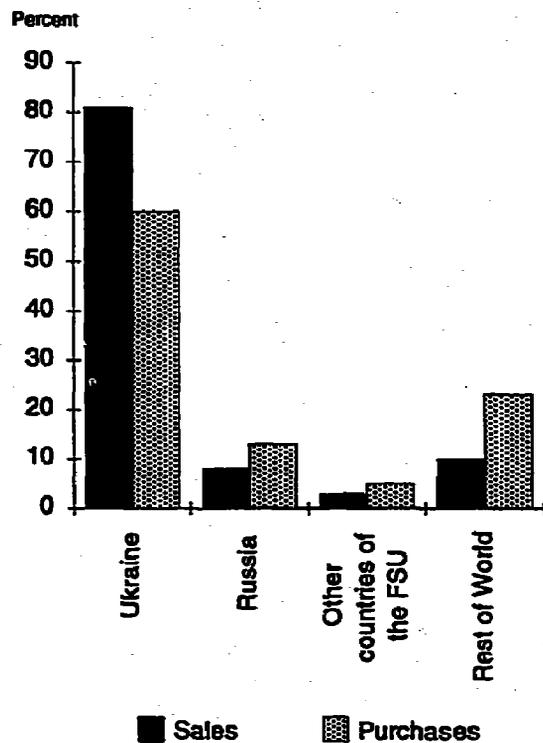
although never accounting for a significant proportion of Ukraine's trade, also appears to have shrank considerably, particularly on the sales side, from 9 percent to 5 percent.

Following its introduction into cash circulation in early 1992, the Ukrainian karbovanets dropped steadily in real value relative to the ruble.¹¹ Growing price differentials between Ukraine and trading partners still in the ruble zone explain much of the drop in the share of purchases from former Soviet markets. Lower prices in Ukraine relative to prices in other countries of the former Soviet Union induced producers to turn to domestic suppliers for inputs. For the sample population the proportion of purchases sourced domestically rose from 54 percent of the total in 1990 to 63 percent in 1993.¹²

Over time, trade with Russia and other countries of the former Soviet Union began to fall under the same controls as other foreign trade, including the system of quotas and licensing and mandatory foreign exchange conversion schemes. Quotas and licensing depressed sales of low-priced Ukrainian exports to Russia, while the extension of foreign exchange surrender requirements (at below-market exchange rates) to rubles further limited the legal supply of rubles available to purchase Russian imports.

Interstate trade as a proportion of total trade flows has not been as important to traders as to producers, accounting for only 10 percent of total sales, compared with 20 percent for producers (figure 4.3). Purchases were more common from other countries of the former Soviet Union, representing 16 percent of the total, but this was still far below the 28 percent share for producers. Several factors help explain the relative unimportance to traders of markets in the former Soviet Union. Most traders began to operate at a time when trade with other countries of the former Soviet Union had become logistically difficult. Also, traders found it difficult to enter these markets because of the traditional dominance of the markets by large state entities, such as the SCMR, which had various unfair advantages (privileged access to local raw materials, to export licenses, to foreign exchange, payment order processing through the central bank's correspondent accounts in 1992, and monopoly control of trade arranged through intergovernmental agreements). The larger margins available to traders in overseas

Figure 4.3 Proportion of Traders' Sales and Purchases in Each Market Area, February-May 1993



markets relative to former USSR markets also influenced trade shares.

Traders operate chiefly on the domestic market, although they also play an important role in importing goods from the far abroad (see figure 4.3). The high proportion of purchases within Ukraine suggests that traders are helping to keep goods moving domestically as centralized supply lines fall apart. There is no reason to believe that traders could not play a similarly important role in external markets if allowed to compete with the state trading monopoly on fair terms.

Trade activity. Corresponding to the sizable fall in the proportion of trade with the former Soviet Union, enterprises experienced large drops in the number of sales and purchase transactions in these market areas (table 4.7). Roughly 60 percent of producers and traders reported decreased trade activity with other countries of the former Soviet Union, and 30 percent of traders reported that their trade activity with other countries of the former Soviet Union fell to zero. Not surprisingly, decreased trade activity with other countries of the former Soviet Union was accompanied by increased activity in domestic markets.

Changes in trade activity in European and other markets are particularly interesting. A surprising

number of enterprises—even among producers—reported increased activity in these markets, a trend that runs counter to expectations, given the large drops in trade with the rest of the world reported in official estimates. This aggregate outcome is easily explained by the sizable drops in trade by large state enterprises with their correspondingly large import and export volumes, losses only partially offset by the increased trade of many small enterprises with correspondingly small trade volumes. This argument is supported by producer transaction data weighted by enterprise size (table 4.8). But even among larger enterprises, many reported increases in trade activity, particularly on the import side.

Overwhelmingly, traders of all sizes reported substantial increases in foreign trade activity, reinforcing the claim that traders are becoming increasingly active as middlemen in overseas markets (table 4.9).

Traders were able to increase their activities abroad because of a general loosening of restrictions on participating in external trade. Although the system of quotas and licensing is restrictive and tends to favor players with connections, everyone now has the right to participate in foreign trade—not just the handful of large state enterprises restricted to buying and selling goods through large

Table 4.7 Reported Changes in Number of Transactions in Each Market Area (percent)

<i>Change in Transactions</i>	<i>Producers</i>		<i>Traders</i>	
	<i>Imports</i>	<i>Exports</i>	<i>Imports</i>	<i>Exports</i>
<i>Trade activity with the former Soviet Union</i>				
Up	25	28	27	22
Same	16	9	11	18
Down	45	47	33	27
Down to Zero	14	16	30	33
<i>Trade activity with the far abroad</i>				
Up	49	37	52	51
Same	11	12	22	23
Down	22	26	19	18
Down to Zero	18	25	7	8
<i>Trade activity - domestic</i>				
Up	64	71	72	79
Same	16	8	12	8
Down	19	21	16	13
Down to Zero	1	1	0	0

Note: Percentage may not total 100 because of rounding.

Table 4.8 Changes in Producers' Overseas Trade Activity Weighted by Size of Enterprise (percent)

<i>Number of employees</i>	<i>Imports</i>		<i>Exports</i>	
	<i>Up/same</i>	<i>Down/none</i>	<i>Up/same</i>	<i>Down/none</i>
Fewer than 250 (50 firms)	66	34	60	40
More than 250 (21 firms)	48	52	27	73
Average	60	40	49	51

Table 4.9 Changes in Reported Trade Activity with the Rest of the World (percent)

<i>Change in transactions</i>	<i>Producers</i>		<i>Traders</i>	
	<i>Imports</i>	<i>Exports</i>	<i>Imports</i>	<i>Exports</i>
Up/same	60	49	74	74
Down to zero	40	51	26	26

state trading agencies a few years ago. By choosing to trade in consumer goods and services and intellectual property, which were unregulated, traders could bypass government controls, providing further scope for trade expansion overseas.

The emphasis on consumer goods makes it likely that these transactions are unrecorded, since the Ukrainian government has paid little attention to consumer goods preferring to focus instead on large industrial goods. Still other imports go unrecorded because of a reliance by trading companies on personal imports. Trading companies regularly send people abroad on cheap shopping junkets to buy goods to take advantage of personal exemptions on import duties (Bull 1994). (Ukraine's allowance for duty-free personal imports is \$10,000.

Expanding Unofficial Trade

The restrictive policy environment in Ukraine at the time of this study would be expected to induce smuggling and creative trade financing schemes. Quotas, licensing, mandatory conversion of half of foreign exchange earnings, a collapse in the payments system and effective price increases for Russian goods made trading difficult business for anyone trying to play by the rules. At the time of this study, Ukraine was just beginning to open customs posts with other countries of the former Soviet Union and comments by interviewees suggest that it

was reasonably easy to evade customs officials in the early days. When problems arose, it was usually possible to "resolve" customs disputes with financial incentives to the right person.¹³

From the data in this survey, it is difficult to distinguish which transactions were not recorded at all, which were partially recorded, and which were physically recorded at the border, but financed creatively. Not all of the types of transactions discussed here could consistently be associated with smuggling, but it is likely that many of them occasionally were. Each of these means of unofficial trade would have contributed to underreporting and undervaluing of trade transactions, helping explain the inconsistency between official statistics and trends observed for many traders.

Enterprises were extremely reluctant to admit to unofficial trade,¹⁴ but two indicators provide some idea of its magnitude: the means of payment for purchases abroad or for sales in other countries of the former Soviet Union (table 4.10) and the source of hard currency obtained by enterprises (table 4.11). Types of payments likely to elude official statistics—such as barter, cash payments, and payments to offshore accounts—were frequently reported by survey respondents for both interstate trade and trade with the rest of the world. (Payment documents are part of the transaction documentation required at the border.) Deals settled in cash or

through payments to offshore accounts were likely to be illegal, particularly after off-shore accounts for enterprises were restricted in the spring of 1993. Barter deals were officially tracked by the Ukrainian government, but there were a number of reasons why many of them might not have been recorded. High taxes on barter trade in the period before the study were a strong incentive for keeping the deals quiet. Also, until January 1993, enterprises were required to obtain special licenses to engage in barter trade. Like other licenses, these were difficult to come by and many people bypassed them. Finally, many barter deals were not directly a goods-for-goods transaction but involved more than two partners; Ukrainians consider these deals to be "clearing" arrangements and would not have recorded them as barter.¹⁵

The proportion of transactions paid for through bank transfers, though remaining high, was less than the 100 percent it would have been before the breakup of the Soviet Union. Even within the banking system, enterprises found creative, unofficial ways of making payments. For example, although it was illegal for a Ukrainian firm to open a ruble account in Russia, a number of firms had them, some having opened before they were disallowed, some not. Producers reported making 6 percent of their payments to other countries of the former Soviet Union through these accounts and traders 4 percent. Enterprises without bank accounts in the ruble zone often sent and received payments through a partner's account in another republic—an account used jointly with a relative or trusted friend

eligible to establish an account in that country. Traders, who generally had less access to official transfer systems in the second half of 1992, reported paying for 23 percent of their purchases through such proxy accounts. Producers used this method for 17 percent of payments to other republics (table 4.12).

The second indicator of unofficial trade activity was the source of hard currency obtained by enterprises. A surprising number of respondents volunteered the information—the question was not asked directly—that they had obtained hard currency on the black market. That suggests that the use of illegally obtained hard currency is even more widespread than estimated in this study.

Firms did not resort to unofficial trade solely as a means of expanding trade, although enterprises that frequently used cash or proxy payments were more likely to experience increases in trade than enterprises that did not. But many firms, particularly production enterprises, were driven to barter by the inefficient monetary and payments system. Thus enterprises that relied heavily on barter were consistently more likely to experience a diminution in trade activity in both market areas, with one interesting exception: some traders used barter as a tool for increasing their activity in other countries of the former USSR. Traders that increased their trade with countries of the former Soviet Union reported paying for 37 percent of their purchases with barter exchanges, compared with 27 percent for the total sample. Thus for certain traders that specialize in trade with other countries of the former USSR, barter may be a tool for getting around

Table 4.10 Means of Payment for External Trade Transactions
(percentage of sales or purchases)

	<i>Exports to former Soviet Union</i>		<i>Imports from the rest of the world</i>		
	<i>Producers</i>	<i>Traders</i>	<i>Producers</i>	<i>Traders</i>	
Bank Transfer	70	65	Hard Currency - Transfer	62	52
Cash (karbovantsi/rubles)	8	8	Hard currency - cash	7	13
Barter	21	27	Barter	23	24
Hard Currency	1	1	Other a	7	11

Note: Percentages may not total 100 because of rounding.

a. Mostly karbovantsi purchases for foreign goods. A number of foreign companies have begun selling goods in Ukraine for karbovantsi, taking a short-term loss in the hope of long-term profits.

Source: Author's survey

Table 4.11 Sources of Hard Currency Obtained by Enterprises^a (percent)

Source	Producers	Traders
Earned from sales	76	56
Purchased on auctions	16	17
Purchased from commercial banks in Ukraine	24	31
Purchased from other firms in Ukraine	17	22
Purchased from commercial banks in former Soviet Union	4	12
Black market	13	15

a. Rubles are not included as hard currency.

Source: Author's survey

Table 4.12 Sources of Payments Received for External Sales in the Former Soviet Union

	Producers	Traders
Commercial banks in Ukraine	58	56
Commercial Banks in former Soviet Union	6	4
Affiliated organizations in former Soviet Union	17	23
National Bank of Ukraine	9	a
Other	10	18

a Included under "other".

Source: Author's survey

payments difficulties and licensing requirements. Since these firms specialize in finding goods that others want to buy, they would have the necessary information and a sufficiently regular flow of different types of goods to make barter work. As specialists in locating goods, traders with good information and contacts in other countries of the former Soviet Union could work on behalf of other enterprises in this market area.

Obstacles to Trade

Survey respondents were asked to rank various factors according to the severity of the impediment they presented to trade on a scale of one to five (the higher the number, the greater the obstacle). For the sample as a whole, the collapse of the payments system was by far the largest perceived obstacle to export in interstate markets with a rating of 4.7 (Figure 4.4.). Inconvertibility of currency at 4.3, came next, followed by legal system instability at

3.9. Traders and producers were unanimous in their top three choices, although traders tended to assign slightly higher scores in all three areas than did producers.¹⁶ For trade outside the former Soviet Union, the greatest obstacles to exports were inconvertible currency (4.4), legal system instability (4.2), and high taxes (3.7; figure 4.5).

The Banking and Payments System

The overwhelming agreement among respondents that the collapse in the payments system in the second half of 1992 was responsible for shrinking trade with other countries of the former Soviet Union raises the question of whether the collapse of interstate transfers was a root cause or a symptom of a larger problem. Anecdotal evidence accumulated over the course of the survey suggests that the logistical inability to transfer payments to Russia and other republics was perceived as the principal factor diminishing trade flows with the former Soviet Union at the end of 1992 and beginning of 1993, but that toward the end of the survey period respondents were beginning to believe that cost was overtaking logistics as an obstacle: Russia was simply getting too expensive.¹⁷ The demise of the united banking system itself reflects the underlying cause of the problem: the divergence of two once-united markets that now had substantially different economic policies—complicated by Russia's growing unwillingness to subsidize its exports to Ukraine. The ranking of the inconvertibility of the currency second to the payments system as an impediment to exports to the former Soviet Union suggests that enterprise managers were already becoming aware of the difference between the purely mechanical payments problem and the underlying economic causes of the collapse.

As the divergence in economic conditions between the two markets grew wider (because Russia pursued price reform more aggressively than Ukraine and had a tighter monetary policy), the banking system could no longer sustain a currency system in which the ruble-karbovanets exchange rate for bank transfers remained 1:1 while the cash rate was 1:1.5 (November 1992), and growing rapidly.¹⁸ Once Ukraine exited the ruble zone alto-

Figure 4.4 Ratings of Obstacles to Export in Interstate Trade
(scale of 1 to 5; the higher the number, the greater the obstacle)

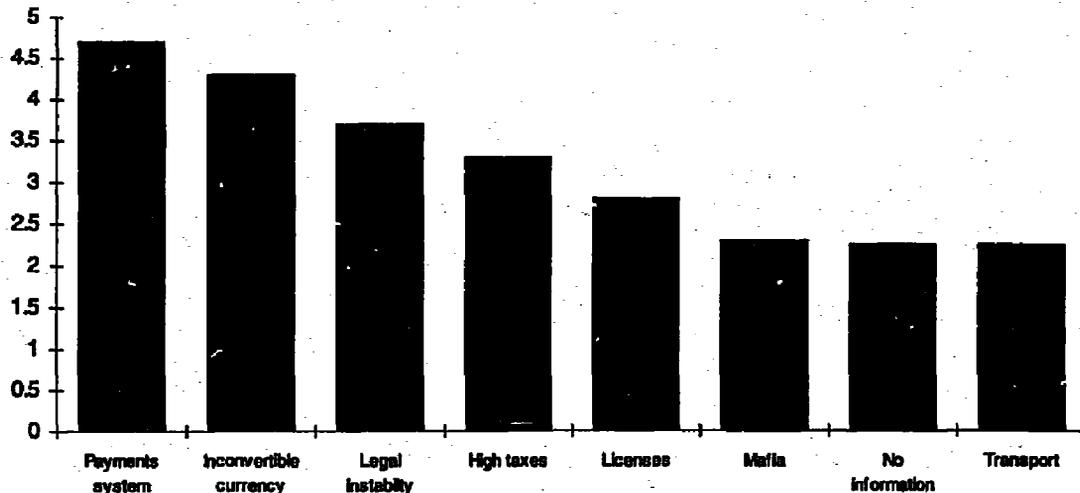
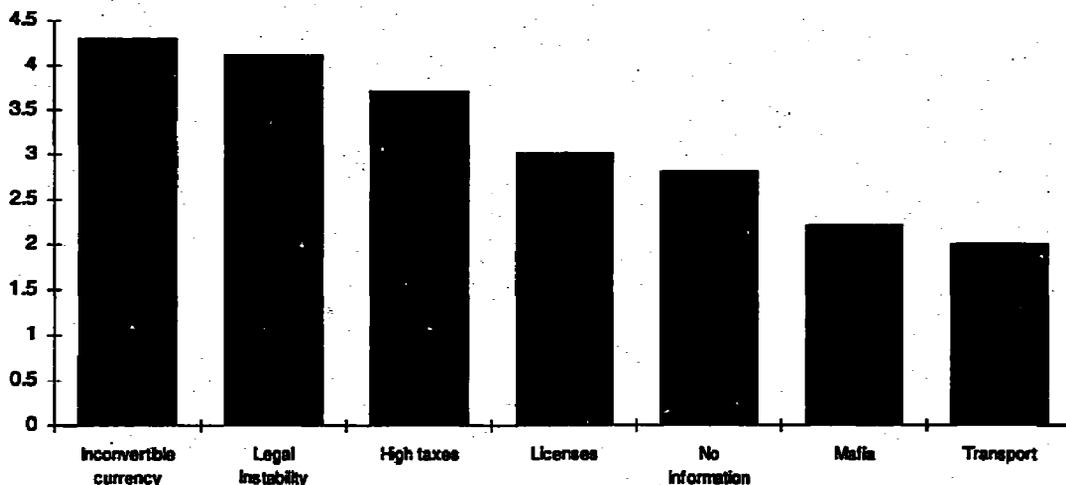


Figure 4.5 Ratings of Obstacles to Export in Trade with Rest of World
(scale of 1 to 5; the higher the number, the greater the obstacle)



gether in November 1992, the ruble became a (relatively strong) foreign currency.¹⁹ Since the Ukrainian government could no longer create non-cash ruble credits, rubles were valued according to their scarcity price causing the prices of Russian goods to skyrocket overnight for Ukrainians and diminishing the price differential between Russian imports and those from the West. In April 1993 the Ukrainian government placed interstate trade under the same quota and licensing regime as other foreign trade in order to prevent Russians from buying up relatively cheap Ukrainian goods. At the same

time, the ruble was placed under the compulsory conversion scheme, further restricting the supply of ruble foreign exchange available legally to Ukrainian enterprises. Ukrainians were then forced to buy rubles at market prices or find creative "unofficial" ways to finance their trade with Russia and other countries of the ruble zone, just as they had begun to do in overseas markets.

The reason for the frustration of enterprise directors is clear from an examination of the damage caused by a combination of purely mechanical banking problems, runaway inflation and interenter-

prise arrears. During the second half of 1992, surveyed enterprises experienced an average delay of 72 days before transfer payments from other republics reached their accounts and were released for use. Since the Ukrainian transfer system was simply an outgrowth of the old centralized Soviet system, problems emerged for payments within Ukraine as well, where the average wait to receive domestic payments was seventeen days. High inflation aggravated the situation by inducing commercial banks to hold money as long as possible, so that they could lend it out as short-term loans. More than one enterprise described protracted struggles simply to get already-transferred money out of their own accounts.

Producers, because they were more likely than traders to use the bank transfers system (and to use it in larger volumes), experienced greater delays: an average of nineteen days for domestic payments and eighty-two days for producers' interstate payments compared with fourteen days (domestic) and sixty-four days (interstate) for traders. On average, producers reported not having received 7.8 payments—payments that should have been sent to their accounts at some time since the beginning of 1992, but had not yet arrived at the time of the interview (early 1993). Traders reported 1.4 payments still outstanding.

State-owned enterprises were much more likely to lose through the payments system than were nonstate enterprises: 24 days for domestic payments for state enterprises compared with fourteen days for nonstate enterprises, 82 days for interrepublican payments compared with 68 days. State enterprises were far more likely to have payments outstanding than were nonstate enterprises: sixteen payments, compared with one for nonstate enterprises. By the time enterprises realized that there was a significant problem with payments, the average state enterprise would have had far more payments in the system than the average nonstate enterprise. Furthermore, correctly guessing that they would ultimately be bailed out, state enterprises continued to make deliveries to Russia, even after it became clear that Russian enterprises were not making payments. This expectation was undoubtedly a principal factor

in the buildup of interenterprise arrears in the second half of 1992.

Legal System Instability, Taxes, and Other Common Complaints

The legal turmoil that followed the collapse of the Soviet Union made it inevitable that firms would cite legal system instability as an impediment to greater exports. In 1992 alone, the Ukrainian tax code changed three times. Export licensing has changed radically four times since July of 1991, with substantial legal adjustments occurring between the major upheavals. Foreign exchange rules have changed continually as well. This instability, exacerbated by the absence of a reliable mechanism for publicizing changes in the law, forced businesses to waste resources trying to keep up with the law and frequently led to unanticipated business losses, particularly when businesses were forced by legal changes to recalculate their taxes.

Both producers and traders ranked high taxes fourth as an impediment to interrepublican trade at 3.2 and third for trade abroad at 3.7. There was no significant difference in assigned ratings between producers and traders or between state and nonstate enterprises, nor was there any significant difference between the two populations in reported taxation rates (the average was 44 percent) or in the likelihood of receiving tax breaks. Only 28 percent of enterprises reported receiving tax breaks of any kind (usually as a startup enterprise, a joint venture, or for production of a good considered important to the Ukrainian economy).

Though the licensing system has changed significantly since the time covered by the survey, one finding probably remains relevant. Traders consistently viewed obtaining a license as a more serious problem than did producers, giving it a 3.6 rating as an obstacle to interstate transactions compared with 2.8 for producers and a 3.6 score for overseas sales, compared with 3.0 for producers.²⁰ Similar differences emerged between nonstate and state enterprises, although less pronounced. Traders were also more likely to be turned down for a one-time license for a specific good: 22 percent of traders reported being turned down, compared with 15 percent of producers.

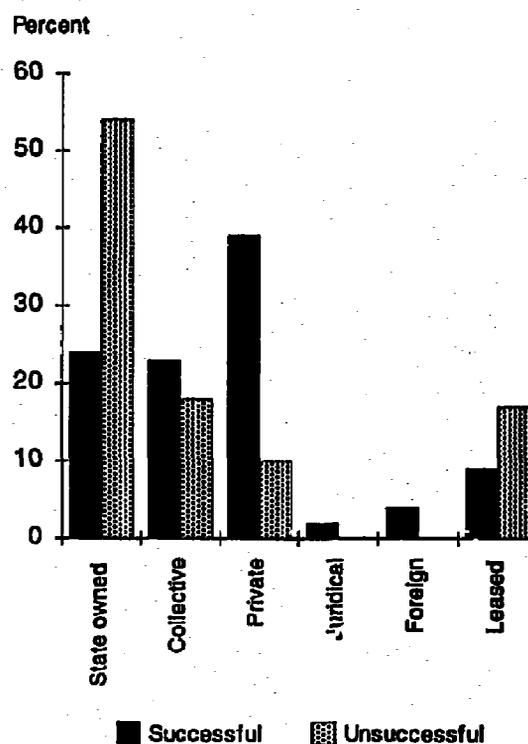
Surprisingly, the mafia consistently received very low scores as an obstacle to export, despite its pervasiveness in retail trade. A likely explanation is that the mafia is so ubiquitous (and the term so loosely defined and overused) and the people in Ukraine have become so accustomed to dealing with the "mafia" that it has become a regular part of the business routine and is therefore viewed as a cost of doing business rather than an obstacle to trade.

Profile of a Successful Producer

Although it seems clear that traders are thriving under the new economic conditions in Ukraine, the fate of producers is less clear. Traders sprang up as a result of the economic changes, whereas producers were more likely to be older and had to adapt to changing conditions. That the old state "dinosaurs" are struggling to survive is now widely accepted as fact, yet it is not true that all producers are failing. From a policy point of view, therefore, it is instructive to examine the types of strategies that allowed certain producers to grow, and the characteristics that kept others struggling to survive.

To distinguish "successful" enterprises from "unsuccessful" ones, producers were asked to describe how the volume of their production had changed over the past three years (increased or decreased by more or less than 50 percent, unchanged or dropped to zero.)²¹ In Ukraine's distorted economic environment, a designation of "successful" in no way implies that an enterprise is profitable, it simply means that it is surviving and in a position to expand production. To avoid picking up the natural growth effects of new enterprises, enterprises under three years of age were screened

Figure 4.6 Ownership Form of "Successful" and "Unsuccessful" Producers



out of the sample for the analysis of strategies of successful enterprises.

Nearly half (48 percent) of producing enterprises reported increases in the volume of production over the past three years, including 30 percent which experienced increases greater than 50 percent. Only 38 percent reported decreases in production, including 16 percent reporting decreases greater than 50 percent. Unsuccessful enterprises were far more likely than successful enterprises to be large, state-owned enterprises (table 4.13), with ownership concentrated in forms typical of state firms, such as collective ownership and leasing, in addition to straight state ownership (figure 4.6). The average unsuccess-

Table 4.13 Changes in Production Volume in the Past Three Years for State and Nonstate Enterprises (percent)

Change in production	Sample average	Broad definition		Narrow definition	
		State	Nonstate	State	Nonstate
Up	48	32	67	32	67
Same	15	16	13	8	17
Down	38	51	19	60	17
Number of enterprises	74	43	31	25	18

ful enterprise had 1,977 employees, compared with a relatively lean 709 for the successful enterprises.

Unsuccessful enterprises struggled to maintain production levels despite a greater likelihood of financial assistance from the government. Unsuccessful enterprises were far more likely than successful enterprises to have received credits in the past year (82 percent, compared with 59 percent of successful enterprises) and to have worked under state orders (82 percent, compared with 71 percent). Although it is clearly the government's intention that these supports should cushion the losses of large state enterprises, it seems equally clear that these "crutches" are not necessarily helping to encourage production, but are simply keeping people employed.

A primary reason for increasing production among successful enterprises appears to be their greater skill at making up for losses in interstate sales through new sales to domestic and, to a lesser extent, foreign markets. Both successful and unsuccessful enterprises experienced a similar substantial contraction in sales to other markets in the former Soviet Union of about 65 percent. But while 88 percent of successful enterprises reported increased sales in Ukraine, only 50 percent of unsuccessful enterprises did. These shifts to domestic markets do not necessarily mean that enterprises will be successful in the long run—there are still too many distortions in the domestic market to make any predictions about the ability of enterprises to stay afloat in the absence of government interventions—but they do indicate that these enterprises are responding to the price signals they observe. More successful enterprises (33 percent) than unsuccessful enterprises (25 percent) reported increases in foreign sales as well. Furthermore, successful enterprises were more likely to have foreign sales to begin with (57 percent) than were unsuccessful enterprises (50 percent).

The shift to domestic markets by successful producers seems to have been aided by a shift within Ukraine toward direct sales to end users—other production enterprises or retail shops and kiosks. Successful enterprises sold only 10 percent of their production through state intermediaries, compared with 20 percent of unsuccessful enterprises, and 85 percent reported direct sales to end users, compared

with 73 percent for unsuccessful enterprises. Furthermore, 54 percent of successful enterprises reported at least one investment in a retail outlet in Ukraine, compared with 43 percent of unsuccessful enterprises, suggesting that successful producers are increasingly managing their own retail trade as well. Successful enterprises were also more likely than unsuccessful enterprises to invest in trading companies in Ukraine and other countries of the former Soviet Union and in other producing enterprises, suggesting a more developed independent network of supply and distribution.

The types of goods produced probably also influenced the shift in sales to domestic markets. Enterprises producing large industrial goods that were part of integrated all-union production processes would have had a hard time selling these goods in Ukraine, much less in foreign markets. The production of "heavy" goods was more commonly associated with unsuccessful enterprises than successful ones, while "light" goods were more commonly manufactured by successful enterprises.²² (No more detail is possible about the role played by types of goods in the success of the enterprise because the proportion of total plant dedicated to the production of each type of good was not known.) Two production areas in which differences were significant were "industrial and half-finished goods," which were manufactured by 20 percent of successful enterprises and 32 percent of unsuccessful ones, and "services and intellectual property," which were produced by 37 percent of successful enterprises and 25 percent of unsuccessful ones.

Although successful and unsuccessful enterprises had an almost identical distribution of sales in each market area, unsuccessful enterprises were likely to be more dependent on imports from other countries of the former Soviet Union, relying on them for 45 percent of their inputs, (compared with 29 percent for successful enterprises). The heavy reliance on inputs from other countries of the former Soviet Union may explain the heavier shift to barter settlement for interrepublican transactions among unsuccessful enterprises than successful enterprises

The use of barter in interstate transactions was more commonly associated with unsuccessful enterprises (27 percent of their interrepublican transactions) than successful ones (15 percent). Once the barriers of separate currencies and state quotas on exports were erected between Ukraine and Russia, the only outlet for enterprises with no access to rubles would have been direct exchange or cash on delivery. With direct support from the state allocated more sparingly (even to priority enterprises), enterprises dependent on fuel and other raw material inputs from Russia (once heavily subsidized) would have been able to buy only as much in fuel inputs as they could sell in output in Russia, placing new limits on their production capacity. Similar trends were observed in foreign trade: unsuccessful enterprises were more likely to report frequent use of barter in foreign trade (49 percent of overseas purchases) than were successful enterprises (27 percent). More than half of unsuccessful enterprises (51 percent) blamed the malfunctioning payments system for their declining production, 23 percent blamed irregular deliveries, and 14 percent political instability.

Producers in Kharkov illustrate many of the points made about unsuccessful firms. Because of the city's location near the Russian border and an industrial profile of large, state-owned enterprises tightly integrated into the Soviet system, enterprises in Kharkov exhibit many of the characteristics of unsuccessful enterprises and were far more likely to experience declining production than enterprises in any other city in the sample: 60 percent of Kharkov producers reported decreases in production (including 26 percent reporting decreases of more than 50 percent), compared with 38 percent for the sample average (with 16 percent reporting decreases of more than 50 percent).

Both customs and taxes were consistently rated as greater obstacles to trade in Kharkov than in the rest of the sample. For interstate markets, taxes received a rating of 3.8 from Kharkov enterprises and 3.2 for the total sample; for overseas trade, the ratings were 4.4 for Kharkov and 3.7 for the sample average. The average reported tax rate was 55 percent in Kharkov, compared with 44 percent for the

total sample. Furthermore, enterprises in Kharkov were less likely to receive tax breaks than enterprises in any other city: 14 percent reported receiving tax breaks, compared with a sample average of 28 percent. Additionally, 73 percent of Kharkov enterprises reported that customs procedures with other countries of the former Soviet Union resulted in losses, while the sample average was only 65 percent.

Conclusions and Recommendations

The private sector is alive and well in Ukraine, although driven underground by the hostile legal and macroeconomic environment. The Ukrainian government should do everything it can to bring the private sector out of the shadows and turn it into an engine for economic growth. There is much to gain from encouraging small-scale entrepreneurship and little to lose. An obvious place to begin to improve the environment for entrepreneurs is trade—both domestic and external—an area in which private enterprises are thriving and that many view as the only way to make money in Ukraine today. If the government allowed traders to make money and offered incentives to keep it in the country and invest it, substantial private sources of capital would develop quickly in the trade sector and could form the basis of a new, privately-owned and-financed sector of the economy.

Ukraine would be vastly better off without the state distribution system. Enterprises have clearly expressed a vote of no confidence in the system, shunning it except for fulfilling state orders and contracts. All vestiges of the planned distribution system need to be eliminated, including state orders and contracts, quotas and licenses in foreign trade, the State Committee for Material Resources, and interstate agreements. The true economic threat of the mafia, while widely publicized, is overstated. If the economy were opened to widespread competition, the mafia would not be able to gain a monopoly over distribution. The mafia is largely a creation of the distorted communist economy: where private commerce was illegal, it simply went underground.

The government should stop bailing out old state enterprises, a practice it can ill afford. While shutting the dinosaurs down overnight would be

undesirable socially and politically, the support they are receiving now is not doing them any good—even the successful enterprises which might be able to survive in a market economy if given the proper assistance in the short term. More likely the state enterprises that are succeeding are doing so because they are changing their behavior. Behavior changes do not come about by continued state support, but rather by the absence of it.

The mandatory foreign exchange surrender laws serve only to chase dollars out of the country and should be eliminated. If Ukraine must use mandatory foreign exchange surrender as a hard currency tax, then the surrender should be at a market exchange rate, not at administrative levels set by the National Bank of Ukraine. That will encourage enterprises capable of selling their goods abroad to do so and will make it more likely that they bring the earnings from these sales back into Ukraine.

Finally, the foundations for any radical change in economic policy need to be clearly articulated at the national level—with authority clearly divided between local and national authorities—so that local authorities are made accountable for any differential regional impact of their policy choices.

Appendix: Survey Methodology

The survey was conducted from mid-February to the end of May 1993 in Kiev, L'vov, Kharkov, and Odessa. The duration of the survey was limited to as short a period as possible to minimize the effects of constantly changing legislation on survey results. When changes in legislation nevertheless affected survey results, respondents were asked to describe the situation affecting them in the last half of 1992. Two separate but similar questionnaires were prepared, one for producing enterprises and another for traders and service providers, reflecting differences in business practices between the two groups.

Sample Selection

Respondents were randomly selected from lists of firms registered as participants in foreign trade for 1992 with the Ministry of Foreign Economic Relations and its regional affiliates. Firms selected

from the list were interviewed briefly by telephone to determine whether the firm fit the criteria required for inclusion in the survey:

- *Located in Kiev, L'vov, Kharkov, or Odessa.* For logistical simplicity, only four sites were selected, chosen for their size, varying economic profiles, historical trade relationships, and locations near different borders of Ukraine.
- *Direct trade relations with firms outside of Ukraine at some time in the past three years.* If the firm bought or sold goods only through local intermediaries, it was not considered to have sufficient experience to answer the survey questions and was excluded from the sample.
- *In business for more than six months.*
- *Willingness to meet with an interviewer for roughly thirty minutes.* A director, a vice director, chief economist, or chief accountant of the firm, knowledgeable about its external economic activities, had to agree to answer interview questions.

The target number of responses was forty traders and forty producers for each city, except for Kiev, where 60 traders and 60 producers were to be interviewed.

Questionnaires

Two interview questionnaires were prepared, one for producing enterprises and another for traders, intermediaries, and other service providers.²³ Although the questionnaires were similar, certain sections varied in order to reflect differences in business practices between producers and intermediaries. Russian-language questionnaires were used in Kiev, Kharkov, and Odessa. A Ukrainian version of each was prepared for use in L'vov.

During each meeting, Ukrainian interviewers had to decide (based on responses to section 1 of the questionnaire) whether to use the trader or producer questionnaire. The following rough set of guidelines helped them decide:

- If the enterprise identified its main activity

as "Trade/ Commerce," the enterprise was given the trade questionnaire.

- If the enterprise identified its main activity as "Production," it completed the producer questionnaire.
- Enterprises that identified their main activity as "Service," "Consulting," "Transport," or "Other" were to be identified as producers if they depended on a continuous outside source of supply for physical inputs to provide their service and as traders/service providers if they could easily switch suppliers or do without a particular good and still function.

Interview Process

Local Ukrainians were hired at each site to conduct interviews.²⁴ Interviewers were required to have no contact with any government-related organization in order to maintain full confidentiality of enterprise responses and to elicit a more candid interview. Students were frequently employed as interviewers.²⁵ Interviewers were required to stress that the results of the survey would be strictly confidential, released only in aggregate form.

Interviews lasting 30 minutes to 2-1/2 hours were conducted with the director, vice director, chief economist, or chief accountant of a firm. The questions were delivered orally, although respondents were offered a copy of the questionnaire so that they could follow along with the interviewer's questions. This technique proved especially useful in questions with a strong visual content, such as those asking respondents to rank obstacles to export on a five-point scale.

Potential Sources of Bias in Data Collection

The profiles for producers in Kiev and in L'vov were radically different than expected and varied widely from those of the producer sample as a whole. In L'vov where a great deal of private ownership and foreign investment was expected, the sample was made up almost entirely of large state enterprises, with almost no foreign investment. Instead of the great variety of enterprise types

expected in Kiev, the producer sample was comprised of largely small, private enterprises.

In L'vov, some interviewer bias became obvious as soon as sufficient numbers of results began to come in—but too late to remedy—and was eventually confirmed by the interviewer. To save time, the interviewer identified the large industrial enterprises with which she was familiar as likely producers, instead of randomly calling enterprises on the list, resulting in a high concentration of enormous state-owned enterprises among the producer sample. Traders were selected randomly from the list because the interviewer had no prior knowledge of various trading firms, so the trader data appear to be relatively sound.

In Kiev, sources of potential bias are less clear. There is no confirmed evidence of interviewer selection bias in Kiev, where the selection and interview process was by far the most controlled. And because there was more than one interviewer in Kiev, any bias is likely to be somewhat dissipated. One possible source of bias, however, was the interviewer's decision whether a firm was a producer or a trader. Toward the end of the survey, one of the Kiev interviewers was having difficulty finding enough qualified producers to interview to meet the quota. Traders might have been identified as producers for expediency's sake, thus skewing the data toward private ownership in the producing sector. Or, it may well be that in Kiev, the capital city and significantly larger than other cities in the sample, the small-scale sector of the economy is simply more developed than in other regions and that there was no bias in the sample.

Notes

This study is drawn on a longer work produced under the World Bank's McNamara Fellowship program, entitled *Foreign Trade in Ukraine: A Microeconomic Analysis*. I am indebted to a number of people for their assistance over the course of this project. First, for guidance in the substantive parts of the paper, I would like to thank Daniel Kaufmann and David Tarr of the World Bank and Lawrence DeMilner of the IMF for their invaluable input throughout the year. I would also like to thank Francoise Le Gall, Natalie Jaresco and Elizabeth Ames for making it through an exhausting first draft of the paper and providing comments. I am particularly indebted to Andrei Honcharuk from the Ukrainian Ministry of Foreign Economic

Relations and Trade for playing the role of mentor throughout the year and walking me through the maze of the Ukrainian bureaucracy. The World Bank mission in Kiev and the McNamara Fellows program in Washington provided valuable logistical support, as did a number of people at the Ministry of Foreign Economic Relations and Trade and the Ministry of Statistics. Finally, I am deeply indebted to Anna Gordin and Natasha Nilova, without whose hard work and patience none of this would have been possible, and to James Hill and Brenda Juntunen, who lent considerable moral support throughout.

1. This value was dropped in averaging since it was so much larger than the others..
2. Collective ownership means that ownership shares are held by employees of the company. Juridical ownership means that other "juridical persons" (enterprises or organizations) hold shares.
3. These terms are commonly used in Ukraine since the breakup of the Soviet Union. The term (blizhnii zarubezh), "near abroad" refers to countries that were once part of the Soviet Union; the term (dal'nii zarubezh), "far abroad" refers to the rest of the world, including Eastern Europe.
4. There was some indication of interviewer bias in the L'vov sample, which may have increased the share of interstate trade and decreased the share of trade with the rest of the world for L'vov producers. For a more detailed discussion, please refer to the Appendix, "Survey Methodology".
5. L'vov, as the unofficial capital of western Ukraine, is generally seen as a gateway into Ukraine from Eastern Europe. A part of the USSR only since the Second World War, it is generally viewed as having higher levels of entrepreneurial activity and foreign investment than cities closer to Russia. Kiev, as the capital of Ukraine, was expected to have a wide variety of different types of ownership and widespread contacts with foreign partners both in inter-republican and overseas markets. Kharkov, which is situated only 40 miles from the Russian border, is a city known for heavy industry—including many enterprises in the military-industrial complex—and subsequently for its very close integration into the Soviet (especially Russian) market. Odessa, the largest port city in the former USSR, is widely regarded as an entrepreneurial and cosmopolitan city, with a particularly strong mafia.
6. The CMEA was the trading bloc of the former Soviet Union, and included the countries of Eastern Europe, as well as a number of socialist countries in Africa, Latin America and Asia.
7. East and West Germany combined.
8. See Bull (1994), Appendix B, for a further discussion of the bazaar.
9. Survey respondents would have had to distinguish not only between currency units (karbovantsi or rubles), but also between the cash and noncash values for the unit they selected.
10. From other countries of the former USSR, producers typically bought chemicals and raw materials (48.2%),

industrial and half-finished goods (39.7%), equipment (36.9%), and consumer goods (27.7%).

11. Average wages in dollar terms at market exchange rates increased from about \$10 to \$100 a month in Russia from February 1992 to February 1994, while not exceeding \$15 a month in Ukraine (see chapter 1, table 1.7).
12. For overseas markets changes in proportion were not significant enough to draw any conclusions.
13. Ukraine started implementing customs control procedures at borders with other republics of the former USSR on 1 April 1993. By this time, according to officials at the State Customs Committee, Ukraine had opened a total of 271 border control posts, including 57 with Russia and 27 with Belarus. [Interview with State Customs Committee, 31 May 1993.]
14. Meaning that the transaction itself was illegal or that the means of payment was illegal or only semi-legal, providing a incentive for the entrepreneur to keep the deal quiet.
15. This survey probably understates the reliance on barter trade. Although the interviewers took great pains to describe what was meant by a barter arrangement, Ukrainians had a difficult time identifying indirect payments with goods as barter. An arrangement in which a factory in Ukraine sends goods to a factory in Russia, which sends payment in rubles to another factory in Russia, which in turn sends goods to the factory in Ukraine was not generally considered barter but rather as a straight cash transaction or as a "clearing" transaction. When they could be identified, such transactions were counted as barter.
16. Higher scores were also typical for nonstate enterprises in comparison with state enterprises in both market areas.
17. By the end of September 1992, Ukraine's debt to Russia was so immense that the Russian government simply forbade any further delivery of Russian goods to Ukraine. This move forced the Ukrainians to introduce the karbovanets into full circulation, including for bank deposits and transfers, which had previously been valued at an implicit rate of 1:1 to the ruble, although the cash exchange rate was 1:1.5. Between November 12 and 16, 1992 the National Bank of Ukraine ordered all commercial banks to convert bank deposits to karbovantsi at a rate of one to one. Citizens were given a set period of time in which to exchange their cash rubles for karbovantsi, although very few people in fact did so, as the ruble was worth 1.5 times more than the karbovantsi by this time. From March 1993 on, interstate transfers were to be made through correspondent accounts held by Ukrainian banks in commercial banks in other countries of the former Soviet Union, at an exchange rate to be determined through inter-bank auctions for hard currency and rubles. The exception to this rule was payments for intergovernmental contracts, which would continue to be cleared through accounts in the National Bank of Ukraine. To lend greater credence to its dedication to maintaining exchange rates, the government began on March 14, 1993 to require that all enterprises earning hard currency place them in accounts in banks with correspondent relationships with Ukrainian banks and that

50 percent of these earnings be subject to conversion to karbovantsi at the official rate of the National Bank of Ukraine. The hard currency generated in this transaction would then provide liquidity for the National Bank auctions, which would in turn determine the market exchange rate for hard currencies. Unregistered off-shore banks accounts were criminalized by a decree of the same time period. Rubles were placed in the mandatory conversion regime, and the first ruble auctions began taking place on a weekly basis on 21 April 1993.

18. By May 1994 the differential had reached 1:26 and was still growing.

19. For a more detailed description of the breakdown of the banking system, see (Bull).

20. Both results are significant at a 95% confidence level. For interrepublican trade, $M = 3.19$ and $CI(0.95) = 3.04 < x < 3.34$ and for overseas trade $M = 3.3$ and $CI(0.95) = 3.15 < x < 3.45$.

21. Traders were not asked this question, as the majority of them had not been in business for three years.

22. "Heavy" goods for the purposes of this survey include: fuels/energy, chemicals/raw materials, industrial and half-finished goods, building materials and equipment. "Light" goods include: finished wood and paper products, consumer goods, agricultural goods and services and intellectual property.

23. Readers interested in reviewing the questionnaire used in the survey should refer to Bull (1994), Appendix C.

24. Each interviewer was walked through both questionnaires in detail and was required to accompany and observe a trained interviewer for at least three meetings. Then the trainee was observed conducting interviews for at least three more meetings. A trained interviewer from Kiev returned two weeks later to follow up with each site interviewer, observing them again in at least three interviews, reviewing the responses they had completed to date, and discussing any substantive questions related to the questionnaire. Two weeks later, the interviewer was asked to come to Kiev to bring the latest responses and to discuss any problems or questions. If all went well, the interviewer would be asked to come to Kiev again after reaching the assigned quota of responses. All other contacts were by telephone.

25. Nonetheless, respondents were often suspicious of the interviewers, believing they were spying on behalf of the government. This worry was alleviated by a letter from the Kiev representative of the World Bank, thanking the respondent for participating in the survey.

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Comment on Chapter 4

Market Liberalization By Stealth: Curse or Blessing in Disguise?

Daniel Kaufmann

Sergyi and Galina Ivanienko are in their early forties. They live in a small flat on the outskirts of Kyiv with their teenage son and Galina's ailing mother. Like many young Ukrainians, Sergyi and Galina have

been independent minded with entrepreneurial spirit since their early youth. They joyously greeted independence in late 1991 and the economic possibilities they foresaw from the eventual opening up of the economy—both domestically and to the rest of the world.

Sergyi decided to try his own economic independence and purchased two glove-making machines with a loan from a new bank and with the help of friends. His hard work and good financial control initially brought some rewards, and his gloves were selling and commanding a good price in Russia, Turkmenistan, and locally.

Soon, however, the problems started. Sergyi's company ran afoul of various export restrictions, enforced with discretion, and exports were held up. His company was also visited by tax and fire officials with numerous, frequently changing demands. Regulations often changed weekly and were interpreted differently by the various inspectors, officials, and business counterparts. In the meantime, the official tax rates became prohibitively high. During one period in 1992 Sergyi calculated that the effective marginal tax rate on his business income exceeded 100 percent. He started losing

money, and in the fall of 1992 he closed down his small business.

Life for the Ivanienkos was particularly difficult immediately thereafter. Galina's salary as a secretary in a line ministry was insufficient for a household of four, and it was declining in real terms because of high inflation and only partial indexation. Similarly, the pension for Galina's mother was barely sufficient to purchase a few food items, and payments often arrived late, when the money was worth even less. No medicines were available officially in any pharmacy for her heart ailment. The few dollars the Ivanienkos had managed to save were channeled to purchase essential drugs in the black market and to pay informally one of the few medical specialists. The son was also facing difficulties at school, where adequate textbooks were unavailable and teachers' morale was low and absenteeism high.

In early 1993 Sergyi joined a state committee, one of whose activities was trading. For Sergyi the official salary (the equivalent of US\$12 a month) and the few benefits he could count on were less important than the informal contacts he made for getting around trade bottlenecks, which would help him with the family's future entrepreneurial plans.

Galina quit her low-paying job and began a business manufacturing and trading socks for men. As Sergyi had a year earlier, she started doing well and managed to export some of her products, particularly to Poland, Sweden, and Belarus. She was more confident now because official taxes were not as high and some hard currency could be exchanged at close to a market exchange rate. There were also fewer export restrictions and more liberal pricing.

But after six months she started to experience problems similar to those Sergyi had faced over a year earlier. This time the inspectors wanted to impose large fines and close down operations for alleged pricing and foreign exchange surrender violations. Soon she found that exporting a sock involved fourteen different regulatory and permit steps, each one requiring payments. The newly imposed foreign exchange surrender requirements at a fraction of the market exchange rate meant that she was unable to export profitably any longer. In her domestic marketing she faced official attempts to have her prices reduced to comply with administratively determined price markup caps. Her business started to lose money in the fall of 1993.

One fateful and bitterly cold weekend in early November Galina and Sergyi consulted with friends. They decided on a different strategy this time. Galina "officially" closed her operations. She moved her few machines to the site of a larger trading firm that was already operating unofficially, and where space, good trading contacts, and advice was available. With the help of Sergyi's contacts in his job, and Galina's patron in the unofficial firm, she also began to operate unofficially. The head of the trading firm knew the officials that would provide trading licenses and had acquaintances in the tax inspectorate and customs. An understanding was reached on the amount of "private" compensation that would grant rapid access to crucial official permits and licenses. Taxes would be levied on only a fraction of actual income. And one official decided to take a 20 percent stake in a new Ivanienco enterprise, in return for his regulatory "facilitation" services.

Now Galina needs to pay off a few people in order to operate, but she knows how much that

costs her every month, and there are no longer any surprise visits or letters. She faces no insurmountable impediments to conducting business nowadays, although the money and effort required to overcome these impediments are significant. And she does not think that the current situation is stable enough to embark on additional investments.

Although relatively speaking the Ivaniencos are better off today, they would rather be operating in an official economy, paying normal taxes as proud citizens of Ukraine, and surrendering the earned foreign exchange (at a decent exchange rate). They are not proud of all the payments under the table needed to operate unofficially. And these payments are expensive, totaling about 20 percent of turnover. They also believe there is a self-interest in being responsible tax-paying citizens. They realize that the government needs resources if it is to turn around deteriorating health and educational services. But they are convinced that at present their business could not survive in the official economy. For the time being, they plan to continue operating as they are.

The story of Galina and Sergyi is a composite of real cases encountered in many interviews and conversations over the past months. It illustrates the paradox in the Ukrainian economy today: increasing administrative controls over the economy are undermining the ability to manage the economy. One substantial segment of the economy has completely "liberalized" itself and gone underground, while another has disappeared altogether. The lack of real market liberalization in the official economy lies at the center of this development and has major macroeconomic implications.

Among other results, Bull's micro survey suggests that there is a substantial amount of unofficial economic activity in Ukraine. In this comment, I build on those results, and explain the causes and consequences of that unofficial or parallel economy.

The Lost Pillar of Economic Reform: Market Liberalization

There is a consensus that not one of the three key pillars of an economic reform program for ex-socialist countries has fared well in Ukraine. First,

there has been very little macroeconomic stabilization. During 1993, for instance, Ukraine's inflation rate was the highest of any country not at war. Second, very little privatization has taken place: by mid-1994 more than 90 percent of assets were still not in private hands. And third, there has not been much market liberalization.

While all three of these pillars have shared a similar fate, there is considerable difference in economic understanding of their importance and in the growth of constituencies for reform. A majority of Ukrainians now recognize the urgent importance of a stable domestic currency and understand the benefits of privatization, but there is yet no such large constituency for liberalization and openness of markets.

The Evolution of Administrative Controls: Empirical Evidence

At independence in late 1991 the Ukrainian economy was almost entirely administratively controlled. The Gosplan central planning approach had been implemented with particular rigor. Few of the apparent benefits of perestroika in the direction of market-based allocation reached Ukraine. Except for a limited degree of autonomy that had been transferred from the center to some firms, little relaxation of centralized administrative controls had taken place in Ukraine.

The approach to economic management did not change dramatically following independence. However, the price liberalization of a large number of items in Russia initiated in early 1992 led to a reluctant loosening of administrative control in Ukraine. It became evident that without some liberalization, Ukraine would be providing a significant and quickly growing export subsidy to Russia. At the same time an elaborate system of export quotas and licenses was set up for some goods.

How Pervasive Were Administrative Controls Following Independence?

To measure the degree of administrative intervention and market distortion data were collected on foreign exchange (exchange rate and foreign exchange allocation distortion indices), trade (export restriction and domestic trade intervention indices), and pricing (wholesale and price controls indices).

(Details on the construction of these indices and the empirical results are in box C4.1). We constructed an overall index of administrative controls over the economy by aggregating all six indices.

For comparative purposes, even if imperfect, we also collected data on administrative controls for Chile and calculated the indices for the past two years. Chile was an economy subject to far-reaching centralized controls until the late 1970s, when the controls began to be dismantled and the opening up process began. On a scale of zero (full liberalization) to 100 (full administrative control), five of the six indices for Chile were zero throughout the period. Prices, trade, and foreign exchange allocation are fully liberalized. The official exchange rate does deviate from the market or parallel exchange rate, but the deviations are minimal (less than 1 percent on average).¹ Thus, the overall index of administrative controls averaged 0.1 for Chile during the period, suggesting an economy virtually free of administrative controls.

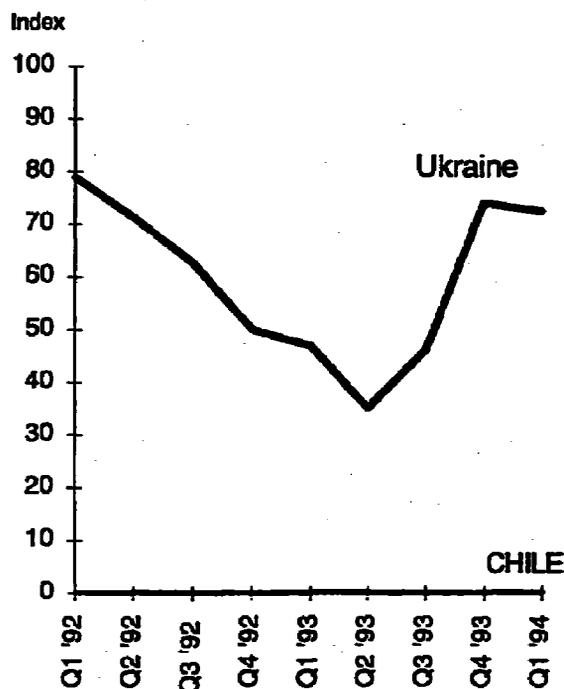
Ukraine had an index of administrative controls of almost 80 during the first half of 1992. With the advent of a new government in October 1992 some partial liberalization gradually appears in prices and export restrictions. A foreign exchange auction is instituted, and by mid-1993 accounts for the bulk of official export proceeds.

In the summer of 1993, a new government came into power. Administrative controls began to creep back in. The currency exchange auction was abolished in late October 1993, and an artificially low official exchange rate was set at about one-third the market rate. Administrative controls over prices became much more prominent by the second half of 1993, and many export licenses were reinstated. Following this administrative control "backlash," the index administrative controls rose past 70 by early 1994, close to its level at independence. Ukraine's official economy is still a "nonmarket" economy almost three years after independence.

Why Has Liberalization Lost Out So Far?

There are many, intertwined reasons why liberalization has become such a lost pillar in Ukraine. Chief among them are the prevalence of myths and

Figure C4.1 Index of Overall Administrative Controls in Ukraine and Chile, 1992-94



Source: See Box C4.1

misunderstandings about economic issues, the power of vested interests eager to maintain controls over economic activities (including licenses and permits), and the inconsistency between fiscal and monetary policies in the political-economy context of Ukraine. A combination of lax budgetary policies and stringent monetary policies has resulted in stabilization efforts that are not sustainable. Payment and wage arrears need to be attended to. The advocates of administrative control support such unraveling of monetary stringency, and push for a tightening of controls instead (see Kaufmann 1994).²

The Impact of Administrative Controls: The Emergence of the Parallel Economy

The prevalence and strengthening of administrative controls have had major effects on the official and the unofficial economies in Ukraine.

Every country has an unofficial economy, a term often used to describe the "informal" economy, which refers to the small-scale, barely visible activities of small entrepreneurs eking out an existence outside the formal, technically sophisticated,

regulated economy, or the "shadow" economy, which usually refers to the criminal segment of the economy, often engaged in activities such as drugs and arms dealing, protection, and racketeering. Some activities fitting these descriptions can be found in Ukraine. But the "unofficial" economy empirically explored here is different. It is the segment of the economy that engages in economic activities that are not inherently criminal and violent. It does engage in skirting and evading government regulation and taxes. And unlike "informal" segments of the economy, its scale of operations may be quite large and its activities are visible. Technology is not necessarily primitive.

Neither are unofficial activities in Ukraine strictly "private," nor fully separated from official activities, with which they often share premises, personnel, and legal identity. A state enterprise may use some of its assets (or time-sharing) to generate income flows for individuals, or it may find creative ways to divest itself of assets at artificially low prices; state managers become principals in the income generation of these assets. Most of these income flows are not officially reported. Many private enterprises also operate simultaneously in the official and unofficial economies. A portion of their income is reported, and their production and distribution conform with state regulations; the rest does not. Thus, there is a physical coexistence of activities in Ukraine along two axis: state and nonstate and official and unofficial. Often the distinction is only in the "accounting" approach or in the entity or individual that receives the income flows from the assets.

What also makes Ukraine unusual is the pace at which segments of the official economy have been crossing to the unofficial economy, as well as the large size and share of the unofficial economy today. (Estimates of the unofficial economy are preliminary and subject to error by definition, so they need to be used with care.)

It is telling to compare Ukraine's officially reported hard currency export earnings with trade partner data at the point of destination. For 1993 preliminary estimates of officially reported hard-currency earnings were US\$2.7 billion. Estimates

for partner country imports from Ukraine totaled about US\$6.2 billion. Even allowing for the possibility of methodological underestimation of official export statistics, the gap could well imply that at least US\$200 million a month of exports from Ukraine are not channeled through the official economy. In other words, about half of all exports may have been channeled through the unofficial economy, in large measure forced there by the administrative controls and restrictions imposed on the official economy.

The antiexport bias of the policy regime has led to major losses in export proceeds and thus in the import capacity of the country. Reviewing the exchange rate policy alone is suggestive. In periods when the effective exchange rate at the auction was close to the market exchange rate (80 percent of the market rate or above), an average of about US\$110 million a month was being sold through the auction. At times when the effective "tax" on foreign exchange receipts was larger than 20 percent, monthly foreign exchange averaged about US\$10-15 million. More generally, a very large amount of exports are no longer going through the official economy, and the bulk of unofficial exports appears to have become capital flight.

The micro-survey evidence supports these preliminary aggregate estimates. In addition to Bull's survey, another survey of over 200 officially registered private sector firms conducted in January 1993 suggested that about 55 percent of activities were in the unofficial economy. Further, a separate small non-random survey of about twenty traders indicated that private traders in 1992 were conducting about one-quarter of their business outside the official economy; by March 1994 that share had grown to almost three-quarters. For state traders the estimated share of unofficial activities was about 10 percent or so in 1992; by March 1994 it was preliminarily estimated at over one-third.

Many state and private traders surveyed in March 1994 reported that in contrast to the past, official regulations no longer presented major problems to doing business. They acknowledged that regulations and administrative control mechanisms had proliferated and repeatedly remarked on the

antibusiness foreign exchange regime and other regulations. What had changed was that many of them were no longer following official regulations or channels. They had adapted to evolving circumstances by leaving the official economy.

Many businesses have a very clear notion of the system cost of acquiring permits, overcoming regulations, evading surrender requirements, and resolving bottlenecks. The "services" rendered to avoid the official economy do not come cheaply, especially to smaller exporters, since some of these fees are quasi-fixed and not related to the volumes traded. Whereas in past surveys traders were quick to point out the major official bottlenecks to trading, the major issue now was the overall cost of doing business.

The empirical evidence and analysis presented above suggest a hypothesis on the paradox of attempted centralized administrative controls over the economy, particularly in nontotalitarian societies where legal, regulatory, and enforcement institution building is under way: beyond a certain point, there is an inverse relationship between the degree of central administrative control over the official economy and the degree of administrative control over the overall economy. In other words an intended tightening of controls over the economy beyond a certain point results in reduced administrative control over economic activity. In effect, it can be viewed as a variant of the Laffer curve.³

Regaining the Lost Pillar of Liberalization

Liberalization in Ukraine has been a "lost pillar" in three respects. First, many analysts have underemphasized the importance of market liberalization, particularly compared with the attention devoted to the other key pillars of reform, macroeconomic stabilization and privatization. The announcement of the weekly price index or the auction of five barber shops and two cafes receives far more comment than any tightening of antimarket administrative controls or regulations over economic activity. Second, and more important, many in government have supported the need for tight controls, while few see the necessity for market liberalization. Third, liberalization has been lost to the

state in the sense that substantial market liberalization has taken place in Ukraine beyond the official economy and the influence of the state. Economic agents, firms, and entrepreneurs have embraced liberalized markets by moving to the unofficial economy. From the perspective of conventional government policy that liberalization is unintended.

The unintended market liberalization that has taken place in Ukraine has positive as well as negative aspects. It has managed to keep the economy afloat, as incentives to produce in the official economy have dropped. Production in the official economy has declined overall income. A significant portion of that decline in official production is accounted for by the accelerating move from official to unofficial activities.

The growth of the unofficial economy has also debunked the myth of Ukraine's "lack of entrepreneurship" or "lack of readiness for market." Entrepreneurial activities in the unofficial market have demonstrated resilience, creativity, and responsiveness to changing economic and financial circumstances. That bodes well for the future of Ukraine, once proper economic policies are in place.

Notwithstanding these positive aspects, the emergence and growth of a large unofficial economy pose serious problems that dominate the positive side. First, there is a large cost in wasted time and effort and in nonproductive payments for permits and licenses that lowers efficiency. Second, the ability of the state to effectively manage the economy is undermined. The tax base is eroded, and so is foreign exchange management. More fundamentally, the legitimacy of the legal and regulatory system of the state is increasingly challenged or ignored.

And third, despite the rapid growth of the informal economy it is still a "survival" economy, with a short-term focus. The large-scale investments so crucial to longer-term growth prospects are virtually absent. In fact, not only is overall investment very low, but many assets being used in the unofficial sector are the result of spontaneous decapitalization of the state sector.

Consequently, maintaining the status quo is not a sustainable way of running an economy that harbors any hope of becoming a strong participant in

the world economy. Measures to lure the unofficial economy back to the official economy are warranted, and that will require official liberalization of the economy.

Loosening the Grip

Official market liberalization could become a major pillar of structural reform, providing the impetus for a turnaround in the Ukraine economy and for future growth. Done right, liberalization would improve the social welfare of the population compared with the alternative of not liberalizing. Furthermore, market liberalization is a crucial input for macroeconomic stabilization, export and domestic production, privatization, and investments. (See Kaufmann 1994 for a discussion of these points).

Ukraine has so much potential.

Unfortunately, this potential remained as unrealized in the early fall of 1994 as it was almost three years ago when this same statement was frequently heard. The policy mistakes and ill-advised measures in the economic sphere over the past few years have prevented resources, including Ukraine's enormous human potential, from being put to good use. The economy today is in a much deeper crisis than it was a few years back. Assets, capital, economic activities, and entrepreneurs have departed from the official economy.

The evidence from Ukraine shows clearly that centralized administrative control will not work to reclaim the unofficial economy, but, to the contrary, is likely to accelerate the flight from the official economy. What is needed is to regain the confidence of economic agents operating in the unofficial economy? Establishing a market-friendly environment for the official economy is the first priority. That means that the state needs to pull out of productive and economic decision-making activities and direct its attention to maintaining macroeconomic stability, developing market and social infrastructure, opening the economy to the world, and protecting the poor. Equally important is for the state to build market institutions and establish enforceable pro-market regulations.

Stemming the tide out of the official economy and reversing the flow to reclaim the unofficial

Box C4.1 Measuring Administrative Control

A simple quantifiable index of administrative controls is constructed by measuring the degree of administrative intervention and market distortion in foreign exchange, trade, and pricing regimes.

Foreign exchange regime indices. The exchange rate distortion index is defined as the percentage deviation of the market exchange rate from the effective official exchange rate (an average of the two different official rates, weighted by the surrender requirement share). An exchange rate distortion index of zero means that the official exchange rate is the same as the market rate. An index of 66 means that the exporter gets only one-third the market rate (a 66 percent effective "tax" on foreign exchange earnings).

The foreign exchange allocation distortion index measures the share of foreign exchange allocated through nonmarket administrative mechanisms and not sold on the official exchange auction (the closest to "market-based" official foreign exchange allocation in Ukraine). A foreign exchange allocation distortion index of 90 means that only 10 percent of official foreign exchange revenues go through the auction mechanism, while the rest is allocated according to administrative discretion (at a rate significantly below a market-determined rate).

Trade regime indices. The export restriction index is defined as the share of overall exports administered by quotas and licenses. An index of 80 means that only 20 percent of exports are free from quotas or licenses. The domestic trade administrative index is the share of state orders and contracts in total output. (These are orders that enterprises are supposed to fulfill by providing specific production volumes to the state or to other pre-determined enterprises.) An index of 55 means that only 45 percent of output is not subject to state adminis-

trative decisions on procurement and internal distribution.

Pricing regime indices. The retail price control index is defined as the share of retail prices subject to administrative controls. An index of 70 means that only 30 percent of total output is not subject to administrative price controls. The wholesale price control index is the share of wholesale prices subject to administrative controls.

An overall administrative control index is then calculated as a simple average of these six indices. The index would be zero in an economy free of direct administrative controls (such as Chile) and 100 in a fully centrally planned economy. In Ukraine the index of administrative controls reached almost 80 in early 1992. (See box table). In October 1992 the new government introduced some liberalization to the economy: partial liberalization of prices, some relaxation of export restrictions, and introduction of a foreign exchange auction. The administrative control index dropped to 35 in mid-1992, a substantial improvement, but still high even by the standards of economies in transition.

The new government that was sworn in in mid-1993 began to reintroduce administrative controls. Price controls became pervasive, which pressured policymakers to reinstate export licenses. The currency exchange auction was abolished and the exchange rate was fixed at an artificially low level. (Since December 1993, the official rate has been raised to 12,000 karbovanec to the U.S. dollar, while the market exchange rate has averaged 37,000 karbovanec to the dollar.) Controlling the exchange rate forces controls on the allocation of foreign exchange and imports. The degree of administrative control over the economy is now virtually the same as it was immediately following independence, meaning that the official economy is only minimally "liberalized."

Data for Overall Administrative Control Index (Inputs for figure C4.1)

	1992				1993				1994
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Exchange rate distortion index	99.7	44.4	41.4	40.5	43.9	21.1	34.7	69.1	60.6
Foreign exchange allocation distortion index	100.0	100.0	100.0	99.0	89.0	35.0	62.0	96.0	92.0
Export restriction index	68.1	79.8	87.9	74.1	75.8	75.8	75.4	92.0	92.0
Domestic trade restriction index	55.1	55.1	55.1	55.1	52.0	52.0	52.0	52.0	39.0
Retail price controls	77.3	75.3	75.4	14.4	5.0	11.0	37.0	90.0	80.0
Wholesale price controls	74.0	74.0	17.0	17.0	16.0	16.0	16.0	45.0	71.0
Overall administrative control index	79.0	71.4	62.8	50.0	47.0	35.2	46.2	74.0	72.4

economy is crucial to regaining a grip over economic management in Ukraine. Herein lies the paradox (captured in the inverted U-shape curve): regaining a grip over economic management will take a loosening of administrative control over the official economy. Pricing, trading, and transacting in foreign exchange and goods ought to be left to the entrepreneurs in the market. Implicit and explicit taxation by the state should not be prohibitive.

Such paradox has been grasped by the new administration that came to power in the summer of 1994. President Kuchma has announced its intentions to loosen the administrative grip over the official economy, so to avoid further drainage into the unofficial economy, to improve overall prospects, and to institute market instruments to effectively manage the economy. A number of liberalization decrees were finalized in the fall of 1994, and initial liberalization measures in the pricing, trade, and exchange rate regimes were taking place before year end. Implementation of further liberalization and of tax reform measures were expected in early 1995.

If the government fully implements such credible actions, Galina and Sergyi Ivanienko would be prepared to move their business back into the official economy and plan for their business's expan-

sion through investments. And they would look forward to brighter educational and socioeconomic prospects for their young son.

Notes

This paper draws from two other papers: *Diminishing Returns to Administrative Controls and the Emergence of the Unofficial Economy*, by D. Kaufmann, presented at the Economic Policy Journal international conference held in Kiev in May, 1994; and *The Unofficial Economy in Ukraine: Preliminary Findings and Implications*, by D. Kaufmann, I. Novitsky, and V. Novitsky, November 1994. I received valuable comments and inputs from a number of World Bank staff, academics, and Ukrainian experts. I would like to thank in particular S. Van Wijaberger, L. Balcerowicz, M. Blejer, M. Bruno, O. Havrylyshyn, V. Kusnetzov, F. Le Gall, M. Michaely, Robert Meyers, R. Ossowsky, S. Rabenok, M. Selowsky, and D. Tarr.

1. For Chile the range in the exchange rate distortion index between different periods was 0.2-1.3, meaning that the highest deviation between the parallel and the official exchange rates was 1.3%. I am thankful to E. Eangel for the collaboration on Chilean data.

2. For details, see D. Kaufmann *Diminishing Returns to Administrative Controls and the Emergence of the Unofficial Economy*, forthcoming Economic Policy, November 1994.

3. A more detailed analytical and graphical elaboration of the resulting inverted U-shape relationship between official controls and effective controls over the economy is presented in Kaufmann (1994).

5

Estonia: A Shining Star from the Baltics

*John Hansen
and
Piritta Sorsa*

- The Macroeconomic Situation and Complementary Reforms
- Trade Flows
- Trade Policy
- Recommendations
- Foreign Exchange and Payments
- Microeconomic and Trade Adjustment
- Policy Conclusions

Estonia, a small country of 1.5 million people on the eastern shore of the Baltic Sea, has a long tradition in foreign trade. Tallinn, the capital, was important in the Hansa trading cartel in the Baltic Sea area in the Middle Ages. In the decades following its independence from Czarist Russia in 1918, trade with industrializing Europe constituted a large share of its GDP. Under Soviet rule, central planning commonly ignored comparative advantages, and investments were made with little regard for relative prices in world markets. Nevertheless, Estonia experienced substantial development, particularly in the industrial sector. It had one of the highest per capita incomes in the Soviet Union, reflecting its highly skilled labor force and comparatively well-developed infrastructure. However, the lack of concern for economic efficiency under central planning kept its development well below potential levels—as reflected in the widening gap between Estonia and Finland, which started out at similar levels of development in the late 1920s and early 1930s. Estonia depended heavily on trade during the Soviet era, but virtually all of this trade was within the former Soviet Union and took place at artificial prices.

Since the restoration of its independence in 1991,¹ Estonia has been gradually shifting the direction and structure of its trade to correspond to its areas of comparative advantage. It is rapidly becoming an important center for East-West

trade and for processing activities attracted to the country by its liberal trade policy framework and highly skilled but low-wage labor force. The evolution of Estonia's trade regime is a model of how to make trade policy work to accelerate development.

The Macroeconomic Situation and Complementary Reforms

Early reforms. Trade adjustment in Estonia was helped enormously by the macroeconomic environment. Introducing a convertible currency stabilized the economy, reduced uncertainty, and improved the business climate, while the currency's initial undervaluation provided uniform temporary protection during adjustment in a transparent manner, which avoided the kind of lobbying for protection that tariffs often elicit. A transparent, open trade regime created incentives to reorient trade to convertible currency areas. Export development was further aided by the generous market access conditions granted by a number of key Western markets. Estonia has had free trade agreements with four EFTA countries since 1992 that gave industrial products restriction-free access to each other's markets. Estonia has also enjoyed generalized system of preferences (GSP) treatment in the EU, Austria, and various other markets since 1992.

Estonia's transition to a market economy started even before independence. The nation took advantage of the economic independence accompanying the perestroika period of the late 1980s by introducing trade, price, tax, and wage reforms. Following Estonia's re-independence in 1991, it began to put in place a liberal external trade regime, accompanied by conservative fiscal and monetary policies (Box 5.1). Trade, growth, and inflation all responded favorably to the new policy environment. Progress has been somewhat slower, however, in complementary structural reforms such as privatization.

Estonia was one of the first of the ex-Soviet republics to liberalize prices, reduce subsidies, and reform taxes. By late 1992 virtually all prices had been freed from administrative controls, and by mid-1994 only public services, such as housing, electricity, heating, public transport, and oil shale (a

government monopoly product) remained subject to price controls.

Wages had been freed in 1990. The government introduced a tax on excessive wage increases in public enterprises to contain wage inflation, but with an already strict no-subsidy policy, the tax was never really tested. A Western-style tax system was introduced in 1991, including a value-added tax of 18 percent, a personal income tax with progressive rates ranging from 16 percent to 33 percent, a corporate income tax of 35 percent, and a payroll tax of 20 percent to finance pensions. An additional payroll tax of 13 percent was introduced in 1992 to fund medical insurance benefits. The tax system imposes no significant duties on imports or exports. Together with a virtual absence of quantitative restrictions, this gives Estonia an essentially free trade regime.

Stabilization. Price liberalization and rapid increases in the money supply led to a period of unstable prices and exchange rates after August 1991. From early 1991 to the introduction of an independent currency in mid-1992, prices rose twenty-two fold. The uncontrolled expansion of ruble credits by the central banks of the ex-Soviet republics exacerbated inflation. The resulting excess of bank credits over currency and the increased demand for currency led to severe shortages of cash by early 1992, which was reflected in an internal premium of about 30 percent for cash over credit rubles. In this climate of high uncertainty and negative real interest rates on domestic assets, foreign currency was increasingly used to maintain the value of money holdings.

Estonia's introduction of the kroon (EEK) in mid-1992 provided an important degree of monetary independence from the ruble zone. To insulate monetary policy from industry or government pressures for monetary financing of deficits, a currency board arrangement was chosen, and the value of the currency was fixed at 8 kroons to the German deutschemark (Box 5.2). Under a currency board arrangement, the country's monetary base is linked to foreign currency holdings at the central bank. All new issues of domestic currency have to be matched by new foreign currency receipts. The central bank

Box 5.1 Major Trade Policy Developments in Estonia

1990

- Jan 1 Price liberalization begins, laying the foundation for major terms of trade gains during 1990 and 1991 within the ruble zone.
- Jan 26 Law on the Regulation of Import and Export of Goods passed, providing foundations for foreign trade policy.
- Feb 13 Decree on Registration of the Import and Export of Goods, Establishment, Alteration and Cancellation of Quotas and Licenses lays the basis for trade liberalization.

1991

- Aug 20 Independence declared. Efforts begun to re-establish diplomatic relations.
- Oct Trade agreement signed with Iceland, followed by Sweden, on most favored nation (MFN) basis.
- Dec Barter trade agreement signed with Russia, but never fully implemented and abandoned with currency reform.
- Dec 10 Joint declaration on future cooperation with EFTA signed.

1992

- Jan 1 Ruble exchange rates consolidated, and official rate set at 100 rubles to the U.S. dollar. Almost all prices are liberalized. Gosbank (Estonia) disappears with the creation of an independent Estonian central bank, which absorbs the foreign currency operations of Veneshekonombank in Estonia.
- Feb 1 Most export quotas and other controls relaxed. Resident enterprises allowed to buy foreign exchange in local currency auction.
- Feb 13 Protocol on Temporary Measures on Economic and Trade Cooperation between Estonia and Finland signed, the first formal statement of Estonia's free trade principles, which it continued to follow in its trade policies.
- Feb 26 Trade agreement signed with Russia. Re-established the flow of oil, but never became fully effective in the absence of agreements on product-specific trade.
- Mar 31 Free trade agreement signed with Sweden (effective July 1, 1992). Similar to agreement with Finland; provided for detailed technical cooperation and updated rules of origin.
- Apr Trade data collection on customs basis begins.
- May Preferential trade agreement signed with EC. GATT observer status granted.
- Jun 20 Estonian kroon introduced under the currency board system with full internal convertibility at fixed rate of 8 kroons to the deutschemark. Correspondence ruble accounts with Russia closed. New bilateral balances of RUR 500m and EEK 50m established.
- Jun 29 All export controls removed except on a few goods such as alcohol, tobacco, grain, cables, hides, and some non-metallic minerals.
- Nov 1 VAT changed to destination basis; imports subject to 18 percent tax, exports exempted.

1992 (Continued)

- Nov 9 EFTA negotiations initiated.
- Dec 1 Free trade agreement with Finland becomes effective.
- Dec 21 Free trade agreement signed with Switzerland.

1993

- Jan 1 Export controls lifted on alcohol, tobacco, grain, cables, and hides, leaving controls only on selected nonmetallic minerals and nonferrous metals (to control illegal metals trade).
- Feb 19 State monopoly established for metals trade.
- Mar 1 Businesses with international transactions allowed to hold foreign exchange accounts (partial capital account convertibility).
- Apr 7 Russia and Estonia agree on temporary MFN status.
- Apr 21 Free trade agreement signed with Latvia.
- Jun Free trade agreement signed with Norway.
- Jun 8 Trade and Economic Relations Agreement for 1993 signed with Russia, with commitments not to restrict bilateral trade; never becomes fully effective.
- Aug 19 A 70 percent duty imposed on wheat flour and related products from Russia to counteract low prices.
- Sep 13 Baltic Free Trade Agreement signed with Latvia and Lithuania.
- Oct 6 Trade pact for agricultural goods signed with Finland.
- Dec 2 Foreign exchange controls relaxed further. Virtually no controls on foreign exchange accounts held in domestic banks, and foreign exchange accounts abroad for legal entities allowed with central bank permission. All restrictions removed on non-convertible currency transactions.
- Dec 5 Tariffs on Russian grain removed after complaints about high prices by consumers and bakers.

1994

- Jan 1 Law ratifying Baltic Free Trade Agreement passed.
- Feb Estonian Metals Export to be reorganized as a joint-stock company preparatory to privatizing the export of metals, the only remaining state trading monopoly. Trade restricted to licensed importers and exporters, however, for metals, spirits, tobacco, medicines, weapons and explosives.
- Feb 23 Agricultural trade pact with Finland approved by Estonian cabinet.
- Apr 1 Baltic Free Trade Agreement takes effect.
- Jul 18 Free trade agreement signed with European Union. Customs duties and quotas to be eliminated starting January 1995. Provides for free trade in textiles and manufactured goods. Agricultural goods, while not on free trade basis, are covered by the agreement. Estonia and EU to start working toward an association agreement, with a view toward EU membership.

is prohibited from lending to the government or to commercial banks except in restricted amounts in the case of certified liquidity crisis situations. The arrangement limits the use of monetary policy, but it has provided a fixed anchor for stabilization in a period of tremendous economic and political change. The currency reform has helped in privatization and private investment by contributing to a relatively stable economic environment for investment and by forcing nonviable firms into bank-

ruptcy, freeing their physical assets for more productive uses. The currency reform has also facilitated trade transactions. The currency was deliberately undervalued to avoid the need for frequent adjustments and to ensure a surplus in the balance of payments. Estonia's early implementation of price reform measures contributed to substantial current budgetary savings in 1991. Although these savings dropped rapidly thereafter as a result of a terms of trade reversal and the fiscal pressures asso-

Box 5.2 Currency Board Mechanism

The Estonian kroon was introduced in June 1992 under a currency board mechanism, an arrangement that pegs the domestic currency to another currency or basket of currencies, backed by foreign exchange reserves and gold.

The Estonian kroon is pegged to the deutschemark at 8 kroons to the deutschemark, and is backed 100 percent by foreign currency. The currency board issues additional domestic currency only in exchange for an equivalent amount of foreign exchange. Conversely, foreign exchange is provided only upon surrender of an equivalent amount of kroons. This ensures that full foreign exchange cover is always maintained.

The exchange rate is set by law and can be changed only by an act of Parliament. With no decision-making involved in issuing additional domestic currency or in selling foreign exchange and no scope for changing the exchange rate, the currency board is guaranteed independence from political interference. In addition, the central bank is prohibited from lending to the government, so there are no pressures of the kind commonly felt by central banks to issue additional domestic currency to cover fiscal or quasi-fiscal deficits. The central bank is also prohibited from lending to commercial banks except in very limited amounts in the event of a major short-term liquidity crisis. These rules provide additional assurances that government or enterprise deficits will not be financed by expanding the money supply.

The currency board also provides several stabilizing and self-correcting mechanisms for dealing with disequilibria on the external side. The fixed exchange rate reduces exchange rate risk, while the guarantee of convertibility facilitates international payments. Both of these factors (together with Estonia's essentially free trade regime) promote the growth of external trade in line with comparative advantage. By controlling pressures to expand high-powered money, the currency board reduces the scope for inflation, thus increasing the confidence that the fixed exchange rate can be maintained. If domestic inflation results in an appreciation of the real exchange rate, leading imports to rise and exports to fall, stocks of domestic currency will fall since domestic currency must be surrendered to get foreign exchange to purchase imports. This drop in domestic currency stocks puts downward pressures on prices, tending to correct the real appreciation of the exchange rate—which in turn stimulates exports and depresses import demand. The contraction of the domestic money supply pushes up domestic interest rates which, along with guaranteed rights to convert and transfer foreign currency under the currency board system, attracts foreign exchange from abroad, helping redress the loss of reserves that came from the original surge in import demand.

Because of these multiple self-correcting mechanisms, the currency board has contributed significantly to stabilization and resumed growth of the economy and to confidence in the domestic currency. This confidence is seen, for example, in falling interest rates, the willingness of residents to hold rising levels of real cash balances, and the emergence of trading in kroons by banks in other countries of the region.

This stability is not without costs, however. The fixed exchange rate and absence of discretion in adjusting the money supply make the economy vulnerable to exogenous shocks. A sharp increase in oil prices, for example, would require domestic prices to deflate to maintain the same level of economic activity. Conversely, sudden inflows of foreign exchange can create inflationary pressures since such inflows can be converted without restraints into additional domestic currency. Furthermore, as the economy grows, additional foreign currency must be brought in to keep the supply of local currency constant with respect to GDP. This requires either maintaining a current account surplus, which can be hard for a country that needs to import goods to finance investment, or attracting foreign savings through higher interest rates to increase reserves.

At this stage in Estonia's transition, however, the currency board has provided an important element of stability and confidence that has played a significant role in the economy's notable transition progress.

Table 5.1 Selected Economic Indicators, 1990-93

	1990	1991	1992	1993
GDP growth rate ^a (percent)	-3.6	-11	-14	-3
Inflation (percent) ^b	17.2	211	1,069	85
Fiscal balance (percent of GDP)	2.9	7.4	1	0
Official unemployment (percent) ^c	—	1.2	2.5	2.0
Real wages (percentage change)	6.4	-36	-38	6

a. Central Bank estimates indicate a small positive growth in GDP in 1993.

b. Year-on-year basis (average of one year compared to average of the next).

c. Share of labor force receiving unemployment benefits.

Source: World Bank (1992).

ciated with the transition process, strict fiscal policies and the early introduction of a modern tax system helped the country avoid current budgetary deficits. These measures also created good prospects for budgetary savings starting in 1994 that will help Estonia resume its program of public investment, which was virtually halted during the two years immediately after Estonia regained its independence.

Impact of reforms. Estonia's early introduction of price reforms improved its terms of trade in 1991 relative to its trading partners in the former Soviet Union and had a positive impact on enterprise profits and performance. The boost in profitability may have delayed adjustment during the following years, however, because the financial cushion that accumulated during the period of a positive terms of trade effect made it possible to hoard labor and avoid restructuring longer than would otherwise have been the case (Table 5.1). The movement in relative prices helped the government budget—subsidies were reduced, and inflation increased the revenue base. Price liberalization also eliminated the monetary overhang. Inflation soared from 19 percent in 1990 to over 200 percent in 1991, as real wages declined by nearly 40 percent.

The real shock took place in 1992. As other countries of the former Soviet Union² started to free prices and decentralize trade, Estonia's flows

with those countries contracted sharply and the terms of trade deteriorated. Based on 1990 data, Tarr (1994) has estimated that Estonia would have suffered a terms of trade decline of about 30 percent (about 16 percent of GDP). Output shrank by 14 percent in 1992, but unemployment rates remained very low. Inflation reached over 1,000 percent during 1992, fueled by domestic price reform, increases in the prices of raw materials and energy as Russia raised its energy prices to world levels, and the creation of the non-cash ruble to finance fiscal imbalances in the former Soviet Union. By 1993 real wages had fallen to half their 1990 level.

Currency reform played a key role in stabilizing the economy in 1993. The kroon has maintained its parity with the German mark, and inflation between mid-1992 and mid-1993 dropped to 85 percent. Foreign reserves of the Bank of Estonia more than trebled following the currency reform, and in early 1994, equaled more than three months of imports. With trade increasingly shifting to Western markets after 1992, Estonia felt less of an impact from the collapse in trade with the former Soviet Union. Annual interest rates on loans dropped from over 50 percent at the time of monetary reform to around 20 percent in early 1994. Real lending rates have generally remained positive with respect to anticipated rates of inflation, which have been falling steadily.

Although GDP fell more than 30 percent between 1989 and 1994, official unemployment (workers receiving unemployment benefits) remained at around 0.1 percent of the labor force until early 1992, rising to 2 to 3 percent during 1993. Hidden unemployment is considerably larger, however, since workers have been on unpaid leave or short work weeks. Including those workers brings real unemployment up to 8 to 10 percent of the labor force in 1994. The private sector is absorbing substantial amounts of labor, and open unemployment has been reduced by the large net migration out of Estonia—especially to Russia. (Between independence and 1994, Estonia's population dropped from 1.6 million to 1.5 million.)

The first signs of a turnaround began to appear during 1993. GDP growth resumed in the second

quarter of 1993, and preliminary estimates indicate an overall decline for the year of only about 3 percent.³ Trade, especially with Western Europe, continues to grow rapidly, responding to Estonia's essentially free trade policies and the favorable market access conditions that European countries have granted. The rapidly growing private sector now accounts for 80 to 90 percent of retail trade and a rising share of manufacturing output. GDP may well show substantial growth in 1994.

Complementary reforms. Progress in structural reforms, such as privatization, labor mobility, and financial intermediation, has been slower than in stabilization. Structural reforms are needed to improve the responsiveness of production and investment to market forces. When structural reform moves too slowly—often to keep unemployment from rising too high—recovery slows as well, which can reverse some of the benefits from stabilization. Aware of these undesirable consequences, the Estonian government has accelerated structural reform since early 1993.

The need for enterprise restructuring and privatization became more urgent with stabilization and the tightening of monetary and fiscal policies. Enforcement of bankruptcy laws also created pressure to reduce inter-enterprise and tax arrears and to privatize failing public enterprises.⁴ Privatization had been slowed by restitution issues, limits on the sale of land, conflicting views of state and local authorities, and problems of valuation. Privatization gathered speed during 1993 however, following institutional and procedural improvements. A single entity, the Estonian Privatization Agency, became responsible for all enterprise privatization. By early 1994 more than 80 percent of small enterprises had been privatized, mostly in trade and services, and only an estimated 300 large enterprises remained to be privatized.⁵ The head of the privatization agency called for more bankruptcy proceedings for state companies that cannot readily be sold through conventional channels.

Closely linked to privatization is labor mobility. Formal constraints to labor mobility do not exist, but structural rigidities, mostly inherited from the Soviet years, continue to reduce labor move-

ment. The housing situation remains difficult and uncertain, and other non-wage benefits provided by enterprises in the Soviet tradition reduce people's willingness to move. Privatization of the housing stock and state enterprises, along with the transfer of responsibility for most social services from enterprises to government agencies, is addressing these problems. Severance pay is high, averaging two to four months of wages, but companies appear to be avoiding severance costs by putting workers on special unpaid leave.

Problems in the financial sector and the reluctance of banks to lend in the current high-risk environment are also impeding adjustment and economic growth. Risks are high because of the uncertain future of many enterprises and the widespread lack of collateral until land rights are better established. The resultant high nominal interest rates discourage borrowing since potential borrowers rightly anticipate future declines in both inflation and interest rates. Non-performing ruble credits and the freezing of the assets and receivables of Estonian banks in Russia have eroded the financial condition of many banks and state enterprises. The value of these claims is further reduced by the high rate of ruble inflation and the small likelihood of settlement.

All of these intertwined problems point to the need to proceed rapidly with privatization, enterprise liquidation, and related reforms in property rights. Increased capitalization of banks could help reduce the risks. Although the banking system is highly liquid, most of its liquidity comes from short-term deposits. The lack of long-term funds exposes the banks to high risks in cases of delayed loan repayments. Without adequate capital and long-term reserves, a bank could be forced to close because of temporary liquidity problems. (As noted above, the central bank in Estonia is prohibited from lending to commercial banks in all but the most exceptional rescue cases.) An emerging inter-bank market is easing some of these liquidity management problems, but a more adequate capital base would allow banks to prudently take on some higher risks. That in turn could make significantly more credit available to enterprises for long-term working capital and investments.

Trade Flows

Estonia has been the most successful among the countries of the former Soviet in reorienting its international trade to the West. That reorientation was facilitated by a pattern of trade during the Soviet period that more closely matched its comparative advantage than was the case for many other republics. Also, the share of Soviet-oriented heavy machinery in total exports was smaller for Estonia than for the two other Baltic countries.⁶

Level and direction. As part of the USSR, Estonia depended on internal trade for 95 percent of its exports, one of the highest dependency ratios in the union (Table 5.2). By 1992 and 1993 well over half of Estonia's exports (measured at official exchange rates) was to the West, the highest share among the former Soviet states.⁷ The reorientation of imports has been even more substantial, with some two-thirds of imports originating in the West in 1993, mostly in Finland. After a sharp drop in 1992, Estonia's trade started to recover in 1993.⁸ Total exports doubled in dollar terms. The most dynamic component has been trade with the West.

The bulk of this trade in 1992 and 1993 was with Estonia's Nordic neighbors. Finland became Estonia's largest trading partner, taking a fifth of Estonia's exports and supplying more than a third of its imports in 1993. Trade with Sweden also increased substantially, probably reflecting geographic proximity and the impact of Estonia's free trade agreements with the Nordic EFTA countries. Trade with the European Union has been less important, but growing, a process likely to be accelerated by the Free Trade Agreement signed with the EU in July 1994.

Of the ex-Soviet republics, Russia's share in Estonia's exports remained important, but fell sharply from 60 percent in the late 1980s to 20 percent. Belarus and Ukraine, once important trading partners, now account for only a small share of Estonia's exports. Baltic trade accounted for 12 percent of Estonia's exports, but only 6 percent of imports. This trade can be expected to increase with the establishment of the Baltic Free Trade Area in April 1994, and with increasing specialization in the three countries.

Table 5.2 External Trade, 1990-93
(in millions of current dollars and percent)

	1990	1991	1992	1993
<i>Value</i>				
Total exports	4,381	3,886	389	802
Former Soviet Union ^a	4,183	3,836	147	341
Rest of world ^b	198	50	242	461
Total imports	5,343	3,200	400	944
Former Soviet Union	4,751	2,996	146	326
Rest of world	592	204	254	618
Total balance	-962	686	-11	-142
Former Soviet Union	-568	840	1	15
Rest of world	-394	-154	-12	-157
<i>Percentage Distribution</i>				
Total exports	100	100	100	100
Former Soviet Union	95.5	98.7	37.8	42.5
Rest of world	4.5	1.3	62.2	57.5
Total imports	100	100	100	100
Former Soviet Union	88.9	93.6	36.5	34.5
Rest of world	11.1	6.4	63.5	65.5

a. Figures for trade with the former Soviet Union are derived from country data and World Bank staff estimates reported in national currencies using official or commercial exchange rate for 1990 and 1991 and annual average market exchange rates for 1992 and 1993.

b. The rest of the world refers to countries outside the former Soviet Union; figures are based on country data reported in U.S. dollars.

Commodity composition of trade. The commodity composition of Estonia's trade with the former Soviet Union has not changed much over the past 50 years. Estonia has exported processed food, textiles, and capital-intensive engineering products in return for energy and raw materials. Since Estonia regained its independence in 1991, the volume of this trade has declined significantly, but the patterns have not changed appreciably—in part because Estonia's production structure under the Soviet regime was less distorted with respect to its underlying comparative advantage than was the case for most of the republics. Food and engineering products continue to dominate exports to Russia and other newly independent states. In trade with the West, mostly with Europe, Estonia exports principally resource-intensive goods, such as wood and food, and labor-intensive manufactures, such as textiles, clothing, and furniture. About a third of imports from the West have traditionally been capital goods and 15 percent energy products. In 1993 imports of capital goods were up 150 percent, reflecting a significant increase in new investment activity, much of it financed by foreign direct investment.

The bulk of Estonia's exports to the Baltics go to Latvia. In 1992 electricity made up two-thirds of those exports, the rest being chemicals, textiles, and machinery. As Estonia sold its electricity in 1993 for less than one-tenth the price prevailing in Western countries, future exports to Latvia are likely to benefit from substantial gains in terms of trade. The modest trade with Lithuania consists primarily of consumer goods—cotton, paper, and clothing were traded (often by barter) for energy and some consumer goods. In 1993 processed food became an important export item to both Baltic neighbors.

Because of its geographic location, Estonia has long been heavily involved in East-West trade. This trade picked up again during 1992. It includes regular re-exports from the former Soviet Union that are shipped to the West through Estonian ports, and re-exports of nonferrous metals and petroleum, much of it of questionable origin.⁹ The large differences between world prices of raw materials and

prices in many parts of the former Soviet Union has stimulated this trade, as have export restrictions in many countries. The Estonian government has used border controls, licensing of petroleum importers, export taxes and a state monopoly on metals to restrict this trade, but the measures have had limited impact because smuggling is difficult to control and the financial incentives are enormous. Much of the problem will disappear as price liberalization proceeds in Russia, a process that had already begun by early 1994. Even after domestic and world prices converge, transit trade in these goods is likely to continue since many countries in the former Soviet Union are major suppliers of such products, and the Baltic ports are well-suited for handling these goods and shipping them on to European and other destinations.

Trade in services is a major source of foreign exchange earnings for Estonia, contributing US\$ 335 million gross and US\$ 77 million net in 1993. Services that year were equal to 41 percent of merchandise exports. Transit trade, tourism, and shipping are Estonia's major sources of service export earnings, reflecting its favorable gateway position between East and West, its long-established role in trade and shipping services, and its many cultural and historic attractions which, together with low prices, make Estonia an attractive destination for tourism. Estonia's liberal trade policies, increasing economic stability, favorable investment climate, and emerging role as a financial center in the region indicate that services will continue to be an important source of export earnings.

Trade Policy

As a small, open economy, Estonia has long relied heavily on trade. Openness provides many advantages for a smooth and rapid transition to a market economy. It provides a rational set of market-determined prices for resource allocation, introduces competition even to local monopolies, and allows countries to specialize according to their comparative advantage. Openness has also allowed Estonia to exploit its advantageous position close to high-income European markets and between East and West.

Export policies. Estonia liberalized its export policies early. Nearly all export restrictions had been removed by 1992.¹⁰ With its more rapid liberalization of prices, Estonia had less need than many of its neighbors in transition for export controls to protect food security or to ensure the domestic availability of goods. These liberal export policies allowed exports to expand and enabled the country to earn the foreign exchange to buy needed imports.

The remaining export and import licenses are based largely on social, security, or health grounds. Some restrictions protect strategic supplies or encourage domestic value-added (as in art glass making).¹¹ The only remaining trading monopoly is in metals exports, an attempt by the government to control this lucrative trade, to get a share of the profits, and to reduce related illegal activities. Although export restrictions are very limited, it is important to ensure that procedures for securing any required licenses are simple and transparent so that licenses are not used as trade restrictions.

Import policies. Estonia has no quantitative import restrictions and very few import taxes.¹² The last of the often high import tariffs on Western trade inherited from the Soviet system were abolished in February 1992 (IMF 1993). Import licenses are in force mostly for health and security reasons. To reduce evasion of the fuel excise tax, the government imposed a license requirement on all importers of fuel products in January 1994.¹³ With these exceptions, any enterprise or individual may import virtually any good.

Until recently, domestic industry has been implicitly protected by the undervalued exchange rate. Estimating an equilibrium exchange rate is difficult under the conditions prevailing in a transition economy, but the slowing and occasional reversal of international reserves accumulation indicate that an equilibrium real rate is developing. Further suggesting that the kroon is no longer significantly undervalued is the threefold rise in domestic prices since the exchange rate has been pegged. The estimated purchasing power parity (PPP) rate was four kroons to the dollar at the time of monetary reform in June 1992, or about one third of the prevailing market exchange rate at deutschemark-dollar cross-

rates. If the PPP rate can be taken to represent the equilibrium rate at the time of monetary reform, inflation has eliminated most of the original undervaluation and the protection which that undervaluation provided.¹⁴

Issues in trade policy. Estonia's liberal trade regime, and its convertible and originally undervalued exchange rate have been instrumental in adjustment and reorientation of its exports. The undervalued exchange rate created incentives for exports to hard currency areas and shielded domestic producers from international competition, providing uniform incentives for producers and allowing viable activities to survive. Exchange rate protection avoided the lobbying that comes with tariff protection and let the market rather than the government pick the winners.

The policy of no protection also established an environment of openness and transparency, with clear market-based signals for producers. Easy access to foreign inputs and foreign exchange at world prices encouraged export development. This policy framework was more effective than a system of duty-drawbacks would have been, especially because inexperienced administrators tend to reduce the attractiveness of such schemes through processing delays and other means. The transparency of economic policies and the duty-free environment were also favorable to the development of subcontracting activities that take advantage of Estonia's highly skilled but low-cost labor. Subcontracting is often a first step to exporting and foreign investment in countries like Estonia, where conditions are less favorable to foreign investment than in industrial nations.

Estonia's trade performance clearly demonstrates the success of these policies. Estonia's trade performance in 1993, the first year for which trade values are relatively reliable, surpasses that of all the other ex-Soviet republics. In 1993 Estonia had per capita exports to the West of US\$297, compared with US\$181 for Latvia and US\$90 for Lithuania. Estonia has also attracted the highest level of foreign investment per capita of the Baltic states (see below). Estonia substantially increased its exports of textiles and clothing to Finland and Sweden, and conquered new markets in the EU, especially in Germany.

The main challenge now is to avoid backsliding in response to protectionist pressures, which are particularly strong now in agriculture. Industry is likely to begin clamoring for protection as hard budget constraints, rising input costs, and the loss of traditional markets force more firms to restructure or close. Government revenue shortages, rising unemployment, and the appreciating real exchange rate may also create pressures to impose barriers to trade.

Since mid-1992 agriculture has been pressuring for tariff protection and for production subsidies and concessional credit to help counter the rapid rise in prices of imported inputs.¹⁵ Parliament passed a producer-price-support law in August 1993 to guarantee agricultural incomes. The law could result in annual support payments of EEEK 1.2 billion, about 20 percent of estimated budgetary expenditures in 1993. The law provided a safety valve, however, requiring the subsidies only if the budget could handle the added burden.

Because the low import prices in agriculture often reflect export subsidies in Western countries or the slower pace of price liberalization in other ex-Soviet republics, across-the-board protection would be overkill, leading almost inevitably to domestic inefficiencies and resource misallocation. Any move to increase protection involves substantial risks. Tariffs are difficult to remove once established. Selective, temporary protection can be used to address unfair trade practices or sudden surges in imports (both countervailing duties and safeguards are permitted under the GATT), but these mechanisms involve considerable danger as well, and the merits of each case should be carefully assessed. They should be introduced only after a public inquiry at which producers and consumers make their interests heard, and should include a sunset clause, invoking automatic expiration after a fixed period, say a year.

The recent increase in export and import controls on health grounds for agricultural and forest products should be reviewed to ensure that the controls will be limited to those required to achieve the health objectives sought. Some risk exists that the licenses may be used to control domestic supplies

or protect domestic producers, particularly if the health controls do not apply to domestic production.

Recommendations

Controls on exports should be used sparingly because of their high economic cost. They are justified only for clearly defined health or security reasons or when domestic price controls that keep prices artificially low cannot be relaxed immediately for social reasons.¹⁶ Export controls might also be justified if Estonian exports in target markets were to become subject to quotas, which would create a need to ration access by domestic producers and exporters to these markets. So far this has not happened.

Export restrictions tend to lower the prices for domestic users, reduce pressures for domestic price adjustments, discourage potentially viable export development, and protect local industries that use the goods as inputs. Export restrictions also affect imports by reducing foreign exchange earnings. Taxes are generally preferred to licenses because they are more transparent, less apt to stimulate lobbying, a good mechanism to transfer the rents from producers to the government. Where price incentives are strong, bans on exports are difficult to enforce. Estonia's failure to control exports of non-ferrous metals through export restrictions is a good example.

Protection from imports will do almost nothing to solve the problems of Estonia's agricultural sector. The problems stem from poor quality, uneconomic scales of production, and distorted input prices. Improving internal efficiency and downsizing the sector in line with market demand are needed. Tariff protection or subsidies would only retard or impede adjustment to world prices.

Similarly, protection will not solve the problems of Estonian industry, which come from outdated technology and inefficient scales of production geared to the large Soviet market. Distorted prices under central planning had led to the use of input-wasting technologies that have become unprofitable as input prices climb to world levels. Erecting protective barriers would retard adjustment by allowing producers to continue using inefficient

methods (instead of exposing them to modern technologies and efficiency-increasing competition) and to continue producing poor quality products unable to compete in Western markets. Estonia needs an action plan for industrial transformation that meets four objectives:

- Moves rapidly on restitution and privatization, with clear titles to property.
- Provides adequate corporate governance and ownership control for enterprises pending privatization (the difficulty of providing good corporate governance for public enterprises leaves rapid privatization as the only viable approach).
- Develops restructuring or liquidation plans for those enterprises that cannot be sold.
- Restructures the banking sector and improves banking skills so that investments can be properly evaluated and adequate finance made available.

The revenue arguments for protection are weak as well. Several factors work against the use of trade taxes for raising revenue. Estonia has entered into free trade agreements with a number of its most important trading partners (four EFTA countries, the Baltics and, most recently the EU) that cover a major share of imports. Since these imports would have to be exempted, the scope for revenue collection is severely limited, and tariffs would divert even more trade toward the free trade partners, further reducing the potential revenue yield. Using trade taxes to raise revenue makes sense only in low-income countries that lack the administrative capacities to collect broader-based taxes, which is not the case in Estonia—even if its tax administrative capabilities are not yet up to European standards. Rather than focusing on import duties, Estonia should make some minor adjustments in broad-based income and value-added taxes, which could boost revenue substantially without introducing large economic distortions.

Pressures for protection will increase as unemployment rises during the transition, but the costs of

yielding to these pressures could be high and the gains small. By weakening incentives to adjust, protection would delay transition and slow economic growth. Although protection might reduce unemployment in the short run, the delay in recovery would mean protracted demands for unemployment insurance and other social safety net spending, increasing the fiscal burden over the longer run. Protection would also force domestic producers and consumers to pay more for products they need, reducing real consumption as well as the resources available for investment in future growth.

Trade Policies with the Former Soviet Union

Estonia has followed a policy of non-discrimination in its trade with the countries of the former Soviet Union and a complete shift from state trade to enterprise-to-enterprise trade within a framework of general trade agreements. Trade with the ex-Soviet republics is subject to the same rules as trade with countries in the West. Indicative lists have not been used since early 1992.¹⁷ Since 1993 exports to non-convertible currency areas are no longer subject to the value-added tax. These measures contributed to some recovery in trade with the former Soviet Union in 1993. After a large drop in 1992, the value of exports to the region in 1993 (measured at official exchange rates) rose to two and a half times their value in 1992.

In early 1992 Estonia had bilateral agreements in place with Azerbaijan, Kyrgyz Republic, Russia, and Uzbekistan. The main benefit of these agreements for Estonia was that they facilitated access to Russian exports of vital goods such as fuel, an advantage that diminished in importance as most of the agreed trade failed to take place and Estonia developed alternative sources of supply in the West.

A September 1992 general trade agreement with Russia was never implemented. Russia failed to ratify the agreement, mostly for political reasons, but also because of disagreements on rules of origin and the handling of re-exports of strategic Russian goods. Russia wanted the government of Estonia to police a ban on such goods. Failure to do so would result in cuts in strategic exports to Estonia such as gas and oil. The main advantage of a trade agreement

to Russia would be to restore most favored nation treatment, under which Russia's import duties on Estonian exports would drop to about half their current levels. Both Russia and Estonia continue to provide duty-free treatment for each other in outward processing activities, such as Estonian processing of Russian raw materials for re-export to Russia.

Estonia should try to conclude a trade agreement with Russia that will grant it most-favored-nation status and reduce the policy-derived uncertainty in trade with Russia. That would help Estonia maintain some trade with its old partners during the transition process, trade that will be particularly important for industries that cannot quickly restructure their production to compete in Western markets. Estonia is likely to be a competitive supplier of food and textiles to the many countries of the former Soviet Union even beyond the transition, another strong argument for placing trade relations with Russia and other newly independent countries on a sounder basis.

A temporary preferential agreement with the countries of the former Soviet Union is sometimes proposed to help maintain trade flows with the area. Such an agreement is unlikely to be in Estonia's interest, however, particularly since Estonia might have to sacrifice its liberal policies to reach compromises with more protectionist partners. More efficacious would be to address the many non-tariff barriers that still impede trade in the region, such as payments problems and currency inconvertibility.

Trade among the Baltic countries is now facilitated by the Baltic Free Trade Agreement, which came into force on April 1, 1994. By removing payments bottlenecks and other non-border constraints to trade, the agreement should improve the market access of Estonian products in neighboring countries and set them on an equal footing with Western free trade partners.

Foreign Exchange and Payments

Establishing a convertible currency was an important improvement in the incentives for foreign trade because increased public confidence in the convertible kroon encouraged companies to engage

in foreign trade and repatriate foreign exchange earnings. This reduced capital flight and improved incentives for domestic investment by establishing positive real returns for domestic assets. Since the currency reform, access to foreign exchange is no longer a barrier to trade; foreign exchange is freely available to all importers at market exchange rates.

Until the currency reform, enterprises were required to surrender foreign exchange at the overvalued official exchange rate and pay a separate tax on their foreign currency profits. A surrender requirement was reintroduced with convertibility, but at market exchange rates, a requirement abolished in early 1994. In a period of hyperinflation, a surrender requirement at below-market rates imposes a heavy cost on enterprises and makes access to foreign inputs more difficult. Surrender at market rates can still carry a cost if the margin between buying and selling rates of foreign exchange in commercial banks is high.

Payments problems with countries of the former Soviet Union still remain, stemming from the credit situation in Estonia and the instability of the Russian ruble, even though many of the physical payments problems—lengthy clearing procedures, physical transfer of documents—have been solved. Introducing independent currencies created some initial problems in clearing payments because the central banks were not accustomed to dealing directly in foreign exchange for transactions within the former Soviet Union. Introducing the kroon made payments easier once banks and traders became accustomed to the change since the kroon was stable, convertible, and widely available as both currency and credit—everything the ruble was not. All ruble correspondent accounts were closed after the kroon was introduced, and new correspondent accounts were opened between the Estonian and Russian central banks. In late 1992 Estonian commercial banks were allowed to open their own correspondent accounts with counterparts in Russia, an arrangement that improved the payments situation substantially. Private commercial banks have started to make payments arrangements with their counterparts in other republics. No hard documents are needed for transactions, and some banks in

Estonia are now linked into the System for Worldwide Interbank Financial Telecommunication (SWIFT). Payments transactions are complemented by open auctions in Tallinn that allow residual balances to be converted into the desired currency when required. However, demand for rubles in Estonia tends to be low, making the market volatile.

Trade finance is still difficult to get and expensive, at least in nominal terms. Banks consider trade finance to be high risk, and since the banking crisis in 1992/93, they have favored security over high yields. Many enterprises are in such severe financial straits that they have no money in the bank to cover payments orders. Until property rights are established and privatization is further advanced, the lack of collateral will limit access to credit. Some countries or areas within countries have no correspondent banks, making access even more difficult for certain enterprises.

Weak prudential supervision in the past allowed some banks to sit on payments orders until funds are received rather than notifying the payee of the fund shortage. The clearing situation improved substantially during 1993, in large part because of the heavy penalties the central bank imposed on banks that delayed payments. Since the end of 1993 payments within Estonia and to the West have generally been executed without delay. Payments with the new independent states improved substantially in 1994, at least for enterprises that are able to use the private correspondent accounts. However, many Estonian enterprises have started to request prepayment or payment in hard currency for trade transactions involving rubles, since high ruble inflation made delaying payments attractive to Russian enterprises. Nevertheless, Estonian companies are sometimes forced to accept rubles in payment because markets are limited for many products, and trade with Russia is the only way in the short term to keep some companies going. Because of these problems, barter still accounts for a significant share of total trade.

Microeconomic and Trade Adjustment

In addition to macroeconomic influences, Estonia's trade adjustment was aided by several structural and microeconomic factors particular to

Estonia. Most important are its location, resource base, industrial structure, and skilled labor force. In addition, successful macroeconomic stabilization is creating a favorable environment for private sector development and foreign investment.

Structural issues in trade adjustment. Estonia's share of heavy industries (whose adjustment to world prices or Western standards is most difficult) was relatively small compared with the other Baltic countries—17 percent compared to 30 percent. Estonia also had a relatively small share of all-union enterprises—40 of a total of 300 large industrial enterprises, whose heavy reliance on subsidized inputs from the region, such as energy, made them especially vulnerable to the terms of trade shock and trade disruption. Switching types and sources of inputs is often technologically more difficult for these firms, while their previous monopoly status and state ownership make it hard to adjustment to competition.

The structure of the energy sector in Estonia also made adjustment easier. The domestic availability of oil shale, which is burned directly to generate electricity, reduced the country's dependence on oil imports—oil shale meets about half the country's energy needs—and lessened the terms of trade shock. Port infrastructure already in place was able to handle supplies from sources outside the former Soviet Union, further facilitating a shift in energy inputs.

Adjustment is generally easier in labor- and natural resource-intensive industries. The high skill level of the Estonian labor force, which facilitates the adoption of new techniques, is also easing trade reorientation. Years of schooling in Estonia are close to those in industrial countries and among the highest in Central and Eastern Europe. The combination of high skills, low wages, and an open trade regime has created favorable conditions for subcontracting, which has promoted exports and adjustment through the transfer of technology and know-how. One Estonian firm that started with subcontracting has since increased both its overall levels of output and its percentage of value added, gradually becoming a successful independent exporter of garments in its own name. The company

has even started to train its own subcontractors in Latvia and elsewhere in Estonia. Estonia is the only Baltic country with substantial labor-intensive exports to the West; Latvia and Lithuania export more resource-intensive goods, which may be the result, in part, of their traditionally less transparent and more protectionist trade regimes.

The more standardized nature of products in resource-based industries makes trade reorientation easier. These goods rely on local raw materials and therefore suffer least from trade disruption with the former Soviet Union. Minor changes in packaging or quality are often enough to meet Western standards. As part of the Soviet Union, Estonia was already exporting large quantities of fish to the West and therefore had some familiarity with Western standards. However, significant investments are often required in food product industries to meet Western health standards.

Excluding metals and petroleum for likely re-export, labor-intensive products (mainly clothing and furniture) accounted for one-third of exports to OECD countries in 1992 (Table 5.3). Nearly another third consisted of resource-based goods such as wood and food. The largest losses in overall trade volumes were in heavy industry and in energy-intensive industries such as chemicals and engineering, which were the most dependent on Soviet markets. Data for 1993 shows a continuation of the trend of Western exports based on labor- and resource-based goods.

Statistics on industrial output for 1992 confirm that no radical change had taken place then, though there is some indication of a switch to labor- and resource-based activities. Heavy industry declined from 24 percent of the total in 1990 to 21 percent in 1992, while light industry increased its share from 26 percent to 29 percent. Clothing is the only industrial subsector that did not suffer a major decline in output in 1992, largely a consequence of its rapid re-orientation to the West (especially through subcontracting arrangements) as demand in ex-Soviet markets fell and terms of trade there worsened.

Import competition hit agriculture the hardest. However, the main causes for the sector's 40 per-

Table 5.3 Structure of Baltic Exports to the West, 1992

Indicator	Estonia	Latvia	Lithuania
Exports (Indigenous) (US\$ million)	219	175	223
Exports per capita (US\$)	137	65	60
Re-exports (US\$ million)	154	372	418
Oil	20	290	247
Metals	134	82	172
Total Exports to the West (US\$ million)	373	547	641
Share of industry (percent)			
Labor-intensive	34	19	17
Resource-intensive	29	31	29
Capital-intensive	20	28	31
Other	17	19	23
Memorandum Item			
Officially reported exports to the West (US\$ million)	242	429	557

Note: Data as reported by OECD countries. Labor-intensive = SITC 65, 82, 84, and 85; resource-intensive = SITC 9, 24, 63; capital-intensive = SITC 5, 7; re-exports = SITC 28, 33, 67, 68.

Source: COMTRADE.

cent decline in output between 1990 and 1992 were the loss of Soviet markets, difficulties in getting inputs, and the sharp increase in the costs of inputs—especially fuel and fertilizer, goods that were highly subsidized under the Soviet regime. A drought in 1992 also hurt output.

Foreign investment. Foreign participation has been important in helping Estonia re-orient its exports. By mid-1993 nearly 4,000 enterprises with foreign capital were operating in Estonia, accounting for nearly 10 percent of registered enterprises.¹⁸ Finland leads in number of ventures, Sweden in terms of capital. The early and gradual involvement of foreign partners since the late 1980s exposed Estonian enterprises to Western business practices. These initial contacts with foreign clients or suppliers often provided the first outlets for re-oriented trade. Some companies used their former clients' distribution networks or hired managers from former foreign suppliers as consultants in market

development. Foreign investors are also likely to be important in the privatization process.

Foreign investment in Estonia has been the highest among the Baltic countries, a sign of the confidence in Estonia that has developed abroad because of its stable economic environment, structural reform and free trade policies. In 1993 Estonia attracted US\$69 per capita in foreign investment compared with US\$18 in Latvia and US\$11 in Lithuania. Foreign investment in Estonia doubled between 1992 and 1993.¹⁹ The bulk of foreign direct investment in Estonia comes from the West and is related to trade, whereas the majority of foreign investors in Latvia and Lithuania are from the other ex-Soviet countries and focus on their own domestic markets.

Private sector. Getting private sector activity to grow quickly is important in the transition for absorbing labor and bringing out a supply response to the new incentives. Information on the emerging private sector in Estonia is patchy, and much of the sector's activity is not captured by official statistics. Its role in adjustment already appears to have been quite important, however. Estonian authorities estimate that by the end of 1992, the sector accounted for about 20 percent of total output (IMF 1993). By early 1994 over 80 percent of retail sales were made by private enterprises. In December 1992 about one quarter of the 50,000 enterprises registered with the national enterprise register still belonged to the public sector. In agriculture, privatization has resulted in the emergence of 10,000 new farms (EIU 1993). The private sector is likely to expand further as privatization of state enterprises gathers momentum.

Private sector growth is a response to the liberal incentive framework and helps explain the low unemployment levels despite the large declines in output and employment in the formal sector since independence. Between 1991 and 1992 employment declined by nearly 30,000 in industry and by 15,000 in agriculture, yet by mid-1993 only about 22,000 people had registered as unemployed. No statistics are yet available on private sector employment.

Policy Conclusions

Recommending improvements in external trade policies is difficult in a country that has done

almost everything "by the book." Estonia has already implemented most of the standard recommendations relevant to its circumstances, and has done so in the midst of the daunting complexities that accompany the transition from a centrally planned to a market-based economy.

Consolidating gains. The main task facing Estonia's leaders today is to protect and preserve what has already been accomplished. Resisting pressures to introduce additional tariffs and other protective barriers is an important challenge. Since the pressures today come largely from the agricultural sector, high priority should be given to finding solutions to the problems of this sector that will ensure the well being of the rural population without recourse to tariff protection. Protectionist pressures from the industrial sector are not yet as strong, but demands for protection may well rise as more of the large state enterprises are privatized and begin shedding substantial amounts of labor.

For both agriculture and industry, the best way to protect the living standards of those now working in these sectors is to maximize the overall growth of the economy and to facilitate the movement of labor into the good jobs that are developing in leading sectors. Growth and labor mobility would be seriously imperiled if protectionist measures that seek to preserve uncompetitive jobs are allowed to prevail.

An agenda for action. The people of Estonia, especially those whose jobs will be displaced as the economy shifts production to sectors in which the country can be internationally competitive, need to understand why protection is not the answer. Public information and education campaigns can make an important contribution. But more is needed. If the government is to successfully resist protectionist pressures, it must not only follow sound economic policies, but must also be perceived by the public to be actively engaged in ensuring a better life for all Estonians in the future. Simply resisting protectionist forces will not be enough. To preserve the remarkable progress already made in establishing a sound economic environment based on competition and free trade, the government will need to launch an active, high-visibility program to facilitate the

movement of workers to new and better jobs. The current economic policy environment, if maintained, will virtually ensure that these jobs will be created. The task is to help workers move to the jobs.

To preserve incentives to change jobs, the government will need to stand firm in refusing to preserve jobs by bailing out inefficient firms that are going bankrupt. It should also keep unemployment benefits close to levels needed to maintain minimum living standards to avoid creating perverse incentives to accepting new employment. The government should also resist efforts to accelerate development in specific areas of the country through public subsidies—a policy that rarely achieves its objectives.

The government could take several actions to facilitate the creation of new jobs and the movement of workers to such jobs.

Market access. The government should seek to improve access to markets in the former Soviet Union as well as in the West. A country the size of Estonia can achieve internationally competitive scales of production only by expanding its markets externally. Initiatives currently under way to improve Estonia's permanent access to the European Union markets will play an important role in maintaining the growth of Estonia's exports to western markets—though it will be challenging to find ways to limit the degree to which Estonia must introduce tariff barriers in order to participate in this customs union.

Adjustment policies and infrastructure. Aside from preserving the progress already made in establishing an investment-friendly, competitive environment, the most important contributions the government can make to growth and employment are to accelerate privatization, especially in large-scale enterprises, land, and housing; improve the security and marketability of property rights; and improve basic physical infrastructure to support private sector economic activity. Such developments will help establish the conditions needed to encourage the sound, market-based lending against collateral that is needed to sustain the transition process.

Education. Ensuring the right kind of education and training in hard-hit areas, especially for people under fifty years old, would make a major contribu-

tion to labor mobility. The Soviet education system turned out graduates with highly specialized skills, but without adequate flexibility to adapt to new types of work. To make it easier for people to leave jobs in declining industries and to find new, more productive jobs, adult workers need training in basic skills such as searching for jobs in a market economy, using a computer, and even, for some workers in old Soviet enterprises, speaking Estonian. Such training can be provided at low cost and can have a large direct impact on changing the structure of employment, while demonstrating the government's concern and thus building credibility for its market-oriented approach.

Education for children will be even more important in the longer term. Experience around the world shows that labor mobility and living standards are highest where general education at the primary and secondary levels is strongest. Since poor, hard-hit areas can rarely afford to finance high-quality education with their own resources, interregional transfers by the central government will be required. A comprehensive strategy for restructuring and financing education for life in a market economy should be developed.

Housing. The government needs to formulate a comprehensive policy package relating to housing development. Many Soviet-era industries and collective farms were located in particular areas for political rather than economic reasons. As a result, today there are large concentrations of people in locations where new employment opportunities will be hard to find. The movement of labor from rural to more urbanized areas, or from large state farms to smaller family-run commercial farms, means that part of an already inadequate housing stock will have to be abandoned or used less intensively by the smaller group of families who remain.

Although some workers can commute from rural to urban areas in many parts of Estonia, other workers will not be able to take new jobs in distant towns if they cannot find a place to live. Since many of the workers who move to new jobs will have very limited financial resources, affordable rental housing is vital. Detailing the elements of a policy package for housing reform in Estonia lies

beyond the scope of this book, but implementing such a policy could go a long way to preserving Estonia's remarkable free trade environment.

Social safety net. Every country needs a system of social services, including social infrastructure, that reaches even the poorest areas. These services—such as health clinics, schools, employment services, police, and infrastructure, including clean water and sewage disposal—have a direct positive impact on people and build confidence that the government is concerned with helping them through the transition process. Furthermore, the provision of such services often involves direct employment opportunities at the local level and, by making real income transfers in kind rather than cash, avoids the problems associated with welfare payments.

A social safety net to protect those least able to adjust to global competition is important for reasons of equity and for reinforcing the credibility and sustainability of the government's policies. Protectionists should not be able to point to groups of people living in squalor because their jobs were wiped out by competition from goods produced more efficiently somewhere else. While the government's emphasis should be on facilitating the movement of labor into new, more productive jobs, significant resources will need to be allocated to provide means-tested transfers so that all Estonians can live decently through the transition process.

In sum, Estonia's stellar economic policies are fostering rapid growth in external trade, especially with the West. Now it needs to give increased attention to the domestic policies required to assure that its trade policies can be sustained.

Notes

This chapter draws upon work on Estonia's trade policies by A. Hillman, and benefitted from comments by Michael Michaely, L. Alan Winters, David Tarr, and Costas Michalopoulos.

1. All further references to Estonia's independence refer to the restoration of independence in August 1991, not to Estonia's independence from Czarist Russia in 1918.
2. Although this chapter refers to Estonia as a former Soviet republic, this status was defacto, not dejure.
3. Preliminary estimates range from the -7.8 percent of the Estonian Statistical Office to the slight positive increase of

the Bank of Estonia. Estimates from the latter source, based on indicators such as electricity consumption which capture the new private sector more adequately than official GDP statistics, indicate that the recovery may have even started in late 1992.

4. Inter-enterprise arrears were estimated at about 20 percent of GDP in mid-1992. These stabilized by year-end, but tax arrears increased to EEK 520 million by end-1992. Net credits to foreign enterprises in the former Soviet Union were estimated by the IMF at EEK 400 million by end-1992 (IMF 1993), much of which may be very difficult to recover.

5. In 1991 Estonia reported a total of about 2,700 state enterprises of which 2,234 were controlled by various ministries, and 421 were controlled by local governments. There were also about 1,773 cooperatives (World Bank 1992).

6. In 1990 capital goods constituted 28 percent of Estonia's exports, compared with 37 percent for Latvia and 43 percent for Lithuania (World Bank 1992).

7. The margin of error in these values is large because of the substantial adjustments in prices and exchange rates in the past few years. For example, market exchange rates indicate GDP per capita of US\$ 3,493 in 1991 and US\$ 959 in 1992, even though real GDP declined by only about 30 percent.

8. The decline in trade from 1991 and 1992 shown in Table 5.2 may be overstated. Exports to the former Soviet Union in 1991 have been converted from rubles to dollars at exchange rates that significantly overstate the equivalent dollar value of the ruble. Using Western price-based deflators would bring the decline from 90 percent to 50 percent between 1991 and 1992.

9. The trade in metals was valued at US\$ 45 million in 1992 and US\$ 90 million in 1993, some 10 to 11 percent of officially recorded exports. Import statistics of OECD trading partners indicate that another US\$ 90 million worth of metals was exported from Estonia, bringing the real total to over US\$ 135 million. In addition, petroleum re-exports accounted for another US\$ 20 million in 1992.

10. The number of export goods subject to licenses was reduced from 201 in 1991 to 38 in early 1992, and to negligible levels in 1994.

11. Licenses are required for exports and imports of metals on security grounds; tobacco products, alcohol, and pharmaceuticals on social and health grounds; and weapons and explosives on security grounds. Recently added to the list of goods requiring a special permit for trade were a number of agricultural and forestry products and pesticides (health grounds); precious metals (security); dangerous waste (social and health); and broadcasting equipment (security). Export licenses are required for silica and quartz sands, fire clay, gravel, petroleum and mineral oils, paraffin wax, and oil shale to protect strategic supplies. Distilled mineral tars have quantitative export restrictions. Export taxes remain in force only for cultural items.

12. Apart from a 0.5 percent statistical tax on imports and exports, the tariffs are effectively excise taxes on luxury items, such as fur (16%) and cars, bicycles and boats (10%), the same rates as the excise rates charged domestically produced goods.

13. These are charged on a specific basis to control tax evasion through under-invoicing of import costs. Although generally inferior to ad valorem duties, specific duties seem appropriate in the present environment of relatively stable world oil prices and significant difficulty controlling under-invoicing.

14. Estimates of the initial undervaluation based on purchasing power parity vary between 15 and 70 percent based on studies conducted in early 1992, before countries began to leave the ruble zone. Average monthly wages were more than US\$ 100 by mid-1994 (up from about US\$ 40 at the time of currency reform). Estonian products are still competitive in world markets at this wage rate, but aside from the margin provided by increasing productivity, the original undervaluation of the kroon seems to have been largely offset by inflation by mid-1994.

15. Domestic producers first complained about a butter substitute that they claimed was being imported at highly subsidized prices from Finland. A closer look showed the low cost was explained by the product being part butter and part margarine. Soon a similar local product appeared in stores at competitive prices. Other complaints related to very cheap agricultural products (especially eggs and cereals) coming from Russia. These complaints resulted in the imposition of a 70 percent duty on wheat flour from Russia in August 1993. The duty was abolished in December 1993, partly because of complaints from consumers, bakers, and pasta makers. By early 1994 Russia's prices had

risen sharply, and egg exports to Russia were again profitable.

16. The GATT rules allow for temporary export restrictions to prevent or relieve critical shortages of foodstuffs or other essential products, or those necessary to the application of standards, in the context of conservation of exhaustible natural resources, if such measures are made effective in conjunction with restrictions on domestic production.

17. Obligatory lists define government-to-government sales at fixed quantities and prices. Indicative lists set out a list of goods to be exchanged, but leave the negotiation of prices to the enterprises.

18. Foreign investment from the West started in the late 1980s, and the foreign investment regime has gradually become more liberal. In 1989 full ownership and foreign representations were allowed. Until late 1993 Estonia's foreign investment policy provided fiscal incentives for foreign investors (lower profit taxes for a number of years, depending on the size of the investments). Since then, foreign and domestic investors have received similar incentives. Sale of land to foreigners was recently liberalized, and both profits and capital can freely be repatriated in foreign currency. The Ministry of Finance provides selective investment guarantees and serves as an information center for potential investors. To improve access to information on its regulatory framework, Estonia has recently opened a special office to provide foreign investors with comprehensive guidance on investing in Estonia.

19. This figure covers only debt and equity investment in physical plant and equipment. Financial investment including foreign deposits brought the overall total up to US\$ 160 million for 1993.

Comment on Chapter 5

The Political-Economy of Macroeconomic and Foreign Trade Policy in Estonia

Ardo H. Hansson

The chapter by John Hansen and Piritta Sorsa on Estonia's foreign trade policies and performance gives a comprehensive overview of recent developments in that country. A reader unfamiliar with the

Estonian case will find much useful information. Seasoned veterans can gain new insights into the changes that have taken place. Estonian policymakers can find sound advice for future actions. The paper is especially useful in bringing together a wealth of statistical information.

In this comment, I will expand on the work done by Hansen and Sorsa, to delve more into the political-economy of Estonia's macroeconomic and foreign trade policy. In particular, I ask why Estonia chose to follow a near-textbook model of financial conservatism (budgetary balance, a strict currency board-type monetary rule, a fixed exchange rate to the German mark, and a functioning bankruptcy law) and economic liberalism (simple, broadly-based taxes with a flat personal income tax, nearly across-the-board free trade, including in agriculture, concerted pursuit of free trade agreements with Western neighbors, early abandonment of indicative and obligatory lists, full currency convertibility, and a near absence of subsidies).

Estonia's remarkable successes make understanding its experience all the more important. Hansen and Sorsa describe Estonia's rapid foreign trade reorientation away from former Soviet markets, and the rapidly growing trade volumes that

have made it the most open economy in the Baltic-Nordic region. Even the composition of Estonia's trade appears to be healthy, with investment goods making up a large share of imports, and exports being close to Estonia's likely comparative advantage, including the booming transit trade in Russian raw materials.

My approach in this comment is to note the few cases where I disagree with the position of Hansen and Sorsa, while providing supplementary remarks in the vast majority of areas where we do agree.

Common Influences on Baltic Economic Policies

It is useful before considering factors specific to Estonia, to review some influences on Estonia's economic policies that are common to all three Baltic States, if not to most economies in transition.

Ever since the start of serious debate on the political and economic future of Estonia in 1987, the overriding concern of Estonians has been to escape the discredited Soviet past and to "return to Europe" (see van Arkadie and Karlsson 1992; Hansson 1993). Such concerns may have been stronger in the Baltic States than in Eastern Europe or the Commonwealth of Independent States (CIS).

The countries of Eastern Europe were less tied to the Soviet market, already had formal independence and national currencies, and generally had better macroeconomic performance than did the Baltics. The non-Russian CIS states suffered from the same ills as the Baltics, but usually had a less clear desire to escape the Soviet system.

As a result, Baltic residents initially had a near-religious devotion to concepts such as currency convertibility and trade reorientation, though the understanding of how to achieve these goals was weak, even among local economists.¹ Among the public, the belief that these goals could be achieved was far weaker than the hope that they could be. That hope created a readiness to support any project that seemed to offer a chance of isolation from Soviet instability or of greater integration with the West. These included monetary reform and the free trade agreements with the EFTA countries.

Such sentiments helped to avoid much of the detailed bargaining over tariff rates that so often hampers trade negotiations. The social demand for a large "window to the West" overrode narrow sectoral concerns. Normal politics was largely suspended. This is one reason for the relative weakness of the industrial lobby in the Baltic States, particularly in Estonia. Because this group sought largely to maintain the status quo, its demands found public animosity rather than support. Such sentiments may have also increased support for free trade as a way to curb the market power of local industries. In the CIS, by contrast, weaker support for reorientation resulted in greater power for the industrial lobby and less support for liberal policies.

Extensive democratization had an influence as well. The first semi-free parliamentary elections were held in 1990. Estonia held fully democratic elections in September 1992, followed by the other Baltic States. Over time, amorphous "movements" and popular fronts began to give way to parties fitting the left-right spectrum of Western democracies. This process, though still far from complete, further undercut the power of lobbies, which work outside the democratic process. Since national politics reformed more rapidly than did industrial associations or labor unions, these groups became politi-

cally weak.² For this reason, I would disagree with Hansen and Sorsa that there has been great pressure for tariffs on industrial goods. The main pressure from industry has so far come for waivers on paying the VAT on imports at the border, but even this pressure has not been very strong and is nothing like the pressure from the agrarian lobby.

The evolution of foreign trade regimes may also have been influenced by the legacy of repressed inflation. During 1990-91, growing nominal demand under fixed prices led to chronic shortages. In an attempt to staunch the outflow of goods in the absence of normal stabilization policies, the Baltics, followed by most of the other Soviet republics, imposed direct export controls to "protect the internal market." After balance was restored by price liberalization and monetary reform, it might not have been easy to move from a mindset that encouraged imports and restricted exports to the opposite view characteristic of more balanced economies. That could have slowed the dismantling of export barriers (which was not the case in Estonia) or the erection of import restraints (which was the case). It remains unclear, however, why these factors would have played a smaller role in the other Baltic States or the CIS, a pattern that casts some doubt on their quantitative importance in Estonia.

Factors Specific to Estonia

If differences in monetary and trade policy are greater among the Baltics than between the Baltics and other economies in transition, it may be that factors specific to Estonia are more important in explaining Estonia's policy differences. I divide these into three categories: objective factors, macroeconomic policy choices, and accidents of history.

Objective Factors

The first objective factor, also identified by Hansen and Sorsa, is Estonia's geographical location. Estonia is in this sense better placed to reorient its trade than are the other Baltic States and some Eastern European and CIS countries. Helsinki is only 80 kilometers from Tallinn. With average

wages in Finland and Sweden some fifteen to twenty times greater than in Estonia, there were many areas in which a new division of labor would cut business costs. Cultural and linguistic ties with Finland (similar languages, the influence of Finnish TV) and, though less so, with Sweden, further strengthened the basis for trade ties. The other Baltic States had less direct access to Scandinavia, while among the Eastern European countries, Slovakia, Romania, and Bulgaria may also have been less favorably located for reorientation.

Another objective factor could be historical and cultural differences. As a nonspecialist on these themes, I am hesitant to elaborate on this topic other than to remark that the recent experience of economies in transition leaves little doubt of their relevance. For instance, any adequate explanation of why the Czech Republic has had more success than, say, Russia or Romania, must include such factors. In Estonia's case, these could include a relatively long period of democracy between the world wars, the knowledge that Estonia had prospered during that period with little access to the Soviet market, and the impact of Finnish TV in easing adaptation to a market economy. These issues deserve more study.

Third, as nicely argued by Hansen and Sorsa, Estonia's better performance than the other Baltic States could be linked to a more favorable initial economic structure. Estonia was less industrialized than the other Baltic States, and the structure of its industry appears better matched to its natural resource and skill endowments. Estonia also had a more favorable energy balance, having produced one-half of its own energy needs (this has since risen to over 60 percent). Latvia appears to have had the worst initial conditions, having been both highly industrialized and heavily dependent on energy imports. Lithuania was similarly energy import-dependent, but may have had a more favorable industrial structure than did Latvia.

A final objective reason for different policies is the much smaller agricultural lobby in Estonia, resulting in an environment more amenable to liberal policies. For whatever reason, the growth of new peasant farms was far slower in Estonia.

Macroeconomic Policy Choices

Hansen and Sorsa correctly emphasize the links between Estonia's macroeconomic policies and its foreign trade performance. The importance of such factors is supported by the transition experience more generally. Tight financial policies combined with an initially undervalued fixed exchange rate appears to be a recipe for trade expansion and reorientation, as well as for keeping unemployment relatively low. A recent study with Jeffrey Sachs (Hansson and Sachs 1994) exploring the link between the choice of macroeconomic policies and economic performance among the Baltic States corroborates the findings of Hansen and Sorsa in the foreign trade area.

The key elements explaining Estonia's sharper and more rapid reorientation in the context of growing overall trade volumes are clear. The currency board system produced a credible economywide hardening of budget constraints. The Bank of Estonia was prohibited by law from financing commercial banks, except in a banking crisis. A similar prohibition on central bank financing of the government almost mandated fiscal balance, reducing the scope for state support for troubled firms. The resulting demand barrier forced firms to seek new customers.

Remaining doubts about the hardness of budget constraints were removed by the harsh resolution of the banking crisis in January 1993 (Hansson 1994c). A government that is prepared to close down the three major banks with little or no rescue of depositors is likely to be unsympathetic to pleas for help from nonfinancial enterprises.

In addition, the initially undervalued initial exchange rate (the average monthly wage in June 1992 was \$35) reduced domestic demand for imports and made export sales attractive. With the kroon pegged to the Deutschemark and fluctuating greatly relative to the ruble, and with payments with the West functioning better than those with the ruble zone, enterprises had further incentives to find new Western markets. And, as noted by Hansen and Sorsa, the initial undervaluation also gave some exchange rate protection which may have dampened pressures for tariffs relative to those under a more appreciated exchange rate.³

Among the Baltic States, Lithuania has had the least success in trade expansion and reorientation. According to figures from the Lithuanian Department of Statistics, 80 percent of trade in 1993 was with the former Soviet Union. Lithuania also took the longest to implement tight policies. Until early 1993 its currency moved more like the ruble than the *Deutschemark*, which may have made it less risky for Lithuanian firms to trade with the ruble zone. A later period of rapid appreciation against the dollar created exchange rate risk in all directions. The introduction of an Estonian-type currency board in April 1994 is a natural experiment on the importance of such factors. If their role is in fact great, trade reorientation and expansion should now take off.

Latvia's trade performance falls in the middle. Latvia has long implemented tight macroeconomic policies, but it has either pursued a floating exchange rate or followed the SDR without a clear commitment to maintain the rate. The residual exchange rate risk might explain some of the differences with Estonia.

A related theme is the impact of monetary independence on the ease of payments with the ruble zone. I do not share the concerns of Hansen and Sorsa regarding the disruptiveness of the breakup. Replacing one currency with several should in principle have complicated interrepublican payments. In practice, payments were already paralyzed by the inconvertibility of different republican rubles (as a result of the differential growth in supplies of noncash rubles, which strained their exchangeability at parity). The replacement of this system with one in which the Russian ruble-kroon rate was market determined eventually restored convertibility and improved the speed of payments. The ruble market in Estonia started out small and highly illiquid. As better correspondent links were put in place with Russian banks, and as some banks began to specialize in trading rubles, liquidity improved over time.

Accidents of History

Most explanations of Estonia's performance would stop here, but that could leave the impression

that Estonia's policy choices and success were almost preordained. Careful examination shows that these choices were often the result of luck or accidents of history. Many choices depended less on economic fundamentals or *a priori* social demands than on the preferences and will of a few decision-makers. More often than not, public support for specific policies (the currency board, zero tariffs) developed only after the fact.

One fortuitous development was the rapid construction of new links with the West, including oil import terminals, and telecommunications links, and ferry, ship and air connections with Helsinki and Stockholm. These physical links laid the basis for trade and investment, particularly with the Nordic countries. Estonia's tourism boom (2.9 million visitors are expected from Finland alone in 1994) has far surpassed that of the other Baltic States. Estonia has achieved energy independence from Russia in all fuels but natural gas. This network and its influence, which depended on the actions and decisions of a relatively small group of individuals, could well have turned out differently, as the experience of Latvia and Lithuania shows. They remain strongly tied to Russia for liquid fuels. Attempts to establish a regular Riga-Stockholm ferry connection have faltered, and delays at the Polish-Lithuanian road border and weaker telecommunication links have further limited the access of Latvia and Lithuania to Western Europe.

Another example is the failed attempt by the leftist former prime minister Edgar Savisaar to declare an "economic state of emergency" during the economic crisis of January 1992 (a time of massive shortages and hoarding). The attempt failed by the smallest of margins. Parliament had initially approved this plan, but the public outcry following the realization that the legislation had passed only because of anti-reformist (largely ethnic Russian) support, gave some initial supporters cold feet. The decree needed to implement the "state of emergency" failed to win the support of parliament, and Savisaar was forced to resign. Had the plan been implemented, Estonia would have started down a very different, illiberal path.

The rapid pace of monetary reform (Estonia was the first to break from the ruble zone) and the choice of a currency board and other strict policies also depended on chance and the activities of a few key individuals. In May 1992, when the reform was in its final stages of preparation, Prime Minister Tiit Vähi (who was also chairman of the Monetary Reform Committee) unilaterally and unexpectedly proposed the early introduction of the one-kroon (with a nominal value of 500 or 1000 rubles), to circulate in parallel with the ruble until the actual currency reform. Vähi viewed this plan as a way to ease the severe cash shortage afflicting the ruble zone and to clear large arrears on wage and pension payments.

Had this proposal succeeded, it would have meant financing a large budget deficit by issuing new money, the antithesis of the strict financial principles that later won support. Its implementation would have delayed the currency reform until at least late summer (the tightly orchestrated three-day switchover could not have been conducted during the summer holidays, when many Estonians are away from home) and would have brought a further burst of inflation. Suppressing this proposal required enormous effort by those committed to strict policies.

Similarly, the choice of an undervalued fixed exchange rate had little support among government advisers and academic economists. Motivated by considerations of purchasing power parity, key advisers pressed for a strong revaluation (of up to eight times!), arguing that only such a large revaluation would generate the levels of dollar income needed to purchase goods at the "world prices" that would supposedly prevail under the kroon. Understanding of the need for undervaluation was limited. Academic economists tended to favor a floating over a fixed rate. The fact that ministers who outwardly supported the currency board continued to lobby the central bank for "credits" after the monetary reform indicates that many politicians probably never understood exactly what they had supported.

The choice of a fixed, undervalued exchange rate and a currency board rule was thus largely an

accident of history. It depended on the political will and savvy of a few people, the most important being Bank of Estonia governor Siim Kallas. Putting such a policy in place was possible only under the unique politics prevailing in the case of such "national projects." Public demand for a convertible national currency was intense, with strong pressure to "do something" by June 1992. In these circumstances, the first coherent plan that promised to achieve this goal would find support. It happened to be the currency board proposal of the central bank.⁴ Counterarguments by opponents were next to irrelevant under these conditions. Had another concrete program been presented earlier, the course of events would have been very different.

Another accident of history was the party in power prior to the major decisions. One interpretation of the results of recent elections in transition economies is that voters wish primarily to punish incumbents for the hardships of transition. In Estonia, the most votes in September 1992 went to the Isamaa party, which supported liberal foreign trade policies and strict financial policies. It had been in opposition to the Savisaar government and had been only loosely linked with the later Vähi government. It benefited from being a relative "outsider." The elections consigned both previous prime ministers to opposition.⁵

In Lithuania, the politically right-wing but economically not very liberal Sajudis government was punished by voters, who supported the ex-communist Democratic Labor Party (LDDP). In the Latvian elections of June 1993, the ruling Popular Front failed to make it into the new parliament, although many of its former members returned under new party affiliations, and the new government was as centrist as the previous one.

The final accidents of history concern the individuals who became the key decisionmakers. It was only by chance that Isamaa, which led the new coalition, had a leader (Mart Laar) with clear, radical views on general policy priorities, rather than a pragmatist with few consistent positions. That the Social Democratic Party within the coalition was led by liberals was also not inevitable. The leadership of a few people allowed the government to

resist the illiberal proposals of some branch ministries, especially agriculture. Finally, Siim Kallas's selection to head the central bank in late 1991 was hardly based on his radical views which would so influence the course of events. Had a few of the people at the top been different, so would have the outcomes.⁶

Some Weaker Influences

Two factors that would be expected to play a role in shaping the general thrust of Estonia's macroeconomic and trade policies were not in fact of primary importance: pressure from the international financial institutions and public opinion. In many economies in transition, there is a conflict between the international financial institutions always urging stricter financial policies and more liberal economic policies, and the governments seeking a loosening of financial policies and slower liberalization. In these cases, pressures from the financial institutions act as a binding constraint on the authorities.

In Estonia, when disagreements arose, it was usually because Estonia preferred more radical policies than did the financial institutions. In the spring of 1992, the International Monetary Fund initially urged Estonia to postpone monetary reform until its technical capabilities were more advanced (Hansson and Sachs 1992). Estonia opted instead for a rapid monetary reform, since postponement was politically impossible and economically undesirable (the ruble collapsed soon after the introduction of the kroon). Also, the IMF had initially suggested a classical central banking model—much like those later chosen by Latvia and Lithuania—that allowed for the issuing of domestic credits. Estonia opted for the more restrictive currency board.

During the banking crisis that erupted in November 1992 (Hansson 1994c), the IMF recommended a less harsh policy package than the one Estonia adopted (which saw one major bank close with no bailout of depositors and two others merged with a partial rescue). Finally, several international financial institutions have recommended imposing uniform tariffs to raise revenues for a government

with great financial needs but few easily collectible taxes. Estonia opted for nearly full free trade.

None of this means that the international financial institutions has been unimportant. The IMF played a crucial role in stressing the need to raise tax rates at the time of currency reform to close the emerging budgetary gap. Its officials also spurred the authorities to restructure the banks in late 1992 and provided the technical assistance to carry this out. In most areas, the views of the government, central bank and international financial institutions have fully coincided. Perhaps because the requirements of the financial institutions have not become a constant source of friction, Estonia's relations with them are excellent.

The second factor that has been less important than might be expected is the impact of immediate public opinion. The government pursued its chosen path at the expense of political popularity. The clearest case of bucking short-term political expediency is in agricultural policy. A government seen to be "nationalist" could be expected to cater to the demands of ethnic Estonians, who dominate the countryside. Many Estonian city dwellers also claim a readiness to support the farm sector, possibly because Estonia's agrarian history remains a strong force in the national psyche. Nonetheless, the government has staunchly opposed costly agricultural support programs.

Trends that Remain Unclear

Some motivations for Estonia's chosen policies remain unclear. I am less optimistic than Hansen and Sorsa regarding the administrative capacity of the state. As in all economies in transition, Estonia's state apparatus is intellectually ill-prepared for the market economy, and sometimes demoralized or corrupt. The natural response is a hefty dose of liberalism (Aslund 1992; Hansson 1994b), which leaves minimal room for corruption and allows the state to focus on the core set of tasks that only it can provide (national defense, internal security, a stable currency). Estonia's very liberal stance has been partly motivated by this understanding. Proposals by the Ministry of Agriculture to introduce untransparent import quotas have been

rejected. Because of its liberal trade regime, Estonia may have the least problematic situation at border crossings among the Baltic States. It remains unclear, however, why these considerations have played a greater role in Estonia than in other economies in transition.

All three Baltic states have a strong commitment to fiscal balance. In 1993, the fiscal position of the central governments ranged from a surplus of 0.6 percent of GDP in Estonia to a deficit of 1 percent in Lithuania. Planned budgets for 1994 were also near balance. In comparison, leading reformers such as Hungary and Poland have had deficits of 4 to 8 percent of GDP. This commitment remains to be explained.

Future Trends and Issues

In the future, Estonia is likely to maintain a relatively liberal position, even if governments change. Support for such a stance has grown with time. The economic activities that have arisen in response to such policies (including shopping tourism from Finland to take advantage of the resulting low prices of consumer goods) have created new vested interests in sustaining such a regime.

At the same time, the greater importance of accidents of history over clear *a priori* social demands in creating a liberal trade regime means that this regime is sustained partly by inertia, and can be pushed in other directions without regular new impulses to keep it on the same path. While high-ranking ex-communists have little chance of regaining power, pragmatic politicians lacking a clear vision are popular and could dominate a future government. They could slowly erode today's ultra-liberal regime. As Hansen and Sorsa note, real appreciation of the kroon and rising joblessness could also boost pressures for protectionism. Public support for current policies is not yet so strong as to preclude such an evolution, which would take away Estonia's uniqueness.

The chances of reversal are reduced by the many free trade agreements with major trading partners. These have long been in effect with Finland, Norway, Sweden, and Switzerland. A free trade

agreement among the Baltic States took effect on April 1, 1994, and negotiations for a free trade agreement with the EU are reaching the final stages. These pacts will cover all of Estonia's major trading partners except Russia, and they can hardly be changed.

Negotiations with Russia are more tricky (Hansson 1994a). They have focused on a most-favored-nation agreement, which has been initiated but not yet signed. Hansen and Sorsa argue that Estonia should make all efforts to get such a treaty. Yet, while this clearly seems a sensible short-run strategy, it may not be the best long-run strategy. Russia has at times taken a threatening tone toward Estonia. Given its muddled politics, Russia is likely to pursue stop-go economic policies for some time. These constitute a source of great uncertainty for Estonia (Hansson 1994a). Continued shifts in Russia's real exchange rate will influence the profitability of activities dependent on Russia. Russia has also been chaotic in its tariff policies, first imposing huge increases, then removing them, with an uncertain promise to reinstate them again in the future.

Ideally, Estonian firms would take this uncertainty into account and take new steps to reorient toward the West. If they are slow in doing so, there may be an argument for spurring reorientation by keeping trade with Russia unattractive. If political security carries a premium, the need to wean Estonian enterprises from the Russian market is all the greater. This at least raises the possibility that Estonia should not make great efforts to reach a most-favored-nation agreement. With only 18 percent of its trade still with Russia, the short-run costs of further reducing this share should not be too high. The main cost of such a strategy would be in strained Baltic unity, since Latvia and Lithuania remain more dependent on the Russian market and thus less able in the short-run to absorb the loss of a share of this market.

Notes

The author is Research Fellow, Stockholm Institute of East European Economics, Stockholm School of Economics; Economic Adviser, Government of Estonia; and Member of the Board, Bank of Estonia. In 1992, he served as advi-

sor to the Prime Minister of Estonia on monetary reform and was an Alternate Member of the Monetary Reform Committee. The opinions expressed are his own, and not those of the Government of Estonia or the Bank of Estonia. He would like to thank John Hansen and David Tarr for comments on an earlier version.

1. For instance, many economists spoke of the need to "strengthen the economy" as a prerequisite for achieving a stable currency, a sequence that makes little sense.

2. The impotence of the labor unions is shown by the constancy of the minimum wage during the nineteen months of the current government, when the average nominal wage more than doubled. The ability of the unions to organize any effective strike action is also doubtful. The near absence of new grass-roots unions to replace the old communist ones is a puzzle.

3. Here, it is still necessary to explain why the other Baltic States and CIS states, which started from a similarly undervalued rate, were less able to resist pressures to impose tariffs.

4. The best indication of the strength of pressures for rapid currency reform is that the three crucial laws that would form the basis of the post reform monetary system were introduced in parliament on May 9, 1992, and passed nearly unanimously only eleven days later.

5. A further chance event is the exact composition of the government. The fact that Estonia's new coalition started with a parliamentary majority of one vote means that minor differences in election outcomes could have brought a very different government to power.

6. In Central Europe, we can similarly contrast the more radical liberal programs associated with Vaclav Klaus in the Czech Republic and Leszek Balcerowicz in Poland to the generally less liberal paths chosen by the more "pragmatic" regimes in Hungary and Slovakia.

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6

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Latvia: Trade Issues in Transition

Piritta Sorsa

Latvia, a small (2.7 million people) resource-poor economy about the size of Ireland, has a centuries old tradition in trade as a gateway between East and West. Its ice-free ports on the Baltic Sea and its location at the mouth of an inland river system made it a central trading post in the middle-ages, when Riga, the capital, was an important Hansa city. Much of Latvia's economic activity during its brief period of independence between the two world wars depended on trade, a pattern continued during its following five decades as part of the Soviet Union, although within a highly distorted allocation of resources.

Latvia's proximity to large, high-income European markets reduces transport costs for Latvian goods and gives it an advantage as a transit center between Eastern and Western Europe. Since re-establishing independence in 1991, Latvia has started to reorient the direction and structure of its trade to match its natural comparative advantage as an intermediary in Europe and as producer of skill-intensive products and services. A first indication of Latvia's advantageous location is the substantial re-export trade that has passed through its borders since independence. Geographic location and related historical ties to its neighbors also facilitated the creation of commercial and other links to the West. Technological and financial assistance from Latvia's rich Nordic neighbors has also been important. Latvia has negotiated liberal free-trade agreements with most countries

of the European Free-trade Association (EFTA), that have opened important trading possibilities for Latvia in the neighboring high-income countries, though Latvia has been slow to take advantage of these agreements. Links to Western Europe will be further reinforced in 1995, when a free trade agreement with the European Union goes into effect.

Macroeconomic Situation and Structural Reforms

Successful trade reform requires a stable economic environment and price incentives that reflect relative resource scarcities. On the stabilization side, Latvia has succeeded in bringing inflation down from an annual rate of 958 percent in 1992 to a projected 35 percent in 1994. Preliminary information for 1994 indicate that the economic decline may be bottoming out, and the economy was expected to rebound in the second half of 1994.

Progress with structural reforms has been slower. Latvia's economic transition started in late 1980, with increased economic autonomy within the Soviet Union. Price, trade, and tax reforms preceded stabilization mostly for political and technical reasons, but the real momentum for reform was not reached until political independence in September 1991 and Latvia's detachment from the ruble zone in mid-1992.

The introduction of convertible currency in 1992, coupled with tight monetary and fiscal policies stabilized the economy, reduced economic uncertainty, and improved the business climate. An initial undervaluation of the currency helped export development and provided temporary protection against imports, but by the end of 1992 the currency was appreciating rapidly, reducing the competitiveness of Latvia's exports. Many of Latvia's trade policies have probably slowed adjustment and trade reorientation. Among these are export taxes on goods in which Latvia may have a natural comparative advantage, such as wood and wood products; highly dispersed levels of protection on imports of many agricultural and other products, with negative effects on efficiency and modernization; discriminatory taxes on exports in nonconvertible currencies, dampening trade with countries of the former

Soviet Union; and frequent changes in the trade regime, which may have promoted lobbying for protection and delayed adjustment. Other distortions result from the lack of a clear and transparent drawback program for exports, while price and export controls in partner countries have enabled the rise of highly lucrative re-exports, which together with service exports, probably contributed to the appreciation of the real exchange rate and attracted resources from other activities.

Initial Reforms

Latvia introduced price reforms in early 1991, and by the end of 1992 less than 8 percent of goods and services in the consumer price index remained under price controls, mostly energy and public utilities such as municipal services. The first elements of modern tax system were introduced in 1991, widening the tax base.¹ The faster liberalization of prices in Latvia than in the rest of the former Soviet Union initially brought terms of trade gains, improved company profitability, increased government revenues, and held output contraction at less than 10 percent in 1991, allowing unemployment rates to remain at a low 0.5 percent of the labor force, (table 6.1).

The macroeconomic situation worsened rapidly in 1992. As other countries of the former Soviet Union started to liberalize prices, Latvia's terms of trade deteriorated rapidly, with total terms of trade losses (comparing 1990 prices to world prices) estimated at between 13 to 24 percent, or about 8 per-

Table 6.1 Selected Economic Indicators, 1990-93 (percent)

Indicator	1990	1991	1992	1993
GDP	-3.5	-8.3	-33.8	-10
Inflation	10.5	262	958	35
Fiscal balance/GDP	2	6.4	-1.5	0
Unemployment ^a (% of labor force)	—	0.5	2.2	5.8
Real wages	5.3	16.3	15.7	0.5

a. Registered unemployment rates.

— Not available

Source: Latvian authorities and World Bank staff estimates.

cent of GDP (Tarr 1994). Higher input prices and excessive credit creation in the ruble zone accelerated inflation, and prices increased tenfold in 1992. Stocks were rapidly depleted, and most companies' financial situation worsened with the deterioration in terms of trade. Unemployment passed 3 percent in early 1993. Trade with the other new independent states collapsed, and GDP shrank by 34 percent in 1992.

Stabilization

In July 1992, the government launched a stabilization program supported by the IMF. Latvia's maintenance of fiscal balance, by reducing pressures for monetary financing of government deficits, facilitated stabilization. Latvia's decision to adopt a flexible exchange rate regime allowed the authorities more leeway in using monetary policy for macroeconomic management of the economy than in Estonia for example, where monetary discipline was imposed by law.² Latvia's policy, however carefully arrived at, may pose greater challenges for the sustainability of the stabilization program than would a less flexible policy.

In May 1992 Latvia introduced a temporary currency, the Latvian ruble, to ease cash shortages and permit an independent monetary policy while the economy stabilized sufficiently to allow for the introduction of a permanent currency. By March 1993 monthly inflation had fallen to single-digit levels and Latvia introduced its permanent currency, the lat. The lat, backed by pre-war gold reserves and foreign currency, was slightly undervalued to allow for inflationary adjustments. The undervaluation—measured by wages in dollar terms³—persisted until confidence in the new currency emerged. By September 1993 the currency had appreciated relative to the dollar by about 50 percent, implying nominal wages on the order of \$60-75 a month. The lat continued to appreciate, reaching a monthly wage equivalent of \$110 by early 1994. In February 1994 the central bank started to use SDR as an informal reference to the value of the currency.

Currency reform was accompanied by very tight monetary policy and tight fiscal policies. Tight

credit was the main policy instrument used. Stabilization was also facilitated by limits on wage increases in state enterprises, which kept budgets in balance and helped contain wage inflation.

The introduction of the convertible currency was important not only to stabilization but also to trade expansion, by providing appropriate incentives to exporters and importers and foreign exchange for imports by reversing capital flight. The currency reform delinked Latvia's currency from the ruble area and helped contain inflation, which averaged less than 2 percent a month in the third quarter of 1993 and 1 to 2 percent in mid-1994. The current account of the balance of payments registered a surplus equivalent to about 6 percent of GDP in 1993. In early 1994 Latvia finalized a second standby arrangement and two systemic reform facility drawings from the IMF for a 15-month period.

Enterprise adjustment moved more slowly. During 1992 enterprises used both interenterprise arrears and tax arrears to the government to delay restructuring. They also increased their stocks of final goods, reduced investment, raised prices, and cut back working hours. In 1992, the largest losses in industrial output in Latvia were in energy and capital-intensive machine-building, steel works, and food and light industry, all of which were the most dependent on trade with the former Soviet Union. Industries that increased production included labor-intensive activities such as textiles, shoes, furniture, linen, and confectionery, and resource-intensive sectors, such as fishing and forestry.

Conditions became more difficult in 1993, as the government got tougher on firms with tax arrears, confiscating inventories and introducing insolvency proceedings. Manufacturing output plunged to 60 percent of its 1992 level. The smallest declines were in industries that had increased exports to the West, such as wood and furniture. The largest declines were in clothing, paper, metal working, radio equipment, and construction materials, which were dependent on markets in the former Soviet Union. As enterprises felt the squeeze, they began to lay off employees. Official unemployment rose to about 6 percent of labor force by the end of

1993, but underemployment is likely to be much larger, as many workers have been on unpaid leave or on short work weeks. Unemployment was low relative to the contraction in output for several reasons, including a decline in real wages and, probably, greater absorption of workers by the private sector, a fact poorly captured by official data.⁴

Structural Reform

The implementation of structural reform measures has lagged behind macroeconomic stabilization policies. In particular, adjustment in Latvia has been influenced by the slow pace of systemic reforms with an impact on the supply response, such as privatization, private sector incentives, development of property rights, factor mobility, and financial intermediation.

Trade reorientation and adjustment to world market conditions are also made more difficult by the large share of heavy industry in Latvia's economy (30 percent) compared with 17 percent in Estonia. Differences in quality and standards in Western markets mean that trade reorientation is likely to require new capital investments. In addition, many of the industries are large (an average of 8,000 employees in the engineering industry, for example), and had no exposure to competition. One hundred and forty of Latvia's 400 industrial enterprises were all-union enterprises—the sole producer of a product in the Soviet Union—and others were near monopolies. Understandably, many of Latvia's most important exports to the former Soviet Union in 1993 were from these monopoly industries. Much of this industry was also very energy intensive, vulnerable to the energy price adjustments accompanying the collapse of old trading arrangements with the breakup of the Soviet Union. For many of these industries, open trade may be the only source of competition and incentive for adjustment for several years to come.

Reorientation of trade will be easier in raw materials production because these products are more homogeneous. And in labor-intensive industries, the high skill levels in Latvia make retraining easier and facilitate a reorientation to Western standards and quality. In 1992 (outside the likely re-

exports of metals and oil) most exports to the West from Latvia were resource-intensive products (31 percent), mainly wood, followed by capital-intensive products (28 percent) consisting mainly of chemicals (table 5.3 in chapter 5).

Other problems remain as well. Latvia has made the least progress in large privatization among the Baltic countries. With the exception of agriculture, in which privatization of farms has resulted in some 50,000 units, most progress has been in small privatization. About 70 percent of small businesses were privatized by mid-1993, mostly in services and trade (EIU 1993). Larger-scale privatizations have suffered from cumbersome institutional procedures and lack of clear guidelines. By the end of 1993 only 19 of the 1,200 large enterprises and 82 of the 1,082 agricultural enterprises under the Agriculture Ministry had been privatized.

Until recently, privatizations were the responsibility of the relevant sectoral ministry, resulting in confusion about such basic questions as who is authorized to carry out privatizations, what forms are permitted, and how information is to be reported and collected.⁵ To speed up the process, the government has centralized all privatization in one agency, the Privatization Agency of the Ministry of Economy. Greater use of vouchers and leasing arrangements has been approved recently, which may facilitate the sale of smaller units.

Constraints on labor mobility may also be slowing adjustment to a new set of market-based incentives. The unavailability of housing because of slow privatization of the housing stock has kept people from moving to new jobs. The large non-cash benefits provided by many state enterprises have also reduced incentives to move, while government mandated severance pay amounting to several months' salary makes enterprises reluctant to lay off redundant workers.

Difficult access to credit until mid-1994 may also have slowed the supply response to reforms and affected trade financing. Interest rates on deposits and credit remained negative in real terms during 1992 despite the tight credit situation. Banks were reluctant to lend long term in the hyperinflationary environment and without collateral. And

savings remained low, in part because until September 1992 foreign currency deposits offered better returns than domestic currency deposits. And interest rates responded very slowly to lower inflation because of inadequate capital and poor bank management. Nominal interest rates exceeded 150 percent a year in 1993 when inflation averaged 110 percent, a reflection of credit scarcity, severe uncertainty, and the nonperforming portfolios of domestic banks. In early 1994 real interest rates started to fall substantially, reflecting an improved credit situation and gradually changing expectations on inflation.

Trade

Since independence Latvia, like Estonia, has continued to serve as an important center of East-West transit trade, transshipping substantial quantities of trade of the former Soviet Union. Latvia has an oil pipeline and a port specializing in oil shipments. Since the start of the transition, re-exports of petroleum and raw materials such as metals have increased, most of it illegal.⁶ OECD estimates

placed the value of this trade at \$300-400 million in 1992. (See chapter 5 on Estonia). Much of this trade is likely to cease once prices in Russia and other countries of the former Soviet Union adjust to world levels or these countries relax their export controls and declining levels were already apparent in mid-1993.

Level and Direction

Latvia has made a good start in diversifying its exports away from excessive dependence on the former Soviet Union, but dependence on the former Soviet Union still seems strong in imports. As part of the Soviet Union, more than 95 percent of Latvia's exports and nearly 90 percent of its imports were within the USSR. By 1992 and 1993, about half of its exports were going to countries outside the former Soviet Union, but nearly two-thirds of its imports still originated in the former Soviet Union (table 6.2).⁷ This is in sharp contrast to Estonia, which was importing most of its goods from outside the former Soviet Union by 1993. This may reflect the fact that until the end of 1993 Latvia had export

Table 6.2 Direction and Level of Latvia's Trade, 1990-93
(in millions of current dollars and percent)

	1990	1991	1992	1993
<i>Value</i>				
Total exports	8,826	6,045	880	1,047
Former Soviet Union ^a	8,522	5,920	451	587
Rest of world ^b	304	125	429	460
Total imports	9,627	4,843	895	988
Former Soviet Union	7,985	4,365	472	649
Rest of world	1,642	478	423	339
Total balance	-801	1,202	-16	59
Former Soviet Union	537	1,555	-22	-62
Rest of world	-1,338	-353	6	121
<i>Percentage Distribution</i>				
Total exports	100	100	100	100
Former Soviet Union	96.6	97.9	51.2	56.1
Rest of world	3.4	2.1	48.8	43.9
Total imports	100	100	100	100
Former Soviet Union	82.9	90.1	52.8	65.7
Rest of world	17.1	9.9	47.2	34.3

a. Figures for trade with the former Soviet Union are derived from country data and World Bank staff estimates reported in national currencies using official or commercial exchange rate for 1990 and 1991 and annual average market exchange rates for 1992 and 1993.

b. The rest of the world refers to countries outside the former Soviet Union; figures are based on country data reported in U.S. dollars.

taxes that affected several potential export items to the West, such as wood (see below). By reducing exports in hard currency, the export taxes reduced the amount of foreign exchange available for imports. The apparent reliance on imports from the former Soviet Union may also reflect technological dependence on the East in production or the role of re-exports both in import and export statistics.

After collapsing in 1992, Latvia's trade levels stabilized in 1993. In 1992 both exports and imports, especially with the former Soviet Union fell to a fraction of their previous level measured at the official exchange rate.⁸ The following year trade with the former Soviet Union recovered somewhat, especially for imports, while trade with the West grew very slowly in dollar terms. Total Latvian exports in 1993 rose only 17 percent (in nominal dollars terms). Exports to the West increased less than exports to the East and imports from the former Soviet Union recovered. In 1993 re-export trade also started to decrease and trade flows were affected by large value changes following price adjustments to world levels for Russia's traded goods. The real appreciation of the lat by the end of 1993 may also have affected export incentives, while re-establishment of some trade links with former Soviet trading partners after the initial collapse in 1992 may have helped exports to the East in 1993.

Russia was still Latvia's main trading partner in 1993 (30 percent exports and 36 percent or more of imports.)⁹ The European Union (EU) was its largest partner in the West (25 percent of exports and 17 percent of imports). Intra-Baltic trade has remained a small share of the total, with exports at about 6 to 10 percent during 1990-93 and imports increasing slightly from 14 to 17 percent, probably reflecting shifting terms of trade with Estonia and Lithuania (EIU 1993; State Committee for Statistics 1994).

Exports to the rest of the former Soviet Union were composed largely of machinery products, following patterns established during central planning, while exports to the West were mainly resource-based goods, such as wood, metals, mineral fuels, leather, and vegetables. A reorientation of trade is

easier in such resource-based goods because quality is more uniform and less important to sales than in the case of machinery and equipment. Many of these products reflect Latvia's resource base and its natural comparative advantages. Trade in services is of considerable importance for Latvia. Receipts from the transport sector amounted to about 15 percent of GDP (IMF 1993). A main services exporter was the Latvian Shipping Company, which operates a fleet of over 100 ships. Tourism and other port enterprises accounted for other services earnings.

Latvia has been less successful in exploiting its skilled labor potential in exports to the West. In 1992 labor-intensive products such as clothing, textiles, and furniture constituted only 19 percent of Latvia's exports to the West, compared with 34 percent for Estonia. That trend continued in 1993. Subcontracting activities and related foreign investment have not taken root in Latvia as they have in Estonia, perhaps because of Latvia's much less transparent trade policies.

Trade Policy

Trade is particularly important for a small country like Latvia, which depends on trade for much of its economic activity. Latvia's trade policies during transition have featured a gradual reduction in export restrictions, a tightening of import restrictions, and a policy-induced bias against trade with the countries of the former Soviet Union. Exchange rate policies have also influenced incentives for foreign trade.

Export Policies

Latvia inherited the anti-export bias of the Soviet system, which restricted exports in order to supply local markets under the distorted price structure. The first step in reform was to abolish state trade in 1992. The only state monopoly left is in nonferrous metals, an attempt to control the illegal transit trade. All exporters to the former Soviet Union required licenses to comply with the agreed product lists negotiated in bilateral treaties (indicative lists).

In mid-1992 all export quotas and licenses were abolished and replaced by a more transparent

Box 6.1 Key Features of the Trade Regime in March 1994

<i>Instrument</i>	<i>Description</i>	<i>Percentage of tariff lines^a</i>
<i>Export restraints</i>		
<i>Taxes</i>		
Convertible currency	Range of 1-100%; 90% of taxes below 100%	8% (leather, wood)
Nonconvertible currency	Range of 1-200%; 84% of duties below 10%	8% (leather wood)
Quotas	None	
Licenses	Metals trade government monopoly	
<i>Import restraints</i>		
Tariffs	Unweighted average 10%, Range of 0-50%	38% below 5% 60% - 15% 1% > 30% 2% specific rates
Licenses	Metals subject to government monopoly	
Quotas	None	
<i>State trading</i>	Abolished in 1992	
<i>Exchange rate</i>	<ul style="list-style-type: none"> • Convertible currency since 1992 under flexible exchange rate regime informally linked to SDR since February 1994. • Real appreciation measured in monthly US dollar wages from \$10-16 in 1992 to \$110 in May 1994. • No surrender requirements. 	
a. At the six-digit harmonized system classification		

system of export taxes. The taxes were intended to compensate for the undervaluation of the real exchange rate, since the prices of most of the goods subject to export taxes had been liberalized. The export tax rates were highly dispersed (ranging from 2 to 300 percent) and higher on exports to nonconvertible currency areas and on barter trade.¹⁰ Excluding specific rates, two-thirds of the taxes on exports in convertible currencies were below 10 percent compared with one-tenth of taxes on exports in nonconvertible currencies. The higher taxes on nonconvertible currencies and barter were reportedly designed to encourage exports to the West.

At the end of 1993, the export tax rates were lowered substantially, reducing their dispersion and restrictiveness.¹¹ Duties were eliminated for many final goods, though a number of new items were

added to taxable exports, including mostly agricultural products and some raw materials. The bias against exports in nonconvertible currencies was reduced with the drop in tax rates and number of goods subject to taxes. The reduction in specific taxes (from over 30 tariff lines to about 20), which tend to hide the level of protection, also improved the transparency of the system. Many of the remaining export taxes have an industrial policy tilt. They are levied on raw materials, which reduces the price of inputs to domestic industries processing these inputs.

In addition to export taxes, export expansion may have been hampered by the absence of a transparent duty drawback scheme. (See chapter 11). Though a second-best option, duty drawbacks are needed in the presence of protection on raw materials and other inputs to help Latvian producers com-

pete in world markets. Although many inputs have been exempted from import tariffs, administrative costs and uncertainty about receiving the exemption are high because producers have to apply for duty exemptions (see below). Latvia is currently preparing a simple, fast, and transparent system.

Import Policies

During the early years of independence domestic industry was protected against imports by the undervalued exchange rate. The import regime itself was relatively open: all state controls on imports were eliminated and everyone was free to engage in foreign trade. Demands for import protection emerged as the real exchange rate appreciated.

The first import duties were introduced in September 1992. The aim was a uniform rate of protection at 15 percent applied to all imports, mainly to raise fiscal revenues. Uniformity is important because it gives the same protection to all activities and avoids the picking of winners by the government that differentiated rates implies. Though the overall level of protection was moderate and mostly tariff-based, the uniformity objective was not reached and the structure of protection became highly dispersed, ranging from zero to 100 percent. First, differentiation according to source was introduced, with a higher 20 percent duty on goods from countries without trade agreements with Latvia (most of the former Soviet Union, Japan, and many developing countries). In 1992 these countries accounted for at least half of Latvia's imports. Exemptions, especially for inputs, further reduced uniformity. A number of products were subject to specific and seasonal rates.

The transparency of the system was reduced by several elements of the tariff policies, including exemptions and the use of specific rates, especially in agriculture. Following petition by importing interests, exemptions were applied at the discretion of the relevant ministry. Specific rates hide the actual level of protection received by both producers and consumers. Furthermore, the customs department uses a system of "minimum prices" for the valuation of agricultural imports. The Ministry of

Agriculture prepares a monthly list of domestic prices for various commodities to serve as basis for customs valuation and duties (IMF 1993). The inexperience of Latvia's customs department in determining the value of goods is given as the reason for the rise of specific duties and minimum prices. This use of domestic prices—if they exceed world prices—instead of international ones can, however, give additional protection to domestic producers.

The Tariff Commission, headed by the Minister of Foreign Trade and composed of representatives from other ministries and producer and trade organizations, set and reviewed import and export policies until the end of 1993. Unlike the case in many countries, which permit changes in duties to be made only by parliament to guarantee permanency and transparency, in Latvia the Tariff Commission had the authority to change rates upon a simple request by any physical or legal person. The Commission modified rates several times, creating an incentive to lobby for protection. Most of the changes to duties have no clear economic justification.

A new law covering import duties entered into force in March 1994. Despite some improvements in the dispersion of rates, the new law seems to

Figure 6.1 Structure of the Tariffs in Latvia in March 1994

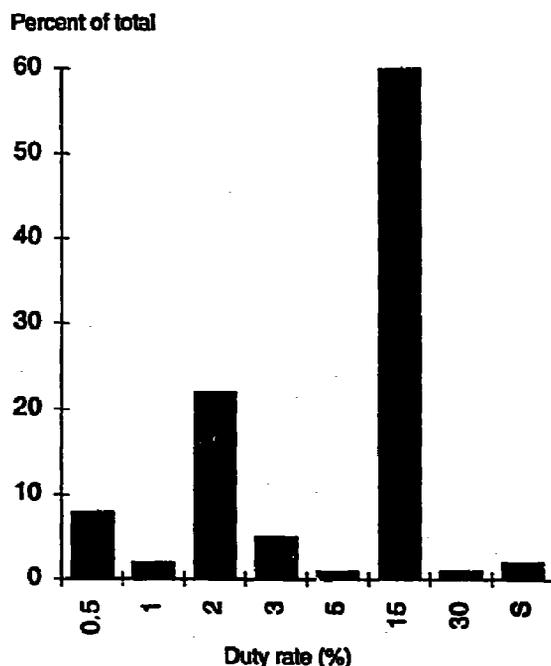
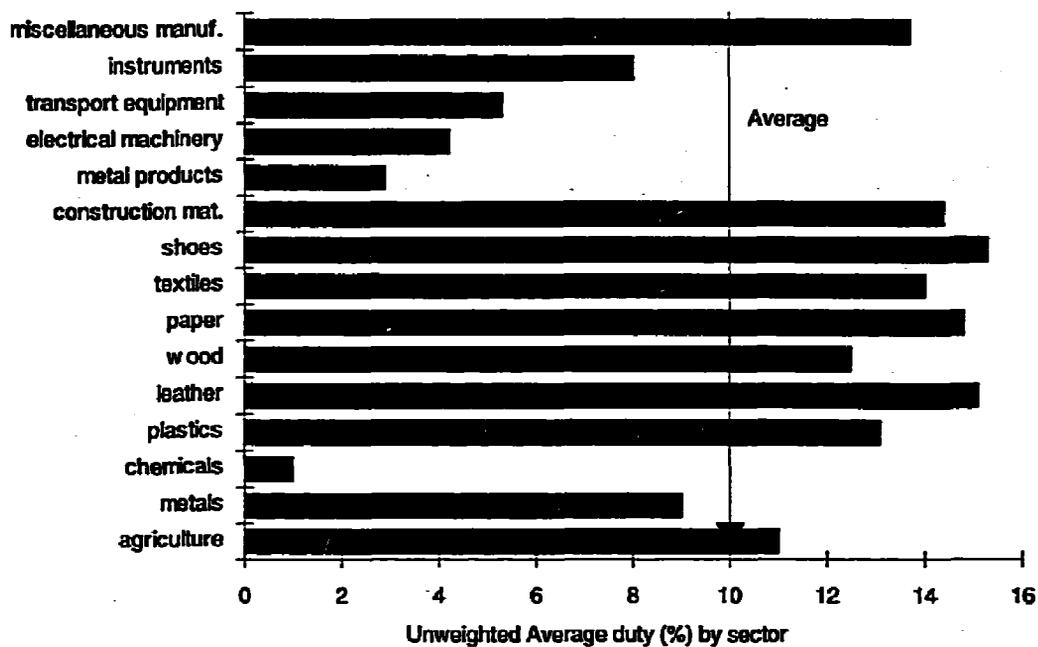


Figure 6.2 Sectoral Distribution of Nominal Tariffs in Latvia in March

have slightly increased the overall level of protection in Latvia. The unweighted average of the duties was about 10 percent (not including specific rates). The number of goods subject to high duties increased.¹² The uniformity objective was still not achieved: 60 percent of duties were set at 15 percent, while 38 percent were at 5 percent or less (figure 6.1). Most of the lower rates apply to inputs, which can result in high rates of effective protection (of value-added). The main improvement is that ministries may no longer exempt specific users from paying customs duties on inputs, which should reduce the dispersion of rates and effective protection to domestic value added.

The highest nominal protection rates (13 to 15 percent) were in labor-intensive industries such as shoes, leather, textiles, wood and paper (figure 6.2). The lowest rates were in capital-intensive machinery production, which exports to markets in the former Soviet Union. The effective rates of protection, especially in the labor-intensive industries, are estimated to range from 100 to 150 percent depending on value added because inputs were in most cases exempt from tariffs. Some industries received additional protection from export taxes (leather, metals, wood) on inputs, which tend to lower the domestic

price of the taxed products. Many labor-intensive industries are likely to have a comparative advantage in trade with the West, so the higher-than-average protection they received may reduce incentives for trade reorientation in these industries. Protection weakens incentives to improve productivity and quality and makes production for the local market or for markets in the former Soviet Union more attractive.

The new tariff structure maintained the discrimination by trading partner. The unweighted average duty for imports from trading partners with which Latvia had no trade agreements was 13.4 percent, (10 percent for those with agreements). Free-trade agreements with most of the EFTA countries and with the other Baltic countries, which granted duty-free entry to industrial goods, further intensified the discriminatory pattern.

Transparency and consistency remained elusive. A large number of products were still subject to specific duties (about 130 product lines at the six-digit harmonized system classification). These rates, though appearing to be low, may easily be in the range of 50 to 100 percent. The Tariff Commission continues to administer changes to duties, but a new customs law has made tariff changes subject to

Parliamentary approval. The law also established the basis for temporary protection measures, such as anti-dumping or countervailing duties under GATT practice.

Following intensive lobbying by farmers against cheap imports tariffs on a number of agricultural goods were increased in June 1994. Protection is unlikely to solve the problems of Latvian agriculture, however, which are related to low productivity and inefficient farm size. Protection will also increase the cost of food to consumers, with potentially adverse consequences for low-income groups.

Exchange Rate Policies

The undervaluation of the exchange rate in early 1992 provided temporary protection against competition from imports, while making exports relatively more attractive than domestic sales. The low average wage in dollars, at about \$10-16 in early 1992—low even after allowing for productivity or skill differentials with other countries—reflected this undervaluation. Asset demand for foreign exchange was strong, fueled by high inflation, uncertainty about the value of ruble assets, and negative real interest for ruble deposits, which tended to depreciate the exchange rate.

The exchange rate began to appreciate substantially following stabilization and introduction of a convertible currency. By mid-1992 average wages in dollars had risen to \$35. By January 1993 they were at \$50 (IMF 1993), and in early 1994 at \$110, a nearly tenfold increase in two years. The real exchange rate appreciated as stabilization and high domestic interest rates reduced asset demand for foreign exchange and resulted in substantial inflows of foreign currency. Foreign exchange from the illegal transit activities, foreign exchange earnings from service activities, and capital inflows from other countries to Latvia's "offshore" banks may also have contributed to the appreciation.

Trade with Countries of the Former Soviet Union

Latvia's trade with the other new independent states is slowly starting to take place through regular trade channels between enterprises as govern-

ment involvement in this trade has gradually been reduced. The introduction of convertible currencies in Latvia and some other countries has reduced the barriers to trade created by unstable nonconvertible currencies, while improved commercial bank networks between republics have improved payment mechanisms (see below). Problems with market access in Russia and the bias created by Latvia's own trade policies also impede trade with countries of the former Soviet Union. Trade among the Baltics has been facilitated by a free trade agreement on industrial goods since 1993.

In late 1991, as the centralized system of control in the former Soviet Union was being dismantled, Latvia and other former republics started to negotiate bilateral trade agreements to maintain trade flows, mainly through obligatory lists negotiated between governments, and indicative lists negotiated between enterprises within an agreed framework set by the government. Difficulties in fulfilling the agreements soon reduced their importance. Quantities delivered fell below targets as traditional supply networks were dismantled and countries, especially Russia, accumulated substantial arrears in this trade. The negotiated fixed prices gave little incentive for Russian enterprises to fulfill the contracts when more lucrative trading opportunities were available at world prices, especially for many energy and raw material products that Latvia had long been importing from Russia and others. Furthermore, the substantial ruble inflation in 1992 made the accumulation of arrears by Russian importers from Latvia attractive. As long as Latvian exports to Russia were denominated in rubles at fixed contract prices, delaying payments to Latvian enterprises provided substantial rents for Russian importers.

In 1993 there was no trade agreement between Latvia and Russia because Russia did not ratify the 1992 agreement with Latvia until April 1994, mostly for political reasons.¹³ The agreement did not include an obligatory list because Russia and Latvia could not agree on implicit prices. With no ratified agreement in 1993, Latvia's exports to Russia were penalized by a doubling of Russian import duties in early 1994, while Russian exporters had difficulty

Box 6.2 Chronology of Main Trade-Related Reforms, 1991-94

Domestic		External	
1991-1992	Most prices liberalized	1992-93	GSP treatment in main industrial countries
1991	Tax reform	1992-93	Free-trade agreements with most EFTA countries (Finland, Norway, Sweden, and Switzerland)
1992-93	Introduction of convertible currency	1992-93	Abandonment of indicative lists
1992	State trading abolished	1992-94	General trade agreements with a number of ex-Soviet republics
Mid-1992	Export quotas and licenses replaced by export taxes	1993	Baltic free-trade agreement
September 1992	Introduction of import duties	1994	MFN trade agreement with Russia
End 1993	Reduction in export restraints	1994	Application to join GATT
March 1994	Reform of import regime	1994	Agreement with the EU on a four-year transition to a free-trade agreement
June 1994	Increase in agricultural duties		

getting licenses for exports to Latvia. Latvia soon applied discriminatory import duties of its own on Russian exports to Latvia. Finally in April 1994, Russia and Latvia agreed to grant each other most-favored nation treatment, eliminating the discriminatory duties on both sides of the border.

After the failure of the government-negotiated trade agreements, trade among the countries of the former Soviet Union shifted to enterprise-to-enterprise barter or hard currency arrangements, which kept some level of trade alive in the region in 1993. So did the various outward and inward processing schemes, which allowed enterprises to bypass border taxes. Under these arrangements, products imported from Russia to Latvia, for example, for further transformation were exempt from border duties, and exports of the final product to Russia were exempt from Latvian export taxes, VAT, and Russian import duties. Because the system did not require strict application of input coefficients for duty-free treatment, it probably permitted Latvian producers to import duty-free more raw materials than needed for the final products, unlike a strict duty drawback system.¹⁴ Though reversing some of the antiexport bias of the export taxes, this arrangement had high administrative costs and the processing provisions were bureaucratically convoluted and subject to discretionary approval. A transparent duty drawback system for all exports would be more efficient.

Trade with the other Baltic countries was on a different footing, following implementation of a free-trade agreement in 1993. That agreement gave the Baltic countries the same free-trade status as most of the EFTA countries had with Latvia. The trade creation potential of the agreement may be limited, however, by the small size of the Baltic market. Trade diversion—the replacement of more efficient third-country imports by imports from protected partners—is unlikely to be a serious problem as long as Latvia maintains only a moderate level of protection.

Issues in Trade Policy

Latvia's trade policies raise a number of concerns for the efficient allocation of resources and a successful transition to a market economy. On the export side, Latvia should remove all remaining restrictions (see chapter 13) and introduce a duty drawback scheme. Now that prices have been fully liberalized, there is no economic reason for export taxes. The high taxes on exports in effect for most of 1993 no doubt contributed to the slow growth in exports during that year. Because most of the remaining export taxes are on raw materials (wood, leather, sands for glass making) not subject to price controls, the taxes protect the domestic production of these inputs, weakening incentives for restructuring the economy. Taxing raw materials may also impede the export of resource-based goods in which

Latvia may have a natural comparative advantage. A tax on exports also interferes with imports by reducing foreign exchange receipts and depreciating the exchange rate. And high taxes encourage smuggling.

The discriminatory structure of export taxes should also be abolished. Higher taxation of exports in nonconvertible currencies is unlikely to encourage a reorientation of trade to the West since products sold to the former Soviet bloc countries could not often be sold in the West. Levying taxes on final goods may make them unmarketable, rendering adjustment more difficult. If the objective of the export taxes was to reduce incentives to trade in nonconvertible currencies, uniform taxes would have been more effective: Latvia's exports to the West grew slower than its exports to the former Soviet Union in 1993, a year when trade bias against countries of the former Soviet Union was high. Trade is best promoted by a transparent and liberal trade policy framework—witness Estonia's success in reorienting its trade using neutral trade policies.

The level of protection of imports is moderate, but the dispersion of rates, lack of transparency, and inconsistency of the regime create problems of allocative efficiency. Latvia should move to a modest uniform rate of about 10 percent or less, phased in over five years. Though some temporary protection may be justified during transition to help enterprises adjust to new relative prices, it should be provided on a uniform basis. The rate should be low, to avoid any build up of pressures to exempt inputs and capital goods from the duties. Also, a high rate of protection would increase the trade diversion cost of Latvia's free-trade agreements, as its free-trade partners can take advantage of high rates of protection against third countries by exporting expensive or outdated products to Latvia. A low rate of protection would promote transit and entrepot activities and would also increase fiscal revenues by reducing incentives for tax evasion.

Second, to improve the transparency of its import regime, Latvia should eliminate specific tariffs and the system of minimum import prices on agricultural goods. Specific rates tend to hide the

true level of protection for producers and consumers, because of the difficulty of computing ad valorem equivalents, and a minimum price system is not the way to solve problems with customs valuation or to prevent fraud. Using domestic prices (minimum prices) as a basis for customs valuation may increase the protection from imports since inefficient production would raise domestic prices. If valuation is a problem, prices are available in international exchanges for relatively uniform agricultural goods, while international experts in customs valuation can establish values for more differentiated products.

Third, Latvia needs to establish an institutional framework for trade policy that is simple, transparent, and based on clear criteria. Tariffs should be established according to specified guidelines and changed only by Parliament on the recommendation of a central organ such as the customs department or the cabinet. Where there is discretionary power to change tariffs, the process is open to corruption and lobbying for protection. And frequent changes in duties reduce the credibility of policies and the stability of incentives, reducing investment and directing it to sectors in which Latvia may not have a longer-term comparative advantage.

Temporary tariffs should be imposed only in clearly defined circumstances, following clearly defined guidelines. The GATT allows countries to impose temporary duties as safeguards against sudden surges of imports or to counter dumped or subsidized imports. The procedure should be public and transparent.

Fourth, Latvia should eliminate import discrimination by trade partner beyond MFN duties. If the aim is to negotiate concessions, charging higher duties on imports from countries with which Latvia has no trade agreements is unlikely to confer much bargaining power. Discrimination against Russia was removed through conclusion of a trade agreement in early 1994, but it remains for other countries such as Japan, a number of countries of the former Soviet Union, and many developing countries. The higher duties charged countries with which Latvia has no agreement only increases the trade diverting effect of free trade agreements.

Latvia is at a stage in its transition when having a transparent and nondiscriminatory framework for protection is critically important. The tariff and import scheme needs to be changed now, before production adjusts to distorted incentive structures. Change will be much more difficult later, once strong vested interests have been created. Already, agricultural interests have successfully lobbied for special import protection on several products, special tax rates, and a clearing of arrears. Overwhelmingly, international experience demonstrates that openness boosts growth and prosperity. Latvia need look no farther than Estonia, whose transparent policy framework and successful adjustment in trade shows how important openness can be to successful transformation from a command to a market economy.

In addition to pressures for protection from special interest groups, fiscal revenue concerns may also influence discussions about the appropriate level of import tariffs. Doing away with exemptions and reducing incentives for smuggling would improve revenue collection. But existing free-trade agreements between Latvia and a number of its trading partners, accounting for nearly a fourth of Latvia's imports (11 percent from EFTA, 17 percent from other Baltics), also reduce fiscal revenues for import duties. Increases in duties would only divert more trade to these sources. This has an efficiency cost, since Latvia would shift imports from more efficient outside sources to less efficient partner countries. So other revenue sources should be sought instead.

The transparency of Latvia's trade policies will be improved by joining the GATT. Latvia has been an observer in GATT since 1993 and applied for membership in 1994. Accession to GATT would require Latvia to remove discrimination by trading partner except for GATT consistent free trade agreements and would be likely to touch on such issues as the state of private sector reforms in Latvia (progress in establishing a market economy is required), justification of current interventions in trade policy, and the binding of import duties at some maximum level, although applied rates can be lower.

Payment Issues

Convertibility of the lat and liberal access to foreign exchange¹⁵ have eased foreign trade transactions and reduced exchange rate risks for Latvian traders. By early 1993 Latvia's trade partners in the former Soviet Union were increasingly willing to accept payments in Latvian rubles (and later in lats). However, the instability of many of the new currencies and the nonconvertibility of some currencies in the former Soviet Union continue to impose high costs for trade in these currencies. Because of the high risk of holding some of these currencies, banks charge very high commissions on these transactions. For example, in 1993 the Russian ruble had a 47 percent commission in Latvia and the Ukrainian karbovanets 300 percent, while the US dollar had only a 6 percent commission. Increased competition between Latvian banks will only partially solve this problem, which partly reflects the respective countries' economic conditions.

Problems in making payments for trade can substantially increase transaction costs. Initially, the largest payment obstacles were related to difficulties in clearing central bank correspondence accounts between republics, payment delays in the banking system, difficulty and high cost of getting trade financing, and nonpayment by trading partners.

Bank-related payment difficulties are gradually being resolved by improved links between commercial banks abroad and the shift to convertible currencies in foreign trade. One of the main impediments to trade, especially with ex-Soviet bloc countries, is the problem of making payments through the banking system. In early 1993, it still took on average three to four weeks to have payments credited, and the cost of the transactions was increased by the high foreign exchange risks.

Slow clearing arrangements between central banks and the nonconvertibility of country-specific balances from exports to the different states of the former Soviet Union also impeded trade. Central bank clearing accounts frequently closed and reopened as countries introduced currency reforms and reorganized the clearing system.

The payment problems made barter the main vehicle for trade with countries of the former Soviet

Union. Barter was often a first step away from the system of state orders and toward enterprise-level trade. In conditions of high market instability, barter transactions probably play a key role in maintaining critical trade flows. Therefore, impediments to these transactions such as the higher taxes on nonconvertible currency trade are counterproductive, at least until effective payment mechanisms are established and economic stability is restored.

Policy Conclusions

Latvia has come a long way in a short time from a centrally planned to a market-based economy. Convertibility of the currency and monetary and fiscal discipline have stabilized the macroeconomic framework, providing the level of confidence necessary for a successful supply response to trade policy reforms. Sustaining these policies will take strong commitments, especially during a privatization phase that is likely to increase unemployment. In the medium term, progress will depend on structural reforms, especially in private sector incentives, property rights, and financial intermediation, to permit a sustainable supply response to the market-based incentives for production.

Further reforms in trade policies are needed so that trade expansion can fuel economic growth. Exports should benefit from removing the remaining export constraints and discrimination against trade with countries of the former Soviet Union and from establishing a simple and transparent duty drawback scheme. The creation of a sustainable basis for growth in trade and foreign investment requires more attention to the transparency and consistency of import policies. Most important is to establish a uniform level of protection based on ad valorem tariffs, greater stability in the tariff structure, and institutional arrangements that leave less scope for discretionary actions. A transparent structure of incentives and open trade policies will allow Latvia to take full advantage of its favorable geographic location and to realize its trade potential in skill-intensive goods and services.

Notes

This chapter has relied on notes on Latvia's trade policies by M. Michaely, A. Hillman, and C. Muller and has bene-

fited from comments by Monsour Farsad, M. Michaely, Morris Morkre, D. Tarr, and L. Alan Winters.

1. Several distortions in Latvia's tax policies affected trade and allocational efficiency. Most important was a value-added tax (VAT) that penalized non-hard currency exports (mostly to former Soviet Union) with a 12 percent VAT when exports to hard currency areas were exempt. (IMF 1993).

2. This flexibility allowed Latvia to adjust to external shocks by adjusting the exchange rate with accommodating monetary policy, but it also made Latvia more vulnerable to speculative behavior, which could hurt the economy. By contrast in Estonia any changes in foreign exchange position were directly transmitted to domestic money supply and thereby to inflation or domestic demand.

3. Establishing the "correct" or equilibrium real exchange rate can be a formidable task. Wages in dollar terms can be one proxy of the overall cost levels in a country. Wages in countries of the former Soviet Union are available mostly for the state sector, which may not reflect costs in the emerging private sector and ignores the potentially large nonwage benefits typical of planned economies.

4. The employment statistics also suggest that the decline in output may have been overstated by the production statistics. Between 1990 and mid-1993 the number of employed in the economy dropped 10 percent while output fell by 50 percent. Energy statistics support a similar conclusion. Exact statistics on energy consumption in general or in industry are not available, but electricity consumption in the economy in 1991 and 1992 fell by only slightly over 20 percent.

5. Privatization has also been delayed by several issues linked to restitution. Because land may not yet be sold in Latvia, pending termination of restitution procedures in most cases is leased for one to five years. Citizenship requirements for restitution have yet to be resolved as well.

6. The substantial difference between local and OECD statistics for these products suggests that much of the re-export is illegal.

7. Official statistics list petroleum as Latvia's main export (20 percent), although Latvia produces no petroleum, which is likely to bias Latvia's trade statistics. It would contribute to an overestimate of the share of Western exports in total and to an overestimate of imports from the former Soviet Union. Accordingly, trade reorientation would have been less successful and dependence on Eastern imports overstated.

8. Trade data for 1992, and especially for 1991, are subject to large margins of error when based on official exchange rates (1.8 rubles per dollar). Using the rate of 5 rubles per dollar (the rate used by the IMF for Estonia in 1991) shows trade contraction about 46 percent, which corresponds better to the estimated contraction in output.

9. The Latvian trade data reports imports of many energy products without a specific source, but most of these can be assumed to originate in Russia.

10. Taxes on exports in convertible currencies covered 270 of 5,020 six-digit harmonized system (HS) lines of which 76 percent were at or below 10 percent, 14 percent between 11 and 20 percent, and 10 percent between 35 and 30 percent. Taxes on exports in nonconvertible currencies covered 422 six-digit HS lines, of which only 10 percent were at or below 10 percent, 62 percent between 11 and 20 percent, and 28 percent between 35 and 300 percent. Some, but not all, of the duties were eliminated on exports to free-trade partners in the Nordic countries: leather (200 percent), ferrous scrap and waste (300 percent), and many wood products (100 percent) remained under duties.

11. However, for exports in convertible currencies the number of six-digit HS lines subject to duties increased from 270 to about 383. Duties ranged from 1 to 100 percent, 90 percent of them at or below 10 percent. In exports in nonconvertible currencies, the number of tariff lines subject to taxes declined from 422 to 406. Duties ranged from 2 to 200 percent, 84 percent of them at or below 10 percent.

12. Chocolate (50 percent or higher specific rate), bread and pastry and some food preparations (30 percent or higher specific rate), insecticides and similar chemicals (30 percent), and parlor games and casino equipment (30 percent) were added to the list of higher duties.

13. Disagreement also persisted over the treatment of re-exports. Russia wanted no re-exports of goods covered by bilateral agreements, and it threatened to stop deliveries of gas, if it found that metals were being re-exported.

14. For example, textiles could be imported duty-free from Russia to Latvia against exports of clothing to Russia for the same value, but which incorporated only 40 percent of the imported inputs (exact barter basis). Strict application of a duty drawback would have allowed duty-free import for only 40 percent of the raw materials used. Thus the

Latvian enterprise received duty-free inputs for domestic production as well.

15. Since independence the foreign exchange market has been based on laissez faire policy and access to foreign exchange has not been a major barrier to trade. As of mid-1992 the market has been organized around the commercial banks and private foreign exchange dealers. While the institutional structure allows foreign exchange transactions through an interbank system, most transactions have been carried out by private agents. Major Latvian commercial banks operate in all convertible currencies and have correspondence accounts in at least five to ten banks.

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7

Lithuania: Trade Issues in Transition

Piritta Sorsa

With 3.7 million people, Lithuania is the largest of the Baltic republics. Its income per capita, though slightly below that of Estonia and Latvia, is among the highest of the countries of the former Soviet Union. More agrarian than Estonia and Latvia, Lithuania is geographically and historically closer to Central Europe.¹ Foreign trade has played an important role in its economy, though smaller than in the two other Baltic states. During the interwar period Lithuania became an exporter of agricultural products to industrialized Europe. During the Soviet years, imports and exports accounted for 50 to 60 percent of GDP. Since independence Lithuania has started to reorient its trade from near-total dependence on the former Soviet Union to the West. Lithuania has considerable potential in products and services that can use its highly skilled labor-force.

The Macroeconomic Situation and Complementary Reforms

Success with stabilization and macroreforms in Lithuania has influenced trade performance by affecting stability of the economic climate and incentives to engage in foreign trade. As in Estonia and Latvia, in Lithuania stabilization was preceded by reform of prices, taxes, and wages. Lithuania was also one of the first countries to initiate privatization in 1991, although progress has been only more moderate in recent years. Stabilization was delayed first because Lithuania remained in

- The Macroeconomic Situation and Complementary Reforms
- Trade Flows
- Trade Policy
- Payments Issues
- The Role of Restructuring and Investment in Trade Adjustment
- Policy Conclusions

the ruble zone until late 1992 and later because of technical difficulties in introducing its own currency. Currency reform played a key role in stabilization, but political interference in monetary and fiscal policies in the early part of 1993 slowed slightly the reform momentum. The replacement in April 1994 of the flexible exchange rate policy with a currency board regime for managing the economy is further stabilizing monetary aggregates and the exchange rate.

Initial Reforms

Lithuania started price reform in February 1991 just slightly behind its Baltic neighbors, but well in advance of Russia and other ex-Soviet republics. By November 1992 only about 15 percent of prices in value terms in the consumer basket remained controlled.² This earlier start in price liberalization than in other countries of the former Soviet Union initially brought terms-of-trade gains to Lithuania and the other Baltic countries relative to the rest of the former Soviet Union and helped hold output decline to about 15 percent for 1991 (table 7.1).

The elements of a modern tax system were introduced gradually starting in 1990.³ They included a profit tax (29 percent), a general excise tax (18 percent), specific excise taxes on alcohol, tobacco, and petroleum products (varying rates between 10 and 71 percent), personal income taxes, payroll tax (31 percent) to cover social security payments. Early tax reform helped to enlarge the revenue base when output declined. Real wages have declined

Table 7.1 Selected Economic Indicators, 1990-93 (percent)

<i>Indicator</i>	<i>1990</i>	<i>1991</i>	<i>1992</i>	<i>1993</i>
Change in GDP	-6.9	-15	-36	-16
Inflation	16.1	225	1,021	410
Fiscal balance (percent of GDP)	-2.6	5.2	0.6	-5.5
Unemployment	—	0.3	0.6	1.6
Real wages	—	-20	-12	-45

— not available

a. Official

Source: World Bank (1993), IMF (1993)

significantly since independence, reducing the monetary overhang, although with a slight delay compared to Estonia and Latvia because wages in Lithuania remained indexed to prices slightly longer.

Stabilization

Lithuania is well on its way to a stable economy, a consequence largely of currency reform coupled with relatively tight fiscal and monetary policies. Convertibility has been important in creating incentives for foreign trade and reducing uncertainty in foreign transactions. Stabilization started in May 1992 with the introduction of a temporary currency. The central bank issued coupons (talonas) to address the shortage of cash rubles. In October 1992 the talonas became the official Lithuanian currency under an exchange regime of a unified floating exchange rate and current account convertibility. In June 1993 once inflation had been reduced to an acceptable level, the permanent national currency, the lita, was introduced.

Until 1994 stabilization efforts suffered from the politicalization of monetary policy, leading to cycles of alternating tightening and loosening. Lithuania, using exchange rate policies similar to Latvia's was slightly less successful in controlling monetary expansion and bringing down inflation. The central bank was unable to resist domestic pressures in early 1993 to slow the appreciation of the lita by selling litas. That increased the money supply and maintained inflationary pressures. As a result, inflation declined more slowly in Lithuania than in the other Baltic countries: average annual inflation was 1,021 percent in 1992 and 410 percent in 1993, falling to a monthly rate of 3 to 5 percent in mid-1994, close to the levels in Latvia and Estonia. The decline of inflation was associated with a strengthening and tightening of monetary policy, which culminated in the introduction of a currency board in April 1994 and the fixing of the lita to the U.S. dollar at a rate of 4 to 1. This mechanism is designed to isolate monetary policy from political or other interference, and thus improve credibility of macropolicies. The currency board arrangement also totally eliminates the use of mon-

etary policy as an economic management tool since the amount of money in circulation is strictly linked to foreign currency and gold reserves. Monetary financing of government deficits is impossible with this arrangement. That means that adjustment to external shocks will directly affect domestic demand. If Lithuania runs a deficit in its current account, domestic demand will have to contract as a result of the tighter monetary situation.

Until 1993 prudent fiscal policies kept budgets in surplus or in balance, greatly easing the task of stabilization. The first deficit appeared in 1993, and fiscal pressures continued to rise in 1994 because of revenue shortfalls and increased spending on social programs to ease the transition.

Trade and other adjustment have been delayed to some extent by negative real interest rates and enterprise arrears. Interest rates remained negative in real terms through 1992 and early 1993, but then turned positive. Interenterprise arrears—in effect, zero-interest financing—might have contributed to negative real interest rates by offering an alternative to credit financing. During 1993 the stock of interenterprise arrears rose to almost the level of total deposits in the banking system. Most of the arrears were of domestic origin, although arrears throughout the former Soviet Union contributed to their growth. By early 1994 Lithuania had yet to mount a major effort to collect the arrears. In the absence of a strong debt collection agency enterprises continue to rely on arrears, although the level stabilized in early 1994. Only two bankruptcies took place in 1993 (IMF 1993).

Output contraction started slightly later in Lithuania than in Estonia and Latvia and was felt mostly in the second half of 1992 (-36 percent). Severe shortages of energy imports from Russia accelerated the decline. There have been some signs in 1994 that the decline is bottoming out. There are also reasons to believe that output may have declined by less than the official statistics show. Unemployment has been low, and the emerging private sector is not covered in the statistics. Despite the output contraction official unemployment has remained low. At 1.6 percent in 1993 (though true unemployment, including workers on unpaid invol-

untary leave, is likely to be larger) the rate was lower than in the other Baltic republics, perhaps reflecting Lithuania's greater tolerance for arrears, a practice stopped sooner in Estonia. Other factors probably contributed as well, such as the terms of trade gains in 1991, government decrees forbidding or limiting layoffs in 1992, and high payroll taxes, which may have driven employment to the informal sector.

Complementary Structural Reforms

Structural reform, despite a quick start on privatization, has moved more slowly than stabilization. Slow structural reform may slow supply response to new relative prices and incentives to export and import. The restructuring of privatized companies has been delayed by the failure to clamp down on arrears and by the high degree of manager and employee share ownership. Greater flexibility in factor markets has been hampered by regulations restricting labor movement and mandating generous severance payments. Restructuring of the banking system has moved slowly as well.

Lithuania started privatization in early 1991, with an innovative voucher scheme for Lithuanian citizens. The vouchers could be used to buy housing, small enterprises, or shares in larger enterprises. Management of the privatization program was given to a centralized agency, thereby avoiding the problems of piecemeal privatization that Latvia experienced. Restitution has not presented much of a problem (except for land) because it applies only to residents. Housing became the first target of the program, and in early 1994 about 95 percent of the housing stock had been transferred to private ownership. Almost all small enterprises and about 60 percent of larger industrial enterprises have been sold to investors. In agriculture almost all agribusiness and land is private.

Labor mobility is improving. Until early 1993 people required official permission to move to certain cities, and the employer or employee had to pay a special tax as well. Restrictions on the production profile and on layoffs in privatized enterprises also reduced mobility and affected trade and other adjustment. Severance payments are as much as six

months' salary in state enterprises and eighteen months in private enterprises, discouraging the shedding of excess labor. The difficult housing situation further discourages changing jobs.

The restructuring of the banking sector has proceeded slowly, though private commercial banking is growing and the role of state banks is shrinking. Credit transactions still carry high risks, making banks reluctant to lend. Trade finance is costly and difficult to obtain for lack of collateral and high perceived risks. Restructuring and stabilization of the financial sector requires further strengthening of private commercial banks (especially in credit assessment and banking supervision skills) and resolving the portfolio problems of the three large state banks.

Trade Flows

Lithuania has been slower in reorienting its trade than Estonia, but has done better than many other new independent states. When Lithuania reestablished independence in 1991 more than 90 percent of its trade was with other countries of the former Soviet Union. Though 70 percent of

Lithuania's imports were still coming from the former Soviet Union in 1993, the share of exports to the West (measured at official exchange rates) was above 40 percent in 1993, up from 6 percent in 1990 (table 7.2). Slowing the process of reorientation were a slower pace of stabilization, a trade policy framework in need of greater reform, uncertainty arising from the low pace of structural and other reforms, and other structural and natural constraints particular to Lithuania.

After a severe slump in 1992 Lithuania's exports and imports increased in 1993.⁴ In 1993 exports to the West continued to grow, and exports to the former Soviet Union recovered even more, climbing 84 percent in nominal dollar terms. Imports increased by more than 60 percent, again with the former Soviet Union accounting for most of the increase. Some of the increases, especially imports from the former Soviet Union, may reflect terms of trade changes. The undervalued exchange rate in 1992 and 1993 boosted incentives for exports outside the former Soviet Union. The reduction in antiexport bias achieved in 1993 (see

Table 7.2 External Trade 1990-93
(millions of current U.S. dollars and percent)

	1990	1991	1992	1993
<i>Value</i>				
Total Exports	11,823	9,613	1,062	1,625
Former Soviet Union a	11,144	9,268	505	929
Rest of world b	679	345	557	696
total imports	12,575	6,726	966	1,597
Former Soviet Union	11,032	6,251	624	1,111
Rest of world	1,543	475	342	486
Trade balance	-752	2,887	96	28
Former Soviet Union	112	3,017	-119	-182
Rest of world	-864	-130	215	210
<i>Percentage distribution</i>				
Total exports	100	100	100	100
Former Soviet Union	94.3	96.4	47.5	57.2
Rest of world	5.7	3.6	52.5	42.8
Total imports	100	100	100	100
Former Soviet Union	87.7	92.9	64.6	69.6
Rest of world	12.3	7.1	35.4	30.4

a. Figures for trade with the former Soviet Union are derived from country data and World Bank staff estimates reported in national currencies using official or commercial exchange rates for 1990 and 1991 and annual average market exchange rates for 1992 and 1993.

b. The rest of the world refers to countries outside the former Soviet Union; figures are based on country data reported in U.S. dollars.

below), probably contributed as well, as did the introduction of a convertible currency, which substantially changed the incentives for foreign trade. Re-exports of raw materials from the former Soviet Union (see below) may also account for some of the increase in exports to the West.

Lithuania's main trading partners are Russia and the European Union (EU). In 1993 the EU absorbed 53 percent of Lithuania's exports to the West, some 21 percent of it going to Germany. Neighboring Poland accounted for 21 percent of exports. Despite free trade agreements in effect since 1992 the Nordic countries' share in exports was relatively small, at 9 percent. In 1993 Russia still provided four-fifths of imports from the former Soviet Union. Lithuania's dependence on Russia, especially for energy imports, was related to the lack of infrastructure for importing oil and gas from other sources and the shortage of foreign currency until 1993. Ukraine and Belarus were also important trade partners. Intra-Baltic trade accounted for only about 5 to 7 percent of import and exports, most of it with Latvia.

In 1992 the composition of trade with the former Soviet Union continued to follow patterns established under central planning, which did not always correspond to Lithuania's natural comparative advantage. (No more recent product data are available). Lithuania exports machinery, food, and light industry products such as textiles and imports energy and raw materials for its transforming industries. Most intra-Baltic trade was in energy.

To the rest of the world Lithuania continued to export mostly food and other resource-based goods such as timber, in which trade reorientation to the West tends to be easier. Other important exports in 1992 were chemicals and petroleum. Lithuania is not yet exploiting its high-skill, low-wage potential for labor-intensive export activities, which is where its comparative advantage seems to be. The share of such labor-intensive items as textiles and clothing in Lithuania's exports to the West in 1992 was the smallest of the Baltic countries at 17 percent (table 5.3 in chapter 5).

Transit trade, much of it of questionable legality and unreported in Lithuanian statistics, has also

been important to Lithuania, as it has to the other Baltic countries.⁵ The OECD reported \$418 million in oil and metal imports from Lithuania in 1992 (table 5.3 in chapter 5), whereas Lithuanian national statistics show only \$4 million in oil and metal exports to the OECD in 1992. This trade reflected the low prices of raw materials in Russia compared to world prices, a price incentive that is disappearing as Russian domestic prices adjust to world levels. The level of this trade in 1992 and 1993 was so large, however, that it must have had an impact on the real exchange rate and on economic activity in Lithuania. With its location at the land and sea crossroads between East and West, Lithuania is likely to continue to maintain a comparative advantage as a transit center.

Trade Policy

To meet the needs of a market economy Lithuania has been gradually reducing export restrictions; introducing modest though volatile and nontransparent, levels of import protection; and shifting to enterprise-to-enterprise trade within the former Soviet Union, with a common set of incentives (boxes 7.1 and 7.2)

Export Policies

Lithuania has substantially reduced the inherited antiexport bias of the Soviet trade regime. After a transition period of export restrictions, including quotas and bans in 1991 when prices had not yet adjusted to world levels, the transparency of export restrictions was improved in 1992, when Lithuania began to replace licenses and bans with export taxes. Most license requirements were lifted in October 1992, except for reasons of food security and the fear of supply shortages for goods whose prices had not yet been liberalized.⁶ Export bans were removed on sugar, butter, vegetable oil, remaining in effect only on nonferrous metals and products conventionally prohibited in international trade (arms, narcotics, cultural items), although some other products were taxed at prohibitive rates (500 percent). Until mid-1993 some exports were subject to the general excise tax at different rates than was domestic production (see below).⁷ During

Box 7.1 Summary of the Trade Regime in May 1994

<i>Instrument</i>	<i>Description</i>	<i>Percentage of tariff lines^a</i>
<i>Export restraints</i>		
Taxes	Range zero to 50 percent; 90 percent of duties less than 10 percent	8%(animal products, leather, wood, metals)
Quotas	None	
Licenses	None	
Bans	Red clover seed, untreated oak, ash- free timber until May 1995	
<i>Import restraints</i>		
Tariffs	Unweighted average 3.2 percent; Range zero to 30 % (except alcohol); Some specific rates; Seasonal duties; 75% of duties = 0	High rates on local products, low rates on inputs
Quotas	Glass bottles, feed and breeding ani- mals, pork for sausages, cereals and mixed fodder, raw materials for sugar processing, unbottled alcohol, technical alcohol, inputs to alcohol	
<i>State trading</i>	None	
<i>Exchange rate</i>	<ul style="list-style-type: none"> • Convertible currency since 1992; cur- rency board since 1994 • Real appreciation measured in monthly wages in USD from 8 to 13 in 1992 to USD 75 by end of 1993. • No surrender requirements 	
a. At the six-digit harmonized system classification		

1992 and early 1993 the remaining antiexport bias may have worsened the collapse of trade, although this influence was countered by the undervaluation of the real exchange rate, which increased the attractiveness of exporting to hard-currency countries.

In June 1993 export taxes were reduced considerably, although other export restrictions were increased slightly. The appreciation of the real exchange rate in 1993 helped reduce the need for export restrictions. Most export duties on final goods were eliminated and remaining duties were lowered to 5 to 50 percent.⁸ However, some export bans remained, and the number of products subject to quantitative export restraints was increased.⁹

Some restrictions covered products still under price control or in severely short supply domestically which could not be adequately addressed by imports due to delays in foreign funding.

Further reforms took place in February and May 1994. Export taxes and the number of products subject to the taxes were reduced, export quotas were eliminated, and bans were lifted on all but two items.¹⁰ Remaining export taxes, mostly on metals, but also raw materials and intermediate products, cover 8 percent of product lines (at the six-digit level in the harmonized system) at rates of 5 and 50 percent. Since the prices of most of these goods had been liberalized, the restrictions were probably intended to protect domestic processing industries.

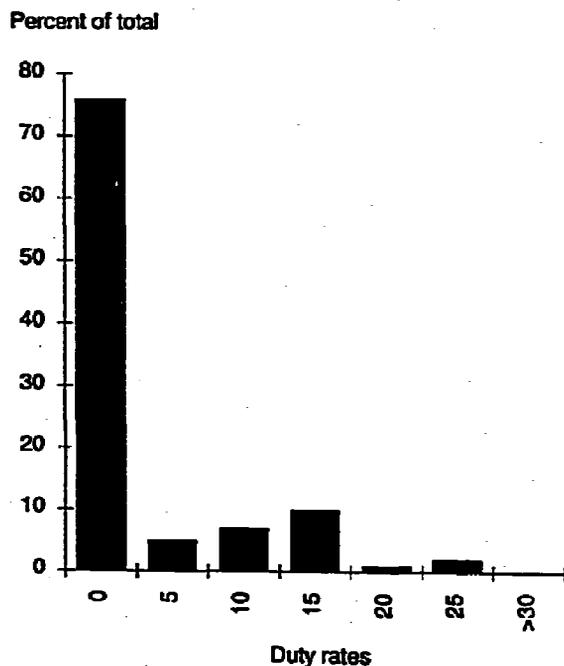
Import Policies

By January 1992 Lithuania had abolished essentially all import restrictions.¹¹ A depreciating and undervalued exchange rate provided some protection against imports, while the lower general consumption tax on imports (10 percent) than on domestic production (18 percent) subsidized imports slightly.

Lithuania's import policies became gradually more protectionist in 1993, as the rapid appreciation of the real exchange rate generated pressures to restrict imports. Lithuania's stated objective was a transparent tariff structure with uniform, moderate tariffs of about 20 to 30 percent. The duties were intended to provide fiscal revenue, and to protect domestic enterprises during the transition. Import duties were introduced in mid-1993 and increased slightly in the fall of 1993, mostly on agricultural goods. In February and May 1994 some of the highest rates were lowered, though duties on a number of products were increased. By mid-1994 pressure to increase agricultural tariffs further was intense.

The import tariff structure in place in mid-1994 falls short of the government's stated objectives. There are 10 different levels of duties from 0 to 100 percent, with most of them between 0 and 30 percent (figure 7.1). While this implies a moderate

Figure 7.1 Distribution of Tariffs



overall level of protection (an unweighted average of 3.2 percent), the dispersion of rates is still high. The higher duties apply mostly to goods also produced in Lithuania,¹² while many raw materials have zero duties (figure 7.2). The highest average unweighted nominal protection rate (about 20 percent) was applied to such labor- and resource-based industries as leather, shoes, textiles, wood, and paper. Effective protection to value added in these industries is even higher as a result of export taxes on some inputs used by these industries (skins, logs), which tend to lower their price below world market levels. Under the temporary transformation scheme, producers may be allowed to import duty free more inputs than needed in the production of exports, further increasing the dispersion of protection (for a discussion of the temporary transformation scheme, see chapter 6 on Latvia).

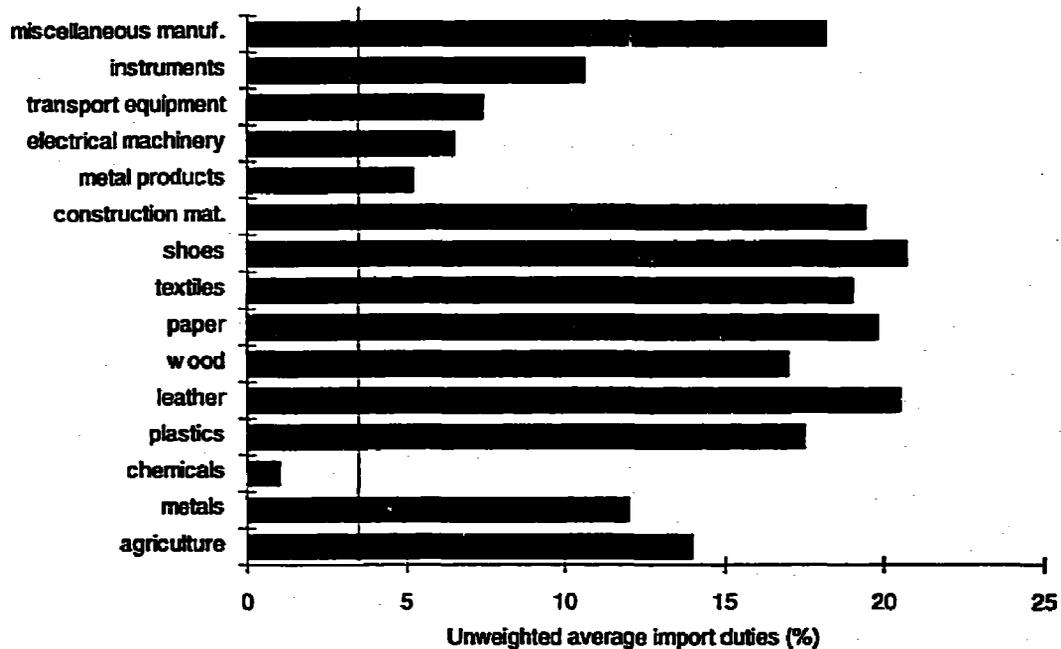
The transparency of the import regime was compromised by non-tariff barriers introduced in 1993 and 1994. Import quotas have been placed on a small but increasing number of products.¹³ In 1993 special import rights were given to selected enterprises to import alcohol, which were replaced by a quota in 1994. Specific duties are applied to some products (cars, some agricultural products, alcohol), which obscures the amount of protection they receive. Many of these restrictions appear to reflect successful lobbying for protection rather than any economic or social justification.

Confidence in the stability of the import regime has been eroded by frequent changes: the import regime was changed ten times between July 1993 and May 1994.¹⁴ Duties have been raised and reduced, and the number of products subject to other restrictions has changed. The easy procedure for introducing changes, and the proven success of producers in lobbying for protection creates incentives for others to lobby. The procedure for changing tariffs is particularly vulnerable to lobbying efforts: the cabinet issues a change through a simple decree, following a request from a ministry.

Exchange Rate Policies

In the early years of the transition, the undervaluation of the currency provided substantial pro-

Figure 7.2 Distribution of Import Protection in Lithuania



tection against imports. The temporary currency, the talonas, depreciated sharply in 1992 and in early 1993. One indicator of this undervaluation is that wages in dollar terms remained at about \$8-13 a month in the state sector in 1991 and 1992. This level was lower than in Latvia and Estonia and probably reflected Lithuania's stronger antiexport bias (although the undervaluation, by increasing export incentives, neutralized some of the antiexport bias of the regime).

With the introduction of the lita in June 1993, the currency started to appreciate in real terms. In late 1993 the monthly average wage in the state sector had risen to \$75, up from \$31 in May 1993. This real appreciation will gradually increase the antiexport bias of export taxes and increase pressures for import protection—a process that has already begun.

Payments Issues

Once Lithuania's currency became convertible, the incentives for trade and to repatriate capital also improved. When the currency was not convertible, transaction costs to firms were high and they had little incentive to repatriate foreign exchange earnings. Full access to foreign exchange lowers another

barrier to trade. Licensed banks may trade freely in foreign exchange. There are no restrictions on currency holdings or on accounts in foreign currencies.

Trade with Countries of the Former Soviet Union

Trade with the countries of the former Soviet Union has shifted from state trade to enterprise-to-enterprise trade. Following independence the government accorded high priority to bilateral trade agreements,¹⁵ which initially may have retarded enterprise adjustment to market incentives since they prolonged government involvement in production decisions. The country's high dependence on energy imports from the former Soviet Union and a shortage of convertible currencies contributed to this reliance on bilateral agreements. The efforts to maintain government-to-government trade (even for indicative list trade) with the former Soviet Union may also reflect an attempt by Lithuania to moderate its terms-of-trade shock in this trade. To encourage enterprises to participate, they were offered preferential access to low-priced raw materials, attractive output prices, and the promise of favorable treatment for export license. Enterprises signed a contract with the government to deliver a specific

amount of a product for export, leaving only a small share of output to be sold freely by the enterprise. Although the undervaluation of the real exchange rate provided substantial incentives to shift exports to hard currency markets, many enterprises involved in trade with the former Soviet Union were unable to take advantage of this opportunity, whether because of a lack of trade contacts or because their products did not meet Western standards.

The agreements failed to maintain trade flows with the former Soviet Union, and were soon abandoned. Most of the negotiated trade never materialized because of difficulties in fulfilling orders and the accumulation of arrears by Russian enterprises. Increasingly, trade began to take place between enterprises and government involvement dwindled. For 1993 the government negotiated only a framework agreement for trade with Russia, its main purpose to guarantee most favored nation treatment. The agreement was never implemented because of a dispute with Russia over re-exports.

Trade in general and that with the former Soviet Union was also affected by payments problems. Lithuania's payments problems are similar to those experienced by other Baltic countries. Making payments through the banking system has been a stumbling block. To facilitate payments Lithuanian banks were allowed to open correspondence accounts in other countries of the former Soviet

Union. But the inconvertibility of many of these countries' currencies has meant that enterprises have been stuck with the claims on the other countries' currency, unless another company that needed the currency has been found to buy the claim. Markets for trading rubles or other currencies of the countries of the former Soviet Union have not yet fully developed in Lithuania (IMF 1993), mainly because of weak demand for rubles. Frequent closing of central bank clearing accounts and difficulties in settling remaining balances also impeded trade with countries of the former Soviet Union.¹⁶

Barter became important in the early stages of transition because of payment delays through the banking system in a highly inflationary environment and the thin markets for rubles and other inconvertible currencies. Barter allowed enterprises to circumvent the high transaction costs of monetary exchange. Because enterprise links were not always direct under central planning, a trilateral barter developed. A Baltic enterprise selling to Russia entered into a second arrangement with another Baltic enterprise buying the goods provided by the Russian enterprise. Barter, though inefficient, helped maintain minimum trade flows in the absence of fully convertible currencies until banks could be relied on for making payments. Recently, the importance of barter has declined as the payments system has improved.

Box 7.2 Chronology of Main Trade-Related Policy Changes, 1991-94

Domestic		Mid 1993- May 1994	Moderate import restrictions introduced and changed a number of times
1990-92	Most prices liberalized	1994	Introduction of a currency board with a fixed exchange rate
1991	Tax reform		
1991	State trading gradually replaced by export licenses, quotas, taxes, and bans	External	
1992-93	Introduction of a convertible currency under flexible exchange rates	1992-93	GSP treatment in main industrial countries
1992	Export surrender requirements at below market rates abolished	1992-93	Free trade agreement with four EFTA countries (Finland, Norway, Sweden, Switzerland)
1992	Elimination of separate profit taxation on hard currency exports below market rates	1992-93	Abandonment of indicative lists
1992	Export restrictions reduced and most licenses replaced by taxes	1992-93	General trade agreements with most countries of the former Soviet Union
1992	Export bias in excise taxes removed	1993	Baltic Free Trade Agreement
June 1993	Further liberalization of export restrictions	1994	Application to join GATT
1993	All surrender requirements abolished	1994	Free trade agreement with the EU over a six-year adjustment period

The Role of Restructuring and Investment in Trade Adjustment

Lithuania has shifted its trade to the West more slowly than Estonia has (know though, that trade statistics are subject to large margins of error). Many factors underlie this development. Lithuania was slower to stabilize its economy than Estonia, and the prolonged uncertainty affected investment and production decisions. The lag in introducing currency reform and convertibility may have affected trade performance by slowing the supply response and the reallocation of resources. Lithuania's trade regime never fully eradicated its antiexport bias, reducing incentives for exporting, while frequent changes in policy created uncertainty, encouraged lobbying, and reduced incentives to invest in activities in which Lithuania has a comparative advantage. Regulations affecting labor mobility and company operations reduced the potential benefits of privatization, further delaying restructuring and a supply response. Lithuania was also slower than the other Baltic countries to give up state trade. Since most of the government's bilateral trade agreements were not fulfilled, total trade was affected. The failure to sustain this trade also contributed to production declines since expected energy inputs were not available.

Lithuania could have reoriented its trade more quickly had it taken better advantage of the relatively favorable market access it enjoyed in its Western markets. Lithuania has had free trade agreements covering industrial goods with most EFTA countries since 1992/93 and has received preferential GSP treatment in the EU and the United States (see chapter 12). Its trade with the EFTA countries, probably reflecting short-term supply constraints, was smaller than trade with the EU, but trade with both groups could expand considerably over the medium term. Lithuania's highly skilled, low wage labor force and geographic proximity should favor development of skill intensive exports to Western Europe.

Structural Issues

Of the Baltic countries Lithuania has been the most dependent on the former Soviet Union for its

energy needs. In 1992 oil constituted nearly two-thirds of Lithuania's imports. Changes in its availability have had a large impact on industrial activity. In 1992 Russia cut off oil supplies and failed to supply the amounts agreed in the initial (indicative) trade agreements.¹⁷ Lithuania could not easily turn to the West to make up the shortfall because its ports were not equipped to receive oil imports by sea.

The structure of Lithuania's industry also made adjustment and trade reorientation more difficult. Lithuania has the highest share of heavy, Soviet-oriented industry in total output among the Baltics (over 30 percent). Their energy intensity is high, and quality differentials with the West are large, making adjustment to new relative prices and standards particularly difficult. Machinery accounted for about 33 percent of industrial employment and other heavy industries such as chemicals, energy, and building materials accounted for another 18 percent. A large share of production was for military purposes (especially electronics and telecommunications), tied to the former Soviet Union. Some 40 percent of Lithuania's 600 industrial state enterprises were all union enterprises. The large size of these industrial complexes—an average of 843 employees compared with 160 in the EU—and inefficiencies that developed as a result of a lack of competition during the Soviet era increased the costs of adjustment to world standards. Even in the light industries such as food processing, many units were organized into associations with a monopolistic position in the domestic market.

The contraction in industrial output took place slightly later in Lithuania than in the other Baltic countries, in part because of hoarding of raw materials and a continuation of barter arrangements. Many enterprises received indirect tax relief, subsidies, or other help from the government or cheap credits from banks. Not a single enterprise closed before mid-1992.

In 1992 industrial output plunged 50 percent. The demand and terms-of-trade shocks, among the most severe in the former Soviet Union, were felt mostly in the second half of the year. The total terms-of-trade deterioration in 1990 prices com-

pared to world prices was estimated at 25 to 35 percent, or 13 percent of GDP (Tarr 1994). In 1992 trade collapsed (table 7.2). Arrears to the government and to other enterprises started to accumulate. Agricultural output shrank 30 percent, however, official estimates of output and trade decline do not capture the huge unrecorded capital outflows and unofficial imports. GDP continued to decline in 1993, but the resumption of some trade and external assistance helped maintain activity.

Foreign Investment

Lithuania has attracted less foreign participation than Estonia. Although the only formal restrictions on foreign ownership are in sectors such as defense, public utilities and energy, transport and communication, alcohol, and tobacco, in practice there are additional constraints that limit foreign investment sales to foreigners. Only a limited list of enterprises is eligible for hard currency privatization, foreigners cannot own land, and the mortgage law is inadequate. Also bureaucratic impediments and discretionary authority (the state privatization committee must authorize sales to foreigners) limit the interest of foreign investors in Lithuania. Between 1987 and 1992 over 2,000 new projects with foreign involvement were registered, about four-fifths of them joint ventures and the others foreign-owned firms. The largest increase was in 1992, when over half the projects were registered. Most of the recent ventures are not yet under way (IMF 1993).

Balance of payments statistics show fairly low levels of foreign direct investment in Lithuania—\$10 million in 1992 and \$40 million in 1993 (table 7.3). In per capita terms that puts Lithuania far

below Estonia, and slightly below Latvia. This is likely to reflect the much more uncertain policy and economic environment in Lithuania (and Latvia).

Foreign investment seems to have had only a small impact on trade reorientation in Lithuania, though it might have helped maintain trade with the former Soviet Union. Most foreign investors in Lithuania are from countries of the former Soviet Union. In 1992 one-third of joint ventures were with Russians, established to ensure the continuation of supplier relationships or to facilitate the re-export of Russian goods. But 60 percent of capital investments were from outside the former Soviet Union, including 305 German joint ventures (IMF 1993), though the amounts invested have been small. Such investments may bring important skills and know-how, however, that can facilitate trade with the West. Most investments have been in the services sector (hotels, restaurants), trade, and communications. There are a few joint ventures in manufacturing, mainly in textiles and furniture (IMF 1993).

Policy Conclusions

After a slow start, Lithuania is making progress in consolidating the gains from stabilization of its economy. Stabilization is crucial to sustainable trade reorientation and a vigorous supply response to new market incentives. Further supply response is likely to depend on maintaining macroeconomic stability, establishing incentives for private sector activity, and making progress in privatizing and restructuring the state enterprises and improving property rights. Getting the incentive framework right is especially important, since privatization will not lead to restructuring unless constraints to private initiative and factor movements are removed.

Issues in Trade Policy.

Lithuania's trade policies raise a number of issues for allocative efficiency and successful transition to a market economy. While much of the explicit antiexport bias of export policies has been removed, the export restrictions that remain have no clear economic justification, now that prices have been liberalized. Import tariffs may have introduced

Table 7.3 Foreign Investment in the Baltics (U.S. dollars)

Country	1993 (million)	Per capita
Estonia	110	69
Latvia	50	18
Lithuania	40	11

Source: World Bank

some antiexport bias. While the level of protection is moderate, the import regime lacks transparency and consistency. Lithuania needs to establish a stable and consistent system of incentives for trade, now, before the new structure of production takes shape.

Lithuania should consider eliminating most of its remaining export taxes and bans. The taxes hinder trade expansion in products in which Lithuania may have a comparative advantage. The main impact of the taxes is to provide uneven protection to domestic industries relative to producers of raw materials. The taxes may even result in negative value added, especially in leather industries, where export taxes of 50 percent have been levied on inputs. Only for some agricultural products whose prices cannot yet be liberalized may export taxes be justified temporarily, and then only if they are linked to the speed of price liberalization (see chapter 13).

Lithuanian export performance would also be improved by the introduction of a duty drawback system to reimburse exporters for duties on imported inputs, improving their international competitiveness. The system would also ensure equal treatment for all exports. The current transformation regime is not transparent since it depends on specific agreements, permits administrative discretion, and rebates duties in excess of the amount of inputs used for export production. (Other potential export promotion measures are covered in chapter 11).

On the import side the main concerns are too much dispersion in rates and the lack of transparency and consistency. Frequent changes in duties and other incentives create uncertainty, which discourages investments and restructuring and encourages producers to lobby for protection.

The dispersion of tariff rates, by favoring one activity against another, tends to promote or extend the life of otherwise uncompetitive activities. It also means that the government rather than the market is picking the winners and losers. A uniform duty would let the market establish the viability of industries. By setting higher rates on existing activities, the government discourages investments in new activities. And by protecting its industry, Lithuania

deprives its enterprises of the benefits of more open competition from trade. The hope that protection will give producers time to adjust the quality of their products to world standards is contrary to experience the world over. Enterprises frequently use protection not to accelerate restructuring, but to avoid it. That perpetuates inefficient production, especially where markets are highly concentrated, as in Lithuania today.

A low and uniform duty of 10 percent or less applied to all imports would establish a more uniform level of protection in Lithuania. Rates higher than that are likely to create substantial pressures to exempt inputs and capital goods from the duties. And because a large share of Lithuania's trade is with free trade partners, a high duty on imports from third countries could easily lead to costly trade diversion.

A uniform tariff would also achieve the revenue objective better than does the current distorted structure. The government's 10 percent revenue target for trade taxes could be achieved with less economic distortion through a more uniform tax with a broader base. According to estimates, during the last quarter for 1993 customs revenue amounted to only about 2 to 3 percent of total government revenues, far short of the projected 10 percent.

Lithuania should also eliminate specific duties and quantitative restrictions on imports to improve the transparency of the regime. Although quantitative restraints now affect very few tariff lines, the increase in coverage in 1994 is worrisome. If quantity restraints are maintained, quota rights should be allocated by auction to ensure that they go to the highest bidder and so the most efficient producer.

Improving the consistency of import policies and the stability of incentives calls for a more stable institutional arrangement. Changes in permanent tariffs or other trade policies should follow clear guidelines and require approval by the Executive and the Parliament to ensure that changes in duties receive strict scrutiny. Temporary protection, such as safeguarding against sudden surges in imports, could be managed by a customs department under strict guidelines and criteria, subject to time limits and public scrutiny. Joining the GATT, to which

Lithuania applied for membership in 1994, should ensure more transparent and stable policies. In the interim, Lithuania should try to conclude at least a general trade agreement with Russia to stop the discrimination it faces in Russian markets.

In summary, more transparency and consistency in trade policies would also accelerate Lithuania's economic transition. Lithuania has removed many restraints on exports and should now remove the remaining export taxes and bans which are unnecessary now that prices have been liberalized. Protection should be uniform and based on tariffs alone. A 10 percent uniform duty would avoid pressures for exemptions on inputs and limit trade diversion in free trade markets. Lithuania should also distinguish between permanent and temporary protection and review the institutional arrangement for changing trade policies. More stability and consistency in trade policy will help establish a framework that will call forth an efficient supply response to market incentives.

Notes

The chapter benefited from comments by A. Hillman, M. Michaely, C. Michalopoulos, M. Morkre, C. Mueller, D. Tarr, L. Alan Winters and U. Zachau.

1. Traditionally, Lithuania has been more agrarian than the two other Baltic countries, although the industrial sector grew rapidly under Soviet rule.

2. This included energy products, municipal and infrastructure services, some breads, some producer support prices in agriculture (pork, beef, chicken, milk, eggs, vegetables), and about 100 items subject to monopolistic conditions.

3. The antiexport bias in the tax system was removed in 1993. Previously, a large number of exemptions reduced the tax base and distorted prices. Excise taxes had been levied in a way that distorted trade. The general excise tax was levied on exports at rates ranging from 10 to 86 percent (IMF 1993), constituting a tax on exports (equivalent to the difference from the 18 percent domestic rate). Imports faced a lower (10 percent) general excise tax than domestic production, which amounted to a subsidy.

4. Changes in the volume of trade are extremely difficult to estimate because of valuation problems in an environment of high inflation and distorted exchange rates.

5. The trade is likely to be illegal from both Lithuania's and Russia's point of view. In Russia the trade circumvents export taxes, and in Lithuania it bypasses the government monopoly on metals trade.

6. Food and energy products, some raw materials, textile, metal and wood products remained subject to license, although prices for wood and many raw materials were liberalized by the end of 1992.

7. Exports in Lithuania were subject to other restraints as well that might have influenced early export performance, but had been eliminated by 1994. Until the first quarter of 1992 convertible currency exports were subject to a surrender requirement of 20 percent of hard currency revenues. This amounted to an export tax of about 20 percent. This was abolished in April 1992, when a new surrender requirement at a market rate was introduced for some enterprises until 1993. Profits from exports in convertible currencies were taxed separately until 1993. The exchange rate used for computing the tax was below market rates, which in January 1992 amounted to another 20 percent tax on foreign currency profits.

8. These included mostly agricultural raw materials, such as livestock, feathers, sugarbeets, leather, timber, and metals.

9. Export prohibitions remained for live swine, red clover seeds, grains, flour, other grain and grain products, bread and bread products, cakes, and pesticides. During the second half of 1993 export quotas were introduced for molasses used in exchange for sugarbeet seeds and agricultural machinery, and technical spirits, meat products for sausages, grain, and fodder.

10. Red clover seed and untreated oak and ash-free timber until May 1995.

11. A statistical duty of 0.01% applied to all trade.

12. After alcohol the highest rates are on glass bottles (30 percent) and sugar (70 percent temporary duty). The 25 percent rate applies mostly to domestically produced goods (carpets, cement, matches, some household machinery, furniture, several agricultural products); 20 percent to a number of agricultural products, corks, electronics, chocolate; 15 percent to textile products, fish, meat products; 10 percent to leather, wood, paper, stone and plaster; 5 percent to a number of agricultural products. The highest duties, 40 to 100 percent, are on alcoholic beverages. A number of fruits and vegetables and flowers are subject to seasonal duties of 10 to 15 percent.

13. Bottles of transparent glass (in addition to a 30 percent duty), feed animals, pork for sausages and other foodstuffs, raw materials for sugar-producing industries, cereals, and mixed fodder.

14. The first changes came only a month after the first customs law was passed, in response to the agricultural lobby's complaints about cheap imports. Duties on meat and poultry were doubled to 30 percent and those on livestock raised from 5 to 30 percent. Duties on crop and animal products were also raised. The ease with which one sector managed to increase protection is likely to send the wrong signals to producers. In September 1993 duties on more agricultural products were raised: potatoes, cereals, margarine, confectionery. Further changes were introduced

in 1994, with increases in seasonal duties for flowers and for a number of other agricultural products.

15. These generally included obligatory lists of state-to-state trade and indicative lists setting a framework for enterprise-to-enterprise trade with licenses and quotas. Payments were to be settled through bilateral clearing of rubles in correspondent accounts in the two central banks. Products in state trading were at fixed prices in dollar terms and quantities, with the dollar prices converted to rubles at product-specific exchange rates (below world market prices).

16. In 1990 and 1991 clearing accounts between central banks in rubles of each year were closed separately. In 1992 separate accounts were opened for each republic. The account with Russia was again closed in mid 1992 for reforms in Russia's payments system. Another closure took place upon the introduction of the talonas in October 1992 and one more closure in June 1993 upon the introduction of the lita.

17. Already in 1991 supplied crude oil by Russia was at 70% of agreed amounts. In 1992 oil imports were at 35 % of their level year before, while in gas the volume of imports was 45 % below the level of 1991.

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8

Moldova's Foreign Trade and Exchange Regime

Jonathan Walters

- Structure of Foreign Trade
- The Foreign Trade Regime
- The Exchange and Payments System
- Completing the Liberalization
- Low and Uniform Tariffs
- Liberalization of the Foreign Trade and Exchange Regime in Perspective

Moldova, like other republics of the Soviet Union, never participated directly in trade with the world outside the USSR or had any influence over the regulations applied to its external trade and payments.¹ Within the USSR, Moldova was a highly open economy, exploiting its broad comparative advantages as a supplier of agricultural and agroprocessed products, as well as producing consumer durables and hi-tech defense systems. Almost all nonagricultural industrial inputs (notably primary energy resources) and most consumer goods were imported from the rest of the USSR. But the division of Moldova's production between domestic consumption and export to the rest of the USSR or beyond, as well as all price setting, was decided in Moscow according to central planning requirements.

Independence in 1991 was accompanied by severe dislocation in the trade and payments system within the former USSR and, for Moldova, an almost complete lack of access to foreign exchange. Unrestrained expansion of money and credit within the ruble area accelerated the disintegration of the trade and payments system, leaving Moldova isolated. GDP was cut in half between 1990 and 1993, while prices soared more than 400-fold.

The initial response was the same throughout the area of the former Soviet Union. Moldova and the other countries of the former Soviet Union erected barriers to export to keep

domestic markets supplied with essential goods. These export controls took their place within a framework of proliferating bilateral state trading agreements and an extensive system of state purchases (known formerly as "state orders") implemented primarily by state trading monopolies. Moldova removed most direct controls over domestic prices when Russia liberalized its prices in January 1992, replacing them with legal limits on profit margins. The interlocking systems of export control, state purchases, and indirect price controls were intended to protect supplies to the domestic market and keep prices down.

Imports were less encumbered by controls, but they were highly constrained by several factors. Rapidly rising prices within the former Soviet Union, as prices rose toward world levels, substantially increased the cost of critical Moldovan imports, particularly for primary energy products. (Moldova imports 99 percent of its energy needs, largely from Russia and other former Soviet Union countries). Russia was sharply reducing its implicit and explicit financing of the bilateral payments deficits of the other new independent states as its own economy came under increasing pressure to moderate runaway fiscal and monetary expansion.² More generally, the breakdown of the payments system, the extreme scarcity of hard currency, and the prevailing exchange rate also led to a contraction of imports protecting the Moldovan market.

In 1993, however, the autarkic orientation of the authorities was modified considerably. There was a growing realization in Moldova that an economy with a production structure highly oriented toward external trade was not going to be turned around by the demand and supply forces generated in its small domestic market alone. It was also becoming clear that the terms of trade shocks from higher energy import prices and the decline in Russian transfers and credits were likely to be permanent.³ Adjustment to external conditions was thus of paramount importance. Such adjustment required macroeconomic stabilization and an independent monetary and exchange rate policy.

In late 1993 the Moldovan authorities initiated a program of macroeconomic stabilization and struc-

tural reforms, supported by the IMF and the World Bank, designed to accelerate the transition to a market economy. Key features of the stabilization program were substantial tightening of monetary and credit conditions, particularly strict limits on credits to the government and the banking system; tight fiscal policy, through strengthened revenue measures, a broadening of the tax base, and phased elimination of consumer subsidies; and introduction of a new currency (the leu), with a floating exchange rate. A structural adjustment program put in place at the same time encompassed more liberal trade and pricing policies, privatization in industry and agriculture, and the replacement of generalized subsidies of consumer goods with more targeted compensation of vulnerable groups.

By April 1994 the stabilization measures appeared to have taken hold. Inflation had fallen to 5 percent a month, the fiscal deficit was on track to stay within the 1994 target of less than 4 percent of GNP, and the monthly refinancing rate of the central bank was highly positive in real terms. Progress was also being made in structural reforms.

Structure of Foreign Trade

Moldova's external trade is undergoing rapid transformation. Before 1991 nearly all trade (most exports and 86 to 89 percent of imports) took place with other Soviet Republics (tables 8.1 and 8.2). By 1992 and 1993 imports and exports outside the former Soviet Union had risen to between 22 and 39 percent. This changing pattern reflects not only an increase in trade outside the region but also a continuing fall in the level of trade within the region—the Ministry of Economy estimates a decline of up to 50 percent in real terms in 1993. Moldova's main trade partners in the former Soviet Union are Russia, Ukraine, and Belarus; important trade partners outside the former Soviet Union include Romania, Bulgaria, Germany, and Turkey (table 8.3). Countries of the European Union (EU) accounted for 6 percent of external trade in 1993.

In the period preceding independence (1987-91), Moldova had a moderately negative balance of trade with countries outside the Soviet Union and roughly balanced trade inside the USSR. The rapid

Table 8.1 External Trade in Current U.S. Dollars, 1990-93
(In million of dollars and in percent)

	1990	1991	1992	1993
<i>Value</i>				
Total exports	10,325	6,370	400	810
Former Soviet Union	9,920	6,190	244	636
Rest of world	405	180	157	174
Total imports	9,893	6,181	547	953
Former Soviet Union	8,461	5,525	377	743
Rest of world	1,432	656	170	210
Trade balance	432	188	-147	-143
Former Soviet Union	1,459	665	-133	-107
Rest of world	-1,027	-476	-13	-36
<i>Percentage distribution</i>				
Total exports	100	100	100	100
Former Soviet Union	96.1	97.2	60.9	78.5
Rest of world	3.9	2.8	39.1	21.5
Total imports	100	100	100	100
Former Soviet Union	85.5	89.4	68.9	78.0
Rest of world	14.5	10.6	31.1	22.0

a. Figures for trade with the former Soviet Union are derived from country data and World Bank staff estimated reported in national currencies using official or commercial exchange rate for 1990 and 1991 and annual average market exchange rates for 1992 and 1993.

b. The rest of the world refers to countries outside the former Soviet Union; figures are based on country data reported in U.S. dollars.

Table 8.2 External Trade in Rubles, 1990-June 1993
(millions of rubles)

	1990	1991	1992	June 1993
<i>Exports</i>				
Former Soviet Union	6,176.7	8,140.8	63,880.0	146,850.6
Agriculture and food industry	5,853.3	7,809.0	47,841.7	83,548.9
Rest of world	3,048	3,595	23,909	—
Rest of world	323.4	331.8	16,038.3	63,301.7
<i>Imports</i>				
Former Soviet Union	6,461.4	8,443.8	94,849.6	184,952.8
Oil, gas, and coal	4,991.6	7,237.3	74,127.3	118,825.8
Rest of world	544	1,364	40,145	80,688
Rest of world	1,469.8	1,206.5	20,722.3	66,127.0
<i>Trade balance</i>				
Former Soviet Union	-284.7	-303.0	-30,969.6	-38,102.2
Former Soviet Union	861.7	571.7	-26,285.6	-35,276.9
Rest of world	-1,146.4	-874.7	-4,684.0	-2,825.3
<i>Trade with former Soviet Union as percentage of total trade</i>				
Exports	94.76	95.92	74.89	56.9
Imports	77.25	85.71	78.15	64.25
Trade balance	-302.57	-188.68	84.88	92.58

Source: National Bank of Moldova

increase in energy prices after independence produced a large deficit in volume terms in trade with countries of the former Soviet Union, despite the lower volume of energy imports. In 1993 energy imports in volume terms were about 60 percent of

their 1991 level, but they have grown to represent almost half of total imports (table 8.4).

The most significant imports in 1992 (the last year for which there are complete data) were raw materials, energy, and other mineral products (table

Table 8.3 Moldova's Main Trade Partners, 1992
(millions of rubles)

<i>Trade partner</i>	<i>Exports</i>	<i>Imports</i>	<i>Balance</i>
<i>Former Soviet Union</i>			
Union	47,841.7	74,127.3	-26,285.6
Azerbaijan	1,259.5	1,149.5	110.0
Belarus	2,776.0	9,571.0	-6,795.0
Russia	25,015.7	42,876.3	-17,860.6
Turkmenistan	1,696.4	1,725.6	-29.2
Ukraine	12,466.3	14,351.0	-1,884.7
Uzbekistan	958.3	1,522.3	-564.0
Other	3,669.5	2,931.6	737.9
<i>Rest of world</i>	16,038	20,722	-4,684
Bulgaria	2,387	2,289	99
Canada	491	31	459
Germany	721	2,813	-2,092
Italy	142	1,419	-1,277
Poland	754	377	378
Romania	6,107	6,855	-748
Switzerland	1,373	27	1,346
Turkey	3,139	34	3,105
USA	0	4,207	-4,207
Others	924	2,670	-1,745

Source: State Department of Statistics, Moldova

Table 8.4 Volume of Energy Imports from Countries of the Former Soviet Union, 1991-93
(thousands of tons)

<i>Product</i>	<i>1991</i>	<i>1992</i>	<i>1993</i>
Coal	4,196	2,060	1,986
Natural gas (million m3)	3,873	1,972	1,829
Heating oil	1,851	1,952.5	1,000
Diesel fuel	990	699.8	400
Benzene	725	364.5	200
Other energy fuel	220	85	70
Energy price index	100	6,143	86,769
Consumer price index	100	889	3,955

Source: State Department of Statistics, Moldova

8.5). There is also a diversified list of other import items, still reflecting the close integration of the economies of the former Soviet Union. The main export products are food stuffs and other agricultural products, closely followed by machinery, equipment, appliances, and textiles. Today, however, Moldova is facing tougher competition in the more liberalized markets of the former Soviet Union.

Without reliable data on trade volume, estimates of the terms of trade loss suffered by Moldova can be only approximate. A very rough estimate can be obtained by calculating the loss due to increased energy prices, for which there are better data, and assuming that other import and export prices have gone up in line with average domestic inflation. That puts the estimated terms of trade loss for Moldova at more than 20 percent of total GDP over 1991 and 1992.

The Foreign Trade Regime

Moldova's trade regime has changed substantially in the years since independence, toward increasing liberalization (box 8.1).

The Export Regime

As of early 1993 Moldova's system of export controls was extensive and complex. All exports required licenses. General licenses (valid for one year) were issued for exports in fulfillment of bilateral state agreements, while specific licenses for each consignment were required for all other exports. All prices had to be validated by the Ministry of Foreign Economic Relations, a measure designed to prevent underinvoicing. Export quotas were imposed on 155 categories of goods, including some to hard currency markets. Exports for barter were permitted only if the exporter could establish that the counterpart imports were used in production of the export. Barter for trading rather than production purposes was thereby prohibited. Export taxes were applied to about 50 categories of goods, most of them raw materials that were re-exports from Russia and other countries of the former Soviet Union (Moldova produces few raw materials of its own).

These controls were progressively lifted during 1993 and early 1994. As of mid-1994, export licenses were required for cereals, leather, and energy products, which are also subject to a quota,⁴ and for thirteen categories of goods for health, environmental, and cultural reasons, including industrial waste, medical supplies, weapons, drugs, precious metals, and nuclear materials. Licenses for textile exports to the EU are imposed according to EU

Box 8.1 Chronology of External Trade Policy Changes, 1991-94

1991-92			
December	Price liberalized and value added tax introduced	1994	
February	Antimonopoly law introduced	January	Foreign exchange surrender switched to inter-bank market rather than to central bank, number of goods subject to export licenses and quotas reduced, excise taxes levied on all non-CIS and some CIS imports
December	Foreign exchange surrender requirements reduced to 35 percent		
1993			
April	Generalized export licensing requirement abolished	March	Import tariffs raised
August	Number of goods subject to export licenses and quotas reduced	April	Export licensing and quotas eliminated (except for limited number of goods), minimum prices for exports temporarily suspended, prohibition on barter lifted for CIS countries and introduced for hard currency countries
September	Export taxes abolished		
October	Permissible trading margins increased	May	Price controls and subsidies on bread and milk removed
November	Import tariff reduced	June	Import tariffs raised (following increases in December 93 and March 94)
November	National currency introduced and the Chisinau Interbank Foreign Currency Exchange established		
December	Import tariffs raised		

requirements.⁵ Exports of radioactive wastes and barter exports to countries with convertible currencies are prohibited. All other products are free of export restraints—licenses, quotas, prohibitions, taxes⁶—except price validation.⁷

The Import Regime

Until late 1993, most imports from outside the former Soviet Union were subject to import tariffs and taxes dating from before independence.⁸ Rates varied from 5 to 1,300 percent. These taxes and tariffs were levied on the ruble value calculated using the fixed "valuta ruble" rate of 1.8 rubles to the U.S. dollar. By late 1993 the ruble had depreciated to such an extent that the highest import duty rate was equivalent to only about 2 percent when recalculated at the prevailing exchange rate. The Moldovan market nonetheless remained largely protected from competition from imports from outside the former Soviet Union as a result of the prevailing ruble-dollar exchange rate and the extreme scarcity of foreign exchange.

A new import tariff was introduced in November 1993, and rates were amended in December 1993, March 1994, and again in June 1994.⁹ The tariff structure includes eleven rates ranging from zero to 300 percent, with most goods subject to rates of less than 30 percent. The lowest

rates are on inputs, the highest on beverages and tobacco products. Rates are doubled for imports from countries to which Moldova has not extended Most Favored Nation (MFN) status.¹⁰ Barter imports are subject to a 30 percent surcharge on the base tariff rate. Imports from CIS countries, developing countries (as classified by the United Nations), and countries with which Moldova has free trade agreements are exempt from tariffs.¹¹ Import licenses are required only for the same categories of goods requiring export licenses for health, environmental, and cultural reasons.

Prices

The liberalization of external trade and payments has been accompanied by progressive liberalization of prices, which is reducing the differential between domestic and world prices. In particular, domestic energy product prices have been allowed to pass through the full price increases of imported energy products as those prices rise toward world levels (although energy prices remain controlled).¹² Direct price controls on food staples were progressively removed during 1993-94, and the last controls, which by then applied only to certain bread and milk products, were abolished in May 1994.¹³ Most controls on wholesale and retail markups remain, but their levels have been increased, and

exports and luxuries have been exempted. Profits of monopolies above a specified norm are subject to an excess-profits tax in an attempt to hold down their prices.¹⁴ Monopolies are also required to report their prices to the Ministry of Finance; the purpose of this requirement is unclear, but it may give rise to informal price controls.

The State's Role in External Trade

Moldova has abolished its once comprehensive state order system, but the state still purchases substantial quantities of certain goods, largely under centralized barter exchange within the framework of interstate agreements with other countries of the former Soviet Union. Most of the centralized imports planned for 1994 are energy products (coal, maoist, and gas), but some grain and medical supplies are included.¹⁵ These goods are supplied to Moldovan producers, households, and the government.

The system works as follows. The Ministry of Economy identifies the "needs of the state" and informs the state procurement agents (Moldcontract, State Fuel Agency). These agents then call for the specified goods from producers identified by the Ministries of Agriculture and Industry.¹⁶ Prices are negotiated between producers and the state procurement agencies. If the procurement agencies fail to call for the goods within the specified quarter, the producers are free to market the goods on their own. In principle, producers supplying state needs receive preferential treatment in the allocation of credit, fuel, and other inputs, but it is not clear to what extent this preferential treatment occurs.¹⁷

Though there are no precise data on the proportion of state purchases for centralized barter in Moldova's trade with the rest of the former Soviet Union, the Ministry of Economy believes that it has been falling rapidly. One official projects a decline from 80 percent of imports from the former Soviet Union in 1993 to only 20 to 25 percent in 1994. The fulfillment rate of planned state purchases for centralized barter in 1993 was only 60 percent.

These trends are consistent with other changes in trade and payments regimes. In particular, the

removal of quotas on exports to the rest of the former Soviet Union and the establishment of a foreign exchange market in Moldova have allowed alternatives to state trading to begin to develop. A notable development in this regard was the emergence in 1993 of a substantial private market for gasoline. Nonetheless, state purchases for centralized barter continue to exert a very significant influence on the Moldovan economy.

Trade Agreements

Since the breakup of the USSR, Moldova has concluded trade agreements on an annual basis with the other countries of the former Soviet Union that have consisted primarily of lists of goods to be exchanged.¹⁸ Trade takes place almost entirely on the basis of barter. Over time, these agreements have been relaxed somewhat, from obligatory lists to mostly indicative lists. Direct trade between enterprises appears to be increasing, but the role of state procurement agencies remains substantial. Bilateral trade imbalances are supposed to stay within the limits established by negotiation of interstate credits, but arrears are frequent.¹⁹ For Moldova the primary purpose of these agreements is to achieve security of energy supplies.

On April 8, 1994, the Moldovan Parliament ratified the CIS Treaty and Economic Union Agreement and on April 15, CIS leaders reached agreement on a free trade area. The free trade area is intended to be a precursor to a customs union. Moldova also has a free trade agreement with Romania, its principal trading partner outside the former Soviet Union.

Moldova has negotiated trade and economic cooperation agreements with a number of countries (see footnotes 13 and 25) and is in the process of negotiating such agreements with several others.²⁰ The principal provision of most of these agreements appears to be the mutual accord of MFN status. Moldova is also negotiating accession to the GATT.

The Exchange and Payments System

Until November 29, 1993 Moldova was a de jure member of the ruble area. On that date, Moldova introduced its national currency, the leu,

which henceforth was the only legal tender in the country.^{21,22} The conversion took place at a rate of 1 leu to 1000 rubles, and did not include any significant confiscatory element.²³ De facto, however, Moldova departed from the ruble area in stages.

When the USSR broke up, the interrepublican payments system broke down. Transfers between the banking system in Moldova and the rest of the former Soviet Union became increasingly difficult. There was thus a premium on Moldovan access to ruble deposits in the Russian banking system, as opposed to those in Moldovan banks. In effect, a Moldovan noncash "ruble" had been created.

In parallel, a shortage of cash rubles emerged throughout the former Soviet Union, and the Central Bank of Russia favored Russia over the other new states in the allocation of scarce cash rubles. In June 1992, Moldova introduced its own coupon (at par with the ruble), which was legal tender only in Moldova and circulated alongside the ruble. The Central Bank of Russia imposed restrictions on the level of debit balances Moldovan entities could accumulate in the Russian banking system consolidating all banking transactions between Moldova and Russia into a correspondent account in the central bank, subject to an upper debit limit.²⁴ Thus, by mid-1992, an embryonic national currency, in both cash and noncash forms, had been created in Moldova.²⁵

Introduction of a de jure national currency in Moldova was delayed for largely political reasons. There was concern that Russia would grant preferences in the prices of energy products only to members of the ruble area, although this concern lessened as the prices Moldova paid for Russian energy rose rapidly toward world levels. There was also concern over the possible reaction of the Transnistrian authorities to formal departure from the ruble area.

On July 24, 1993, the Central Bank of Russia withdrew from circulation all pre-1993 "Soviet" rubles and replaced them with new Russian rubles. The new rubles were made available only to countries that elected to join a "new" ruble area. The following day, the National Bank of Moldova began withdrawing from circulation all rubles in denominations greater than 100 (equivalent to US\$ 0.10 at

that time) replacing them with coupons at par. On August 9, 1993, the National Bank began quoting an official exchange rate for the noncash Moldovan ruble against other currencies, including the Russian ruble (the initial rate was 1.3 Moldovan rubles to the Russian ruble).²⁶ On November 16, 1993, the Chisinau Interbank Foreign Currency Exchange was inaugurated.

The Chisinau Exchange was founded by seven commercial banks as a closed joint-stock fund, with the National Bank of Moldova playing a supervisory role. Eighteen of the country's twenty one commercial banks are licensed to participate in the market. U.S. dollars, Russian rubles, Romanian lei, and deutschemarks are traded at the auctions, held three times a week.²⁷ In the initial weeks of operations, the National Bank was the only seller, but now several other banks are also active on both sides of the market.

Participating banks accumulate demands for foreign exchange on behalf of their clients and themselves. Foreign exchange may be purchased for clients only for current account transactions and must be used within thirty days of acquisition. Banks are permitted to maintain an open position in foreign exchange, subject to an upper limit (assets minus liabilities cannot exceed 10 percent of the bank's total net assets for any given foreign currency and 30 percent for all foreign currencies). Only banks with a general license can transact in foreign exchange directly with nonresidents; banks with a local license must deal through the correspondent accounts of the National Bank of Moldova.²⁸

The supply of foreign exchange on the Chisinau Exchange comes mainly from exports and from foreign credits, most of them channeled through the National Bank of Moldova. Exporters are obliged to repatriate 100 percent of the proceeds for deposit in Moldovan banks within ninety days of the goods leaving Moldova. Moldovan residents may open accounts in foreign banks (outside the former Soviet Union) if they have a long history of foreign transactions and a demonstrated need for rapid payments; about ten such authorizations have been given. At least 35 percent of the repatriated proceeds of exports sold outside the former Soviet

Union must be sold on the Chisinau Exchange with fifteen days of receipt. (Before January 13, 1994, the surrender was made to the National Bank of Moldova.) The remaining 65 percent can be held on deposit in interest-bearing accounts (at unregulated rates), but an enterprise or individual can hold only one hard currency account for each foreign currency. Transfers between foreign exchange accounts have to be authorized by the National Bank. In addition, hard currency accounts can be cashed only for expenses associated with business trips.

There are some 200 exchange houses, both bank and nonbank, authorized to deal in cash foreign exchange. The exchange houses set their own exchange rates, but the spread between buying and selling rates cannot exceed 10 percent. Every foreign exchange purchase is supposed to be for current account purposes and individually documented for scrutiny by the National Bank of Moldova. The nonbank exchange houses can access the Chisinau Exchange auctions only indirectly through a bank. There is also a street market in Chisinau, in which activity seems to be modest.²⁹ The supply of foreign exchange to the exchange houses and street market appears to come largely from savings, tourism, and small-scale exports.

Since the introduction of the leu there has been little intervention by the National Bank in the foreign exchange market (it had sold less than \$20 million net of purchases on the Chisinau Exchange as of the end of April 1994). Within the first few weeks of the startup of the Chisinau Exchange, exchange rates in the three markets—Chisinau Exchange, exchange houses, and street—began to exhibit a high degree of convergence, suggesting that the markets are broadly competitive.³⁰

Completing the Liberalization

Moldova has done much to open its trade and exchange regime since late 1993. Although it is too early to assess the effects of this liberalization, it has paved the way for Moldova's integration into the world economy. Exposing Moldovan producers to competition in domestic and export markets will allow resources to shift to those sectors in which Moldova has a comparative advantage from less

efficient sectors. Competition will also stimulate innovation and the acquisition of more efficient production techniques. However, further measures are needed to realize the full benefits of liberalization.

More Liberalization of Exports

The remaining restrictions on cereals, leather, and energy should be removed. The restriction on cereals is designed to provide food security and to keep down the domestic prices of animal feed. However, with import liberalization and the greater availability of foreign exchange, such food security concerns can be accommodated by trade; cereals can be exported in times of surplus because they can be freely imported in times of deficit. On the animal feed issue, the solution is not to keep prices artificially low but to restructure the livestock industry so that it is competitive at world prices. In June 1993 the grain procurement price was set at its presumptive world level, though no Moldovan grain is traded on world markets, so it is not clear that the price was set at an appropriate level. Proper pricing represents a further reason to liberalize grain exports.

Similar arguments apply to the ban on leather exports, which results in implicit subsidies to industries that use leather, such as leather processing and footwear. The ban on energy exports should be lifted as well, except insofar as Moldova is bound by agreements with CIS countries on reexports (agreements that are rooted in the continuing subsidization of energy and other products in those countries).

The prohibition of barter exports to countries with convertible currencies intended to reduce capital flight through export sales disguised as barter to evade repatriation requirements, should be removed. Such prohibitions are unlikely to be effective so long as the underlying incentives for (macroeconomic instability and an unfavorable investment climate) continue to exist. Similarly, the validation of export prices by the Ministry of Economy probably does little more than add to the costs of exporters through administrative delays, while contributing to a climate of business uncertainty by sig-

nalizing to producers that export controls could easily be reintroduced. The use of minimum reference prices should be permanently abolished (the practice was temporarily suspended on April 29, 1994).

To realize its growth potential, Moldova should seek to negotiate improved access to as wide a range of markets as possible. The most effective means of pursuing this objective would be through GATT membership, closer association with the European Union, and removal of any residual obstacles to free trade arrangements with the CIS and Romania. The further reduction of barriers to the entry of Moldovan products into export markets will be of critical importance to economic growth.

Low and Uniform Tariffs

Experience worldwide demonstrates that import tariffs should be low and uniform if the stimulation of domestic production is to be accompanied by increased productive efficiency. High rates protect inefficient producers, and a wide range of rates distorts producers' decisions. Inefficient producers cannot compete in competitive export markets. High tariff rates tend to cause appreciation of the exchange rate through their depressing effect on imports, which reduces the profitability of exporting.³¹ In addition, high tariffs often lead to high rates of evasion rather than to revenue gains. Experience in East Asia and elsewhere suggests that any tariff protection given to producers should be temporary and that producers should know in advance that it will be temporary.

The government is committed to reducing tariff rates that are above 20 percent. All rates higher than 20 percent are expected to be cut to 20 percent by November 1995, two years after introduction of the first tariff decree. A progressive reduction is recommended, starting immediately by reducing the highest rates to 50 percent or less.³² Though low tariff on inputs should eventually be harmonized with tariffs on final goods to reduce the dispersion of effective protection, that should await the maturation of the customs administration and the introduction of a duty drawback system for exporters.

Moldova's membership in the CIS has important implications for its tariff policy. Membership in

a CIS free trade area will influence Moldova's tariffs on imports from non-CIS countries. If Moldova places a significantly higher tariff on a given product than do other member countries, that product is likely to be smuggled into Moldova through those other countries. In an area with such long frontiers and weak customs administrations rules of origin will have only a limited effect in preventing such smuggling. Higher tariffs will also do more to divert trade from non-CIS to CIS countries than it will to promote Moldovan production. The upper rates of Moldova's tariff structure are already significantly higher than the norm for other CIS countries.

Moldova could achieve greater uniformity of tariff rates by applying MFN rates to all countries of origin (except those where free trade agreements apply)—a move that will in any case be required for accession to the GATT. Because of Moldova's fiscal constraints, it is not in a position to offer rates lower than MFN to developing countries. The 30 percent surcharge on barter imports is unlikely to deter barter significantly and should be removed. Duty exemptions for foreign investors and small businesses are probably only a weak investment incentive at best and will be difficult to administer. Their use should be minimized.

Reforming Value Added and Excise Taxes

In their current application, both the VAT and excise taxes discourage exports and domestic production. For trade with CIS countries both taxes are levied on an origin basis: domestic production—whether for export or for domestic consumption—is taxed and imports are not (except for excise taxes on imports of gasoline, tires, cars, and diesel fuel). The system appears to reflect the view that CIS trade is not really international trade, as well as a desire to avoid the price-raising effect of taxing imports, although Russia, a major CIS partner, is imposing its VAT on a destination basis. Applying these on a destination basis has several advantages. It avoids the bias against exports and domestic production in favor of imports created by applying the tax on an origin basis. This measure could have a positive effect on revenues by reducing Moldova's trade deficit with the rest of the former Soviet

Union. For these reasons, the government should consider applying these taxes on a destination basis (after consultation with other CIS members), which would mean that imports would be taxed and exports would not.³³ For some goods the price-raising effect of taxing imports would be partly offset by diversion of trade to non-CIS imports.

For trade with non-CIS countries, the tax regime is already on a destination basis, but delays in crediting exporters with VAT paid on inputs could be an impediment to exports.³⁴ A VAT refund system should be considered.

Price Reform and Competition Policy

Remaining price controls still constitute a wedge between domestic and world prices and should be progressively removed. Margin controls inhibit investment in the trading sector and may result in shortages; they should be lifted. Energy prices charged by state-owned utilities should continue to reflect increased costs, and cross-subsidies should be removed as a more effectively targeted social safety net is put in place. For energy products in which private trade is permitted (as is already the

case for gasoline), price controls should be removed. Monopoly price control and regulation should be reviewed. In a small country like Moldova, liberalization of external trade can go a long way in promoting competition in tradables, obviating the need for direct controls on monopolies. Price reporting by monopolies could be removed immediately, except for clearly defined statistical purposes.

A Smaller Role for State Purchases

Reform of the system of state trading is of the highest priority. The continued involvement of the state in external trade retards the transition to a market economy by placing barriers between domestic producers and world prices. Payments by the state to domestic suppliers are often delayed, without adequate compensation, depressing the effective price paid to producers well below world levels. Producers are deprived of the stimulus of competition and of the profits that signal optimal resource allocation.

As a first step, state procurement should be put on a competitive basis, with suppliers invited to bid

Box 8.2 Access for Moldovan Exports to OECD Markets

Exports from the USSR faced the highest tariff barriers in OECD markets and were subject to nontariff barriers beyond those imposed on most OECD trading partners. For example, in 1990, import tariffs for Soviet goods in the United States, the European Union, and Japan were 70 to 90 percent higher overall than the average tariff on all imports in those markets. This differential is even greater when FSU goods are compared to those from areas that were treated preferentially, such as EFTA and developing countries under the Lome Convention.

Since the breakup of the USSR access has been eased somewhat, particularly by the United States, but substantial barriers remain. Access has improved more for Eastern European countries than for countries of the former Soviet Union and more for the Baltic countries than for the rest of the former Soviet Union, a differentiation that is strongest in the EU market, the closest geographically to Moldova.

Moldova's exports are clustered in product groups for which OECD markets have particularly high levels of protection: agricultural and agroprocessed products, clothing and footwear, and other light goods. In 1990, 82 percent of Moldova's exports within the Soviet Union and 85 percent of its external exports would have been subject to trade barriers in the EU market—higher than the 73-75 percent average that would have applied for the Soviet Union overall. The extent of nontariff barriers, which have particularly distortionary effects, was considerably higher than average for Moldova.

Accession to the GATT in order to receive MFN treatment from all members, and negotiation of free or preferential trade agreements with the EU and other OECD members are clearly of high priority to Moldova. The post-Uruguay Round reduction in trade barriers should provide further benefits, although it will take some time to implement. However, the emphasis on reduction of nontariff barriers in the Uruguay Round should be of particular benefit to Moldova.

on state contracts. In addition, the state should encourage competition by seeking out several procurement agents for each commodity, including private trading companies. The introduction of competition will result in fiscal savings in some cases and improved profits for producers in others; overall it will bring prices in line with supply and demand.

Competitive procurement will have less impact on prices where markets are dominated by a single buyer and alternatives to supplying the state are limited. Although some enterprises and farms in Moldova are exporting independently, and some competition among traders exists, many markets are dominated by monopsonies. Where these exist, any statutory monopsony rights should be removed. Assistance in marketing should be provided to producers who require it, either directly or through export promotion agencies.

Similarly, competition should be encouraged, on the import side, particularly for grains and agrochemicals, which are dominated by large, state enterprises, by allowing free entry into those markets and by privatization. State trading agencies should be encouraged to resort to the foreign exchange market rather than to barter for imports. In addition, traders and producers involved in centralized trading through state purchases should be placed on an equal footing with their competitors; they should receive no preferences in the allocation of credit or inputs.

Further Liberalization of Foreign Exchange

The leu was introduced smoothly into the Moldovan economy. The new currency is accepted by the population, and its introduction did not disrupt external trade relations (as happened in some other countries). In large part, this success was due to the macroeconomic stabilization policies that accompanied the currency introduction.

In parallel, the Chisinau Interbank Foreign Currency Exchange and the exchange houses have developed a well-functioning, competitive foreign exchange market, an important achievement. A competitively determined exchange rate and the market allocation of foreign exchange will contribute greatly to the restructuring of the Moldovan economy.

One measure that would strengthen confidence in the operation of the market would be to remove the requirement to surrender 35 percent of hard currency proceeds. The surrender requirement suggests to economic agents that there is a tax implicit in the market rate or, worse yet, that market determination of the exchange rate could be suspended at any time. The surrender requirement might therefore be significantly deterring exports and ought to be removed immediately.

Of perhaps greater importance than improving the functioning of the foreign exchange market is increasing its scope. Currently, a large share of imports is being financed by foreign credits, while only a small portion of the proceeds of those credits is being allocated by a market. In future credit negotiations, the government should strive to increase the portion that can be allocated by the market. Credit disbursements in currency should be channeled through the Chisinau Exchange, and goods that are supplied directly should be auctioned.

Some imports financed by foreign credits have been subsidized, either directly or, more often, through payments arrangements by purchasers to the government budget on credit terms and conditions that were not market determined. And even when market interest rates have been imposed on such credit, repayment has often been over long periods and poorly enforced. These explicit and implicit import subsidies should be eliminated; they misallocate foreign exchange and undermine fiscal discipline.

Liberalization of the Foreign Trade and Exchange Regime in Perspective

Moldova's fertile soil and low labor costs give the country considerable export potential; its small domestic market implies that recovery and growth will depend strongly on export performance. Sustained economic growth will require substantial capital investment. With domestic savings likely to remain low for the next few years, significant foreign inflows will be needed. In the early years of recovery, these inflows can be expected to be dominated by loans, particularly from official sources.

Table 8.5 Trade by Product and Destination, 1992
(millions of rubles)

Product	Exports			Imports			Trade Balance		
	Total	Former Soviet Union	Rest of World	Total	Former Soviet Union	Rest of World	Overall	Former Soviet Union	Rest of World
Livestock and products	3,241.90	3,097.40	144.50	379.30	360.20	19.10	2,862.60	2,737.20	125.40
Vegetable products	5,930.60	4,581.10	1,349.50	10,497.70	4,470.30	6,027.40	(4,567.10)	110.80	(4,677.90)
Oils and fats	1,273.30	1,256.10	17.20	82.90	80.70	2.20	1,190.40	1,175.40	15.00
Foodstuffs, alcohol, and beverages	15,344.10	14,897.70	446.40	2,067.90	855.80	1,212.10	13,276.20	14,041.90	(765.70)
Mineral products	945.00	59.60	885.40	41,665.00	41,654.80	10.20	(40,720.00)	(41,595.20)	875.20
Chemical products	1,908.70	452.70	1,456.00	4,053.90	3,454.40	599.50	(2,145.20)	(3,001.70)	856.50
Plastics, rubber, and products	661.50	615.70	45.80	2,114.70	1,964.40	150.30	(1,453.20)	(1,348.70)	(104.50)
Leather, fur, and products	583.20	474.70	108.50	394.40	174.10	220.30	188.80	300.60	(111.80)
Wood and products	121.90	17.00	104.90	1,578.20	1,349.80	228.40	(1,456.30)	(1,332.80)	(123.50)
Paper, cardboard, and products	1,145.70	535.60	610.10	2,202.50	1,997.20	205.30	(1,056.80)	(1,461.60)	404.80
Textiles and products	5,941.60	4,413.90	1,527.70	9,765.80	6,082.50	3,683.30	(3,824.20)	(1,668.60)	(2,155.60)
Footwear, hats, umbrellas, other	1,144.50	567.70	576.80	549.20	186.60	362.60	595.30	381.10	214.20
Products of stone, ceramic, glass	583.20	550.50	32.70	1,139.80	632.10	507.70	(556.60)	(81.60)	(475.00)
Precious metals, gem, and jewelry	812.90	809.00	3.90	350.60	335.30	15.30	462.30	473.70	(11.40)
Metals and products	6,635.80	309.60	6,326.20	5,748.40	5,137.70	610.70	887.40	(4,828.10)	5,715.50
Machinery and equipment	6,396.30	5,429.20	967.10	3,500.40	1,392.30	2,108.10	2,895.90	4,036.90	(1,141.00)
Electric equipment and appliances	7,251.60	6,144.30	1,107.30	3,834.70	1,719.90	2,114.80	3,416.90	4,424.40	(1,007.50)
Vehicles	2,570.90	2,369.20	201.70	3,801.80	1,665.00	2,136.80	(1,230.90)	704.20	(1,935.10)
Cameras, watches, medicine, musical instruments	235.10	207.40	27.70	300.20	270.60	29.60	(65.10)	(63.20)	(1.90)
Various products	1,072.30	986.60	85.70	785.70	322.30	463.40	286.60	664.30	(377.70)
Art products, antiques	2.30	2.20	0.10	16.90	16.30	0.60	(14.60)	(14.10)	(0.50)
Services of material character	77.60	64.50	13.10	19.60	5.00	14.60	58.00	59.50	(1.50)
Total	63,880.00	47,841.70	16,038.30	94,849.60	74,127.30	20,722.30	(30,969.60)	(26,285.60)	(4,684.00)

To receive these loans, Moldova will need to demonstrate its creditworthiness through prospects of strong growth in hard currency earnings. External credits will progressively be replaced by foreign direct investment. Investors will be attracted primarily by Moldova's potential as an export base, particularly for regional markets.

Liberalization may be a necessary condition for export expansion, but it will not be sufficient. Complementary policy reforms and investments will be needed to induce producers to respond to price and profitability signals. Macroeconomic stability will remain crucial.³⁵ In the absence of such a comprehensive approach, even the partial liberalization that has occurred so far is unlikely to be sustainable.

Credit allocation on the basis of profitability will have to become the norm. Bankruptcy and collateral laws will need to be enforced, and conditions

fostered for institutional development in the financial sector. Measures to promote competition and to increase confidence in the banking sector, and positive real interest rates, will be necessary to attract deposits and the repatriation of foreign exchange.

Producers will be far more responsive to profit signals if the dominant form of ownership in Moldova shifts from public to private. The privatization program will need to be accelerated, and measures taken to facilitate the startup of new businesses, with Moldovan and foreign investment. More carefully targeted social protection programs and policies that promote the free movement of workers will be necessary to facilitate the shift of resources to more productive sectors. So will removal of subsidies to producers.

To help Moldovan products remain competitive in traditional markets and become competitive in new markets will require substantial investment

in new technology, including investments in upgrading quality and packaging. Investment in transport will also be needed, both in infrastructure and in carrying capacity. These investments will be forthcoming only in a business climate friendly to investment.

Institutions that facilitate trade are also necessary. More efficient payments mechanisms are being designed, for implementation in 1995, to overcome the substantial delays in settlements. The effectiveness of new mechanisms in Moldova is closely tied to CIS-wide developments in the payments system. Financing instruments adapted to the needs of international trade will also be needed. The Customs Department has been receiving training and technical assistance on streamlining procedures and cutting delays in trade clearance—particularly important for expanding perishable agricultural exports. An export promotion agency is being established to provide advice on market opportunities and trade procedures and to publicize for Moldovan products through trade fairs and other media. Enterprise surveys have exposed considerable confusion about trade regulations. An export promotion agency could play an invaluable role in making such information accessible to producers and potential investors.

Notes

1. In the perestroika era, Moldova did develop very limited direct trade relations with the rest of the world.
2. Political factors affected the distribution of these reductions among the other ex-Soviet republics, however. The terms and conditions of Russian financing for Moldova seem to have been strongly influenced by Moldova's refusal to ratify the treaty establishing the Commonwealth of Independent States and by the lack of agreement over the status of Transnistria and over the presence of the 14th Russian Army in that region.
3. Tarr (1993) has estimated that the terms of trade shock from the move to world prices will be greatest for Moldova of all countries of the former Soviet Union. Similarly, Orlowski (1993), in a comparison of prices in the former Soviet Union and world prices, finds that goods that constitute a large proportion of Moldova's exports, such as foodstuffs, other agricultural goods, and consumer goods, were "overpriced" in the Soviet Union, while energy products were highly "underpriced."
4. This quota is currently set at zero for all three products, thereby effectively prohibiting exports of those products (as has been the case for some time).
5. Licenses are still specific to consignments (except for exports in fulfillment of state needs or interstate agreements) but have to be issued within 10 days of the application for a license. Following the abolition of the Ministry of Foreign Economic Relations in April 1994, licenses are issued by the Ministry of Economy.
6. Exports to CIS countries are subject to Moldovan VAT and excise taxes (at the same rates as for domestic sales).
7. Validation is carried out by the Customs Department in accordance with minimum reference prices established by the Ministry of Economy. Information used to establish these reference prices appears to come mainly from the exporting enterprises themselves. Exports priced below the reference levels are reported to the Department of Prices of the Ministry of Finance.
8. Import tariffs dated back to 1981 while import taxes were introduced in 1991. Tax rates were generally considerably higher than tariffs.
9. The amendments resulted from representations by producers to reduce tariffs on inputs and machinery, as well as to increase them on some final goods. In addition, the tariff rates on some luxury goods were reduced since excise taxes on non-FSU imports of those goods were being introduced.
10. MFN status has been accorded to (and by) Austria, Canada, China, Czech Republic, EU, Finland, Hungary, India, Latvia, Norway, Switzerland, Slovakia, Turkey, Ukraine, and the United States.
11. A few other categories of goods are exempted, including inherited property, social and humanitarian goods, samples, advertising materials, goods under cooperation agreements, investments in and inputs for joint ventures with foreign partners and for small businesses, and imports financed by the state budget or by external credits to the government.
12. There are also cross-subsidies within the structure of utility prices from producers to households, as well as targeted subsidies and transfers to pensioners for coal and gas supplies.
13. Direct controls remain on public transport tariffs, charges for communal services, and rents.
14. Monopolies are defined by law as enterprises that account for more than 35 percent of sales in the domestic market. A list of such enterprises is specified by joint decisions of the Ministers of Economy and of Finance. The latest such decision dates from January 20, 1994 but is based on 1992 market data. The Decision provides, however, that a listing based on 1993 data should be drawn up by June 1994. Given the marked increase in openness to imports of the Moldovan economy since 1992, this updating is important.
15. For details of planned centralized exports and imports, see Government Decision 71, "On volumes and distribution

mechanisms for supplies to meet state needs in 1994" February 11, 1994.

16. Centralized exports planned for 1994 are meat products, edible oil, sugar, tobacco products, wines, canned fruits and vegetables, washing machines, carpets, pumps, and furniture.

17. The degree to which credit is directed by the government has declined sharply with the introduction of refinancing auctions by the National Bank. However, directed fuel supplies remain of some significance.

18. As of April 1994, agreements for 1994 had been concluded with all countries of the former Soviet Union except Armenia, Belarus, Estonia, Georgia, and Uzbekistan. For the last four countries, agreements were reported to be in the final stages of preparation.

19. As of April 1994, Moldova was in substantial arrears to Russia for natural gas and fuel, although it was not clear if this figure, net of arrears by Russia to Moldova, exceeded the outstanding balance on the interstate credit of 50 billion rubles agreed in 1993. Ukraine and Turkmenistan were in net arrears to Moldova.

20. Australia, Bangladesh, Bulgaria, China, Cyprus, Egypt, France, Greece, Iran, Israel, Japan, Korea, Saudi Arabia, Slovenia, South Africa, Sweden, Syria, Thailand, and the United Arab Emirates.

21. However, in Transnistria the leu was not admitted as legal tender, although small amounts entered into circulation. Instead, the pre-1993 Soviet ruble continued as legal means of exchange, later overprinted with a sticker depicting Field Marshal Suvorov (a nineteenth-century Russian Field Marshal responsible for conquering Romanian-speaking Bessarabia). In addition, the new Russian ruble was circulating widely in Transnistria since this was the medium of payment of the 14th Russian Army based in Tiraspol. There also appears to have been some dollarization of the Transnistrian economy.

22. However, hotel bills and apartment rents can be paid in foreign exchange by those who are not permanent residents of Moldova.

23. Cash amounts in excess of 70,000 rubles had to be placed in blocked accounts, but only for a few days and the accounts were remunerated at a market-based interest rate.

24. The CBR imposed such restrictions on all FSU countries to stem the surge in money creation, and to ration the access of the newly-independent states to that money creation. In effect, the conditions of supply of rubles became specific to each member country of what was still nominally a monetary union. See pp 56-57 of Russia: Joining the World Economy, World Bank, October 1993 for an account of these developments.

25. However, severe restrictions on the convertibility of this currency existed. Not only were there limitations on conversion into other FSU currencies (as described above), but Moldovan residents faced a severe shortage of foreign currency in Moldova and had no legal access to foreign currency markets in the rest of the FSU.

26. Prior to this date, there had been no official recognition that the Moldovan currency was no longer equivalent to the Russian ruble. The official exchange rate quoted by the National Bank of Moldova since late 1992 had been that established by the Moscow Interbank Foreign Currency Exchange at the session of the Friday prior to the date of quotation. From late 1992 on only one official rate was quoted; prior to that there were different "investment" and "commercial" rates.

27. At each session, there are up to 10 participants in the US dollar auction, and fewer in the auctions of rubles, Romanian lei and deutschmarks. The auction process is simple and open. For a given currency the chairperson calls out exchange rates in small rising increments. Participants (including the NBM) declare their desired demand or supply at each rate until the rate at which demand and supply are equal. Actual trading takes place at this market-clearing rate, which is quoted as the official rate by the National Bank of Moldova until the next session. This is the only rate at which the NBM conducts or accounts transactions. Banks' permissible buying and selling rates are the official rate plus and minus 1 percent for hard currencies or 2 percent for other currencies.

28. The local license operates as a "learner's permit" (intended for one year) while banks acquire experience. The criteria for the granting of a general license relate mainly to the availability of trained personnel and an adequate accountancy system. This licensing system applies mainly to transactions outside the former Soviet Union; for transactions with other countries in the former Soviet Union, most Moldovan banks now have direct correspondent account relationships in those countries.

29. This market seems to exist for those who wish to make small, rapid transactions or who wish to avoid official scrutiny. In the weeks after the withdrawal of the pre-1993 ruble and after the introduction of the leu, this market saw considerable activity in rubles. Most of these rubles were presumably destined for Transnistria.

30. There is, however, a wedge between the Chisinau Exchange rate and the exchange house rates because when exchange houses buy foreign exchange at banks they pay the bank's markup over the Chisinau Exchange rate plus a 4 percent commission for cashing the foreign exchange. This places a wedge between the CIFCE.

31. Experience in the successfully transforming economies of Eastern Europe shows that producers in formerly centrally planned economies can survive low import tariffs; import liberalization appears to provide an impulse to greater competitiveness of producers in both domestic and export markets. Poland, Hungary, and the former Czechoslovakia, which experienced impressive export growth in the early 1990s, had average import tariffs of 15 to 20 percent.

32. The revenue implications of this measure cannot be computed now because the data are absent, rapidly improving data collection systems should make such calculating possible soon. Revenue could be protected by imposing an excise tax on the products in question that would apply equally to imports and domestic production. Since no

import duties are imposed on goods from Moldova's main trading partners, reducing the high tariff rates is not likely to have a large effect on revenue.

34. Exports are effectively zero-rated even when the VAT on inputs was paid in another country rather than in Moldova. However, those VAT payments are not refunded but are credited against the enterprise's next VAT payment; for an enterprise exporting most of its production to non-CIS countries, that imposes a long delay in receiving the credit.

35. The experience of Czechoslovakia, Hungary, and Poland compared with that of Bulgaria and Romania is instructive. In the first group of countries, the steady pursuit of macroeconomic stabilization and the consequent decline in domestic aggregate demand, promoted firms to take advantage of the trade and exchange liberalization and to seek export markets. Bulgaria and Romania, which were less effective in their pursuit of stabilization and liberalization, did not experience an export boom (Kaminski 1993).

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Kyrgyz Republic: External Trade for a Small Country

Kathie Krumm

The extensive and often arbitrary division of labor in the highly integrated economy of the Soviet Union left Kyrgyz enterprises with little autonomy and little information about the identity of their eventual customers. When the Soviet Union broke up, the problems the Kyrgyz Republic faced as one of the newly independent states were compounded by a sizeable trade deficit with both the former Soviet Union and the rest of the world and by a substantial deterioration in the terms of trade. In addition, the Kyrgyz Republic lost official transfers from the Soviet Union on the order of 10 percent of GDP. The required external trade adjustment for the Kyrgyz Republic is daunting.

The trade regime needs to accommodate the temporary difficulties of the transition while leading the economy toward trade patterns consistent with the country's longer-term goals. Key objectives for the transition and the medium term are to earn foreign exchange through export growth to allow imports to recover, and to stimulate efficient production through multiple trade channels and adjustment of productive capacity.

In exports the strategy is to more fully exploit the markets that already are being tapped and to diversify markets where that seems appropriate. Attaining projected export growth requirements for the coming three years will require a 15 percent a year expansion in exports outside the former Soviet Union and maintaining the level of exports within the region.

- The Macroeconomic Situation and Complementary Reforms
- Evolution of Trade
- Trade Policy
- Foreign Exchange and Payments
- Microeconomic and Trade Adjustment
- Policy Recommendations

The composition of imports and exports with those markets will change, however, since much of the previous trading pattern was inefficient.

The Kyrgyz economy is relatively small, but a diverse set of neighboring markets should allow expanded production to be based on comparative advantage and trade integration with other economies. Policymakers are coming under pressure to use the trade policy to protect specific industries from the need to adjust. But agriculture and mining sectors, in particular, should be advocates of low protection. Competitive exporters of processed and manufactured goods could be expected to grow alongside an agricultural and mining base. The recent establishment of a system for dealing with the largest, loss-making enterprises should help to make policy pronouncements on openness to trade credible.

In early 1994 the Kyrgyz government sharply accelerated the pace of trade reform and removed most formal barriers to trade. This is a pragmatic approach for a landlocked republic surrounded by countries that also are experiencing rapid economic change. But to achieve the country's objectives for trade, implicit barriers to trade will need to be attacked as vigorously.

The Macroeconomic Situation and Complementary Reforms

The government of Kyrgyz Republic has taken courageous steps on the road to a market economy.¹ In May 1993 the Kyrgyz Republic left the ruble zone, the first of the new independent states to do so after the Baltics. It introduced its own national currency, the som, and adopted a stabilization program supported by an IMF stand-by arrangement and access to the Systemic Transformation Facility. The program targeted radical changes in monetary and financial policies in order to move the economy toward a market-based allocation of resources. Some progress was made, interspersed with periods of faltering. The country adopted a program in mid-1994 under the IMF's Enhanced Structural Adjustment Facility to support further stabilization efforts for 1994-97. A reasonably stable macroeconomic environment is important for facilitating external trade.

Throughout 1993 the economy continued to adjust to severe external shocks, including the terms of trade shock, a shrinking volume of external trade and loss of union transfers. Real GDP declined continually—by 5 percent in 1991, 19 percent in 1992, and 16 percent in 1993. Unemployment has not increased at a level commensurate with the decline in output. Open unemployment reached 1.5 percent of the labor force in 1993; including workers on unpaid leave the underlying rate could have been as much as 10 percent at year's end.

Although the government succeeded in reducing its budget deficit from 16.6 percent of GDP in 1992 to under 9 percent in 1993, it did so by severely cutting all expenditure categories, rather than by improving its revenue effort. In fact tax revenues fell precipitously from 14 percent of GDP in 1992 to 8 percent in 1993, largely due to lack of enforcement, multiple exemptions, and a proliferation of barter activity and unreported transactions. The tax effort declined further in early 1994. With the difficult fiscal situation, strong measures are planned to ensure that the value added tax and the income tax carry the major burden for raising revenues, complemented by other reasonably transparent and efficient taxes. Only in this way can pressures be resisted to impose excessive trade taxes, which will jeopardize export growth and trade efficiency, as well as excessive taxation of emerging business activities.

Despite stabilization efforts, inflation remained high, reaching 1,300 percent in 1993 (700 to 850 percent on a wholesale price index basis). Only part of the increase can be explained by monetary developments such as the price increases following the shift to the som in May. Monetary control began to bite by mid-1993, but the financial problems of ailing enterprises interfered with stabilization. Faltering enterprises infected other enterprises, banks, and the central bank, largely through a buildup of arrears, which introduced a channel for implicit cross-subsidization within the economy. Most detrimental was the implicit subsidization of the enterprise sector by the agricultural sector. As enterprise arrears to the domestic energy complex mounted, the generation of domestic currency from barter energy imports came to a halt, cutting off

payments to farmers for crops for the complementary barter exports (see discussion of state trading through bilateral agreements). Farmers required additional credit for seasonal agricultural payments.

Monetary control was relaxed between August and October 1993, with the major source of expansion being the central bank. Inflation soared above 30 percent in September. Real interest rates were at highly negative annual rates during the second half of 1993. After October the National Bank of Kyrgyz Republic regained some control over credit expansion, keeping the monetary reins tight through the first quarter of 1994 and bringing monthly inflation down to 7 percent in March 1994. However, in the absence of payments discipline and control over interenterprise arrears, such severe monetary tightening was required that there was substantial demonetization. Most trade transactions are reportedly being conducted on barter terms.

The som was introduced at 4 som to the U.S. dollar and 200 ruble to the som. Official exchange rates were determined in the foreign exchange auction market under the auspices of the central bank. Soon after its introduction, the som was widely accepted as the medium of exchange, and for a few weeks it even appreciated against both the dollar and the ruble. In July 1993 the som started to depreciate, but less rapidly than inflationary developments. This resulted in a substantial real appreciation against the dollar by the end of 1993, but consistent with an even sharper appreciation of the ruble against the dollar, a real depreciation against the ruble (figure 9.1). The real exchange rate stabilized and depreciated slightly in early 1994. Competitiveness has not been undermined despite the real appreciation against the dollar, with an

average monthly wage estimated at US\$20 as of mid-1994 (table 9.1).

Evolution of Trade

According to official estimates both export and import volumes dropped by about a third in 1992 and continued to fall in 1993, to half their 1991 levels (table 9.3).² These figures probably overestimate the trade decline, however, and unrecorded trade outside the state trading system has expanded rapidly. Nonetheless, by all accounts, there has been significant deterioration in the terms of trade estimated at 20 percent since 1991 (based on 1990 weights, table 9.3) or estimated at 15 percent in 1992 and a further 30 percent in 1993, for an accumulated deterioration of 40 percent since 1991 (based on 1993 weights). The trade deficit reached 12 percent of GDP in 1993, compared with 11 percent in 1992. The deficit was financed primarily by international donors. Also, the National Bank was granted technical credit from Russia, and there was a small inflow of foreign direct investment in 1993.

The share of trade with the former Soviet Union fell sharply in 1992 and further in 1993, especially for exports, though remaining large, about 72 percent of total exports in 1993 (table 9.2). Less change has occurred in trade in traditional exports, such as wool, tobacco, minerals, and engineering products, which accounted for a third of exports in 1993 (nearly half of exports to the former Soviet Union) as they had in 1992. There has been a marginal shift in composition, with fast growth in minor agricultural products such as honey and a collapse in some industrial products such as agricultural machinery. Driven by the large increase in energy prices, the change is even greater for

Table 9.1 Exchange Rate, Inflation, and Real Wages, May 1993-May 1994

Date	Average exchange rate (clearing rate, NBK auction)	CPI Monthly percentage change	Index of real wage (1992=100)	Average wage in US dollars
May 1993	3.9	21.4	65.0	13.8
Dec 1993	8.0	15.7	53.0	22.3
May 1994	12.3	3.5	48.0	20.1

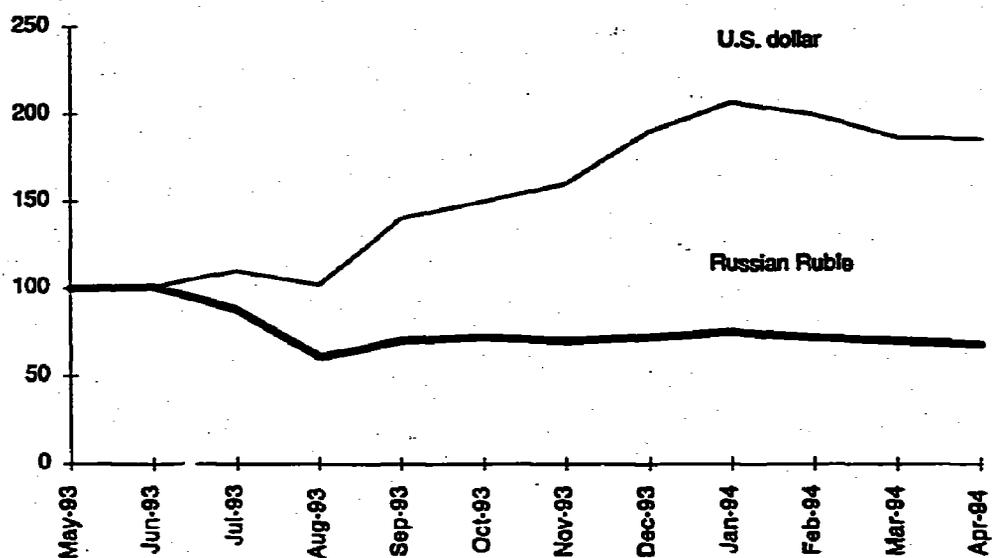
Source: Kyrgyz authorities and staff calculations

Table 9.2 External Trade, 1990-93
(millions of current U.S. dollars and percent)

	1990	1991	1992	1993
<i>Value</i>				
Total Exports	4,233	5,186	313	394
Former Soviet Union a	4,144	5,163	236	282
Rest of world	89	23	77	112
Total Imports	6,686	5,078	415	490
Former Soviet Union	5,388	4,293	344	378
Rest of world	1,298	785	71	112
Trade Balance	-2,453	108	-102	-96
Former Soviet Union	-1,244	870	-108	-96
Rest of world	-1,209	-762	6	—
<i>Percentage distribution</i>				
Total Exports	100	100	100	100
Former Soviet Union	97.9	99.6	75.4	71.6
Rest of world	2.1	0.4	24.6	28.4
Total Imports	100	100	100	100
Former Soviet Union	80.6	84.5	82.9	77.1
Rest of world	19.4	15.5	17.1	22.9

a. Figures for trade with the former Soviet Union are derived from country data and World Bank staff estimates reported in national currencies using official or commercial exchange rates for 1990 and 1991 and annual average exchange rates for 1992 and 1993.
b. Rest of world refers to countries outside the former Soviet Union; figures are based on country data reported in U.S. dollars.

Figure 9.1 Evolution of the Real Exchange Rate, May 1993-April 1994
(May 1993=100)



imports, where the share of traditional energy imports from the former Soviet Union increased from 9 percent of the total value of imports in 1991 to about a third of total in 1993 nearly half of total imports from the former Soviet Union.

The reorientation of trade is more apparent in markets outside the former Soviet Union. By 1993 exports outside the region had increased to 28 percent up from less than 1 percent in 1991.³ Trade increased with countries as disparate as China,

Table 9.3 External Trade Volume, Terms of Trade and Composition by Commodity Groups, at Domestic Prices, 1990-93 (percent)

	1991	1992	1993
<i>Volume index 1991=100</i>			
Total exports	100	65	46
Total imports	100	69	52
<i>Terms of Trade</i> (price of exports relative to imports)			
1990 weights	100	84	79
1993 weights	100	85	61
<i>Exports</i>			
Machinery & metal works	31	41	—
Light industry (including wool products)	29	24	—
Nonferrous metallurgy (including antimony, mercury, and gold)	8	11	—
Food production (including sugar and tobacco)	20	7	—
Other	13	17	—
<i>Imports</i>			
Oil and gas	9	28	—
Machinery & metal works	19	24	—
Light industry	22	7	—
Food production	16	6	—
Other	34	35	—

Note: Classified according to official sources
Source: Staff calculations

Korea, Turkey and the United Kingdom. Major exports include hides, with investor interest in leather industry links. Trade with China includes transit or reexports, such as Russian vehicles, but also Kyrgyz consumer and industrial goods. China is quickly becoming the Kyrgyz Republic's largest trading partner.

Trade Policy

Early in the transition, the government's trade policy was shaped by the demands of short-run pressures, particularly by the need to ensure energy and raw material supplies through clearing arrangements, a desire to satisfy local needs by restricting exports, and resistance to a reorientation of production and trading patterns. The result was a trade policy regime inadequate to the daunting task at hand and heavy with distortions such as state trading through bilateral agreements, direct trade restric-

tions including export licensing and taxes, dual exchange rates, and an absence of supportive infrastructure and financial services (table 9.4).

State Trading through Bilateral Agreements

In 1993 and 1994, bilateral agreements were reached with Russia and Uzbekistan; additional agreements were reached with Azerbaijan and Tadjikistan in 1994. The barter terms for obligatory list purchases are now defined in dollars at prices closer to world prices. Kyrgyz Republic also entered into indicative list agreements with these and other countries, defining the levels of exports ("quotas") on which the originating country agrees not to impose restrictions; prices are determined between enterprises.

The number of commodities covered by the two types of agreement has been falling steadily from 118 in 1992 to 70 in 1993 in the case of expected delivery from Russia. For obligatory list arrangements the number is relatively small; for example, eight commodities from Russia in exchange for five commodities from Kyrgyz Republic in 1994 and five commodities from Uzbekistan in exchange for seventeen commodities from the Kyrgyz Republic. The volume of trade planned under the clearing arrangement with Russia for 1994 declined as well, apparently influenced by the shortfall in performance under the 1993 agreement, which reached only about 55 percent of planned levels. Overall, however, the centralized character of trade is changing only gradually. The value of trade under obligatory or clearing agreements negotiated for 1993 was equivalent to about a third of exports and a fifth of imports. In addition, procurement and distribution of commodities under the agreements are dominated by the state-owned trading companies, under the coordination of the Ministry of Trade.

The days of using bilateral agreements as a channel for trade subsidies from neighboring countries are nearly over. Recent agreements have encouraged the use of world prices in U.S. dollars as the implicit mechanism for balancing flows of goods under the obligatory list. With large relative increases in energy and grain prices only partly off-

Table 9.4 Chronology of External Trade Policy Changes, 1993-94

<i>Date</i>	<i>Regulations</i>
1992	
January	Price liberalization, including elimination of margin controls
March	Liberalization of agricultural marketing, with replacement of state order system with state purchases.
April	Export licenses, prohibitions, taxes for countries outside CIS
October	Export licenses for CIS countries
March	Introduction of export duties for exports to Russia
May	Introduction of the som and foreign exchange auction
June	Introduction of trading margins and price controls on "monopolies"
August	Lifting of trading margins for imported goods
November	Reduction in number of goods subject to trading margins (to ten)
1994	
February	Wide access to foreign exchange auction
April	Elimination of trading margins except on bread
April	Removal of direct price controls on enterprises other than natural monopolies
June	Elimination of export licensing and taxes from all but a limited number of goods
June	Repeal of legislation on state orders and domestic supply contracts and replacement with voluntary purchases for state needs

Source: World Bank (1994d) and government documents.

set by higher relative prices for some key Kyrgyz exports, this shift has resulted in a 20 percent deterioration in the terms of trade (even higher using more recent trade weights). In 1993 favorable exceptions in pricing appear to have been limited to wool and tobacco exports under the agreement with Russia and natural gas imports under the Uzbek agreement (table 9.5). The implicit prices paid by Russia under the 1993 agreement were about 35 percent higher than the estimated world price for

tobacco and more than 100 percent higher for wool. The trade subsidy embedded in the Russia agreement helped stabilize wool prices for Kyrgyz Republic at a time of collapsing world prices. In the case of gas, the arrangements were more complex. The implicit price paid by Kyrgyz Republic for Uzbekistan natural gas under the 1993 agreement was 40 percent less than estimated world prices, a pricing arrangement linked to Uzbekistan's dependence on irrigation water flowing from Kyrgyz Republic. To time the flows to meet Uzbekistan's needs, the Kyrgyz Republic generates less hydroelectricity than it otherwise would have, and these shortfalls are made up by other energy inflows including gas. Under the 1994 agreements, however, the implicit prices paid by Russia for Kyrgyz tobacco and wool exports fell to close to world levels, and the implicit price paid by the Kyrgyz Republic for Uzbek gas rose to near world levels, implying a further deterioration in terms of trade by 1995-96.

The benefits of these agreements are limited and short term, whereas their defects create substantial harm over the medium term. The clearing arrangements subsidize industry at the expense of agriculture and mining through the domestic pricing and payment system. This analysis assumes that it would be appropriate for the government to realize the gain from any trade subsidies from neighboring countries implicit in prices different from world levels. Though domestic prices for oil are adjusted quarterly to reflect international prices, several (primarily industrial) enterprises have not paid their bills and are running arrears. Price data for 1993 indicate that other inputs, such as aluminum, copper, and metal products are also selling at below world levels. Agricultural producers, meanwhile, are required to sell to the state at domestic prices that are below world prices. Payment delays to producers constitute another burden on agriculture; the six-month payment delay in 1992/93 implied a tax on producers of about 50 percent. These implicit taxes on output are partly offset by input subsidies, such as below world prices for fertilizer, though problems of availability are reducing the value of the subsidy. Continuing to place such a heavy rev-

Table 9.5 Price Comparisons for 1993 Clearing Arrangements between the Kyrgyz Republic and Russia and Uzbekistan (U.S. dollars)

<i>Direction of Trade/Commodity</i>	<i>Clearing Price</i>	<i>World Price^a</i>	<i>Ratio of clearing price to world price (%)</i>
<i>Exports to Uzbekistan</i>			
Antimony	1,480	1,530	96.7
Mercury ^b	4,350	3,000	145.0
<i>Exports to Russia</i>			
Antimony	1,749	1,530	114.3
Mercury ^b	4,350	3,000	145.0
Cotton fiber	1,134	1,300	87.2
Natural wool	4,500	2,000	225.0
Raw Tobacco	3,000	2,160	138.9
<i>Imports from Uzbekistan</i>			
Natural gas	48	80	60.0
Automobile gasoline	200	195	102.6
Diesel fuel	160	162	98.8
Heavy fuel oil (mazut)	80	65	123.1
Refined copper	2,200	1,922	114.5
Raw aluminum	1,220	1,922	114.5

Note:

a. Prices are per ton or cubic meter. Unadjusted for transport or insurance costs. July prices from several sources including World Bank data, *The Financial Times*, the *Mining Journal*, and the *Metal Week*.

b. Average producer price January-June 1993, estimated from World Bank (1994c.)

enue burden on the traditional agricultural sector, which is already under stress, cannot be successful. As for the export-oriented mining sector, more transparent taxation methods should and can be used. Taxes should be kept moderate, however, to avoid discouraging the foreign investment so critical to developing the mining potential of the Kyrgyz Republic.

Most of the gain from (the rapidly declining) trade subsidies from neighboring countries and the implicit taxation of traditional exports is going not to the government but to enterprises consuming oil but not paying for it and to gas consumers. The system, which was supposed to provide the state with financial resources from the sale of barter imports such as oil to finance purchases of barter exports such as agricultural commodities, has been disrupted by mounting arrears. The government and the National Bank of Kyrgyz Republic had to use extraordinary measures in 1993 to secure short-term

finance for seasonal crop procurement. Such crisis management will not allay farmers' fears about future compensation. And the burden for subsidizing enterprises arrears was also borne by other (presumably productive) users of credit who were cut off so that the government could maintain its overall credit control. All these distortions mean that incentives to optimize import consumption and production of traditional exports have not been transmitted to the economy, perhaps the most critical reason for reforming clearing arrangements.

These state interventions, because of the restrictions needed to enforce the bilateral agreements, had repercussions on other trade as well. Export licensing and taxes were particularly onerous. In 1993 producers of the four major agricultural commodities—wool, tobacco, cotton, and wheat—were obligated to sell 80 percent of production to the state. Halting efforts to liberalize agriculture trade had been under way since 1991, but the sys-

tem remained highly controlled and inconsistent — and unsustainable. Production fell in both agriculture and processing industries. Though the non-clearing indicative list might have facilitated trade at a time of restrictive export licensing by trade partners in the former Soviet Union, the benefits will be short lived. And they came at the cost of continuing support for a broader state contract system that inhibited the emergence of private entrepreneurship, dynamic trade patterns, and new market contacts favoring efficient activities.

In early 1994 the government started to dismantle the state trading system associated with bilateral agreements. A February 1994 decree explicitly abolished state orders and replaced them with a procurement system based on contractual arrangements and financed through budget allocations. By-laws related to obligatory domestic supply contracts were allowed to expire. The number of commodities covered was reduced for 1994, and the proportion of the projected harvest covered by state needs fell. The government indicated its intentions to eliminate bilateral agreements as soon as feasible, perhaps as early as 1995.

However, operational changes to implement the new state procurement policy were still being put in place by mid-1994, and considerable ambiguity remains among producers and traders about whether supplying state needs is compulsory. Unless institutional and financial mechanisms are put in place to satisfy state needs, particularly for critical imported energy commodities and major agricultural crops, the government will continue to be tempted to resort to ad hoc control measures. Also, large state trading institutions continue to dominate the market, leaving defacto monopolies, and impeding the growth of more efficient private market-oriented trading networks.

Private sector trade is emerging but public sector marketing agents will continue to play a role—albeit a declining one—until the private sector has expanded sufficiently to take over all trade. Recent experience indicates the importance of adequate public sector financing and border pricing to emergence of a private sector able to fulfill that role in a way consistent with market orientation.

Restrictions on Direct Trade

The greatest damage among restrictive trade policies came from export restrictions, which presented a formidable obstacle to exports while protecting inefficient enterprises. In 1993 over half of exports were subject to licensing and nearly a third to export taxes.

The Kyrgyz Republic began taxing many of its exports to Russia in March 1993 in retaliation for Russia's levying of export taxes. The tax rates ranged from 10 to 150 percent on exports to Russia, with a 10 to 50 percent surcharge for barter exports. Taxes did not apply to exports of other countries of the former Soviet Union though they did apply to exports outside the former Soviet Union, generally at lower rates than for exports to Russia. Unofficial charges imposed by various administering officials and further restrictions and administrative interventions by local authorities increased the effective rate of export taxation. These taxes raised very little revenue for the government budget—about 2 percent of the value of exports in the first five months of 1993, for example—because of numerous exemptions and incentives to export illegally. For the Kyrgyz Republic the only commodities for which it is a major world producer are in the mineral sector, namely, mercury and possibly antimony, accounting for 20 percent and 15 percent, respectively, of total world consumption. This would not be sufficiently oligopolistic to justify a significant export tax. In the second half of 1993 the government revised the export tax schedule several times, including the introduction of a 10 percent surcharge on re-exports, while continuing country-specific tax exemptions in the context of bilateral agreements. Early 1994 the government reduced the maximum export tax rate to 30 percent (with one exception) and eliminated export licenses except for a small number of hazardous materials and items of cultural importance.

There were few direct barriers to imports because the government sought to avoid restricting the supply of raw materials and commodities from any source. Imports from countries outside the CIS were subject to low customs duties of 5 to 15 percent of their value at world prices; no customs

duties are levied on imports from within the CIS. Exporters do not receive rebates for duties paid on imported inputs, but in early 1994 the government eliminated import duties. Excise taxes were imposed on a few imports, mainly tobacco, alcoholic beverages, and luxury commodities, at nearly the same rates as those imposed on goods produced domestically (10 to 30 percent), reversing a policy of discrimination in favor of imports. The value added tax (VAT) continues to be imposed on an origin basis. It needs to be converted to a destination base, which would be in line with recent developments in Russia.

Other Trade Relations

The Kyrgyz Republic intends to apply for observer status at the GATT, seeking eventually to become a member and to gain access to the existing multilateral trade framework. It is also being approached by other bilateral and regional trading partners to enter into agreements that provide a framework for trade. The Kyrgyz Republic is a member of the CIS and of the Economic Cooperation Organization, which seeks to further economic ties between Muslim countries (Afghanistan, Iran, Pakistan, Turkey and five Ex-Soviet republics). In early 1994 the Kyrgyz Republic entered into a free-trade agreement with Kazakhstan and Uzbekistan, but export controls for key commodities remain in those partner countries. The government is developing free trade agreements while continuing the process of economic reform, including unilateral and multilateral lowering of trade barriers. Because of its small size, the Kyrgyz Republic's ability to extract concessions in exchange for lowering its own barriers is minimal.

Foreign Exchange and Payments

Under a floating exchange rate regime, the official value of the som against the dollar is determined by the free interplay of supply and demand in weekly auctions held by the National Bank of Kyrgyz Republic. This weekly auction is the principal source of dollars for the banking system, with the dollars supplied mainly from bilateral and multilateral loans. The official supply from exporters is

negligible. Participation in the auctions was initially limited to commercial banks, but access to the auction has been broadened to include all exchange bureaus. There is also another market in which both commercial banks and exchange bureaus participate. In July 1993 the som started to depreciate in nominal terms, falling from its introductory rate of 4 som to the U.S. dollar to 12 som to the dollar and from 200 rubles to the som to 150-160 ruble by March 1994. This represented a real appreciation of about 50 percent against the U.S. dollar and a real depreciation against the ruble. The sharp decline in real incomes and financial savings and the tight money supply could have contributed to the som's real appreciation against the dollar.

Other problems confront the exchange regime for currencies of the countries of the former Soviet Union. There, improving the payments system for interstate trade is critical, both to increase the availability of other currencies and to reduce pressures on the som from the ruble. The reliance on decentralized correspondent bank accounts has not resolved those difficulties. Ruble trade is hampered by highly segmented markets and the absence of a portfolio of currencies including rubles held by the large financial institutions. Cash ruble trade is further hampered by the lack of a framework for volume transactions. These problems were exacerbated by the introduction of the Kazakh tenge in November 1993 and by the designation of the Uzbek som as the sole currency in Uzbekistan in January 1994. A significant portion of interstate trade appears to continue to be settled on a barter basis.

Microeconomic and Trade Adjustment

Some reorientation of trade has taken place, particularly in markets outside the former Soviet Union. A driving force behind the new export push is the need to find alternative sources of imports, both of consumer items such as electronics and clothing and of oil and industrial inputs. Much of this trade remains on barter terms, primarily because of continuing payments problems and so its size is unknown. (In interpreting historical trade data, it is important to account for some large pro-

cessing activities located in the Kyrgyz Republic, which have now ceased operation — for example, the processing of sugar which was imported from Cuba, a negative value-added activity).

The process of industrial restructuring has just begun. Several industries, at least partly because of their noncompetitiveness in trade, halted production in 1993, placing many employees on leave-without-pay status. Among the large industries affected were machine-building products, whose exports had been part of an integrated Soviet production chain; textiles, which included import-competing items; and building products, which had been exported. Many of the competing imports are financed on a barter basis through exports to new markets.

On the positive side, the solid mining potential of the Kyrgyz Republic has begun to be tapped, with new investment in gold mining and increased exports of antimony and mercury to markets outside the former Soviet Union. In manufacturing, some producers have found market niches, including leather producers and a few high-tech military-industrial enterprises. Some new trade relations are developing to supply critical industrial inputs now blocked within the interrepublican system, such as dyes for textiles. Joint ventures frequently play a role in the real side adjustments. Recent export-oriented ventures include leather, gold, and cigarette manufacturing. Privatization, once based on sales to manager-worker collectives, now stresses voucher privatization and strategic investors, including foreigners.

In agriculture there is little evidence of a shift in production or marketing patterns for major commodities, despite serious problems. The strong market potential for tobacco and sheep products, for example, has yet to be realized because of the constraints imposed by marketing policies reinforced by oligopsonistic marketing structures. Producers were required to sell most of their output to the state, which traded primarily in traditional markets in the former Soviet Union. The movement away from the state order system and the eventual demopolization of marketing should facilitate the tapping of new markets. Grain production increased in response to pricing policies that reduced food

imports, but more attention to world pricing would be more appropriate. For smaller crops such as fruits, vegetables, and honey there is evidence that the removal of trade barriers has facilitated trade.

Policy Recommendations

To move the economy toward a market-oriented base, with most transactions carried out directly by firms, the government began to progressively dismantle most formal control in early 1994, removing the web of explicit restrictive trade policies that prevailed in 1993. These reforms have yet to yield the expected results, in part because implicit barriers to private sector expansion remain in both the domestic economy and external trade. To complete the process the government would need to:

- Further curtail the role of the state by breaking up the dominant state trading companies into commercially oriented and competitive units and by not restricting the trading spheres of such privatized entities.
- Eliminate bilateral clearing arrangements. If key neighboring trading partners insist on such clearing arrangements, the focus should be on setting up transparent bidding and procurement arrangements. Resist any further buildup in arrears on domestic oil sales.
- Join GATT. Avoid participating in free trade zones where there will be pressures to raise tariffs in the process.

To ensure an exchange and payments regime supportive of exports:

- Strive to maintain a unified exchange rate and full convertibility of the som for trade purposes.
- Investigate the possibility of establishing a venue for non-dollar trading by interested parties with the facilitation of an impartial intermediary.

In agriculture the private sector will shortly be in a position to replace the state in agricultural trade without leaving a transitional marketing void. To unblock the system and press ahead with the shift:

- Give an explicit commitment to private sector participants in agricultural trade and processing that their contribution is viewed favorably by government. Beware of measures by local authorities to restrict such participation.
- In areas where large state enterprises continue to have a predominant role in price-setting (for example, where processing remains highly concentrated), link prices closely to border prices. Accelerate payments to producers for commodities delivered to state agents, preferably through immediate cash payments, since delays are as important as low prices in disrupting production and marketing.
- Implement a procurement system (including the major agricultural commodities) by offering a competitive price to create a voluntary and secure basis for deliveries under bilateral clearing arrangements.

As important as the direct factors just discussed are a number of other factors that are impeding trade. Macroeconomic and trade reform will not yield their full benefits unless several other constraints to the operating activities producing and trading enterprises are lifted.

- *Property rights.* Property rights must be clearly defined and enforceable under law if mutually agreed commodity trade and private capital investments are going to occur. The Kyrgyz Republic is undertaking an ambitious program to privatize a large share of state-owned enterprises. In January 1994 Parliament passed a new concept note for privatization that should improve the quality of the privatization program by focusing more on competitive measures.

- *Entry and competition policy.* Creating an enabling environment for traders and increasing competition by reducing impediments are essential to resource reallocation to meet the changing structure of prices. The freedom of firms to enter and leave an industry plays a crucial role in resource allocation, including for export production. Perhaps the most harmful barriers to entry for traders are the high profits tax rate and limits on trading margins. In November 1993 margin controls were lifted except for food products such as dairy and grain products, for which differential margins are allowed for remote areas. The list of commodities for which the Antimonopoly and Pricing Commission sets prices has been reduced to a handful of natural monopolies. There remain instances, however, in which oblast authorities have imposed their own price control mechanisms.
- *Taxation.* To meet the fiscal pressures of the transition, any solid source of government revenue has to be exploited. The VAT and the income tax will need to carry the major share of the revenue burden, but their base needs to be broadened. The system needs to be implemented in a reasonably transparent and efficient manner, to resist pressures to impose excessive trade taxes that will jeopardize export growth and trade efficiency or overburden emerging business activities.
- *Transport, communication, and business services.* The Kyrgyz Republic has a fairly well developed system of roads, railways, and air links, and its freight system copes quite well with large bulk shipments. The system is poorly suited to smaller shipments and quick-response trade movements, however, which are critical to the emergence of a new structure of production and trade. Transport policy needs to be adjusted toward greater reliance on

roads, smaller transport companies (with implications for transport asset divestiture), and dependable telecommunications. There is substantial knowledge about markets in the former Soviet Union, though it needs to be continually updated in a fast evolving market situation. Also, much of that knowledge is held by the staff of the old state trading companies and the trade ministry, and those market-making services need to be spun off and barriers to entry removed.

In combination with the completion of trade reforms, these policies would move the Kyrgyz Republic a long way toward meeting its short-term trade objectives and its medium-term economic vision.

Notes

This chapter draws from a World Bank (1994b) report on the Kyrgyz Republic's external trade policy, prepared by a team led by Kathie Krumm (principal author); Tom Daves (World Bank, Tashkent); Alex Duncan (Oxford University); Chris Jones (Center for International

Economics); Anita Kochkorbaeva (World Bank, Bishkek); Dani Rodrik (Columbia University); and Pedro Rodriguez (World Bank).

1. The macroeconomic update draws on World Bank 1994a.

2. Calculations of the terms of trade are sensitive to the choice of base year, and they are seriously compromised by the poor tracking of export prices in Kyrgyz Republic and the incomplete coverage of transactions. As a result, estimates of the deterioration in the terms of trade with the former Soviet Union in 1991-93 vary widely, ranging from about 10 percent to more than 40 percent.

3. A significant—but impossible to quantify—portion of the increase, however, is due to valuation adjustments.

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Uzbekistan: Trade Reform in a Cotton Based Economy

*Michael Connolly
and
Silvina Vatnick*

- The Macroeconomic Framework for Trade: Policy and Trends
- Trade Policy
- The Resource Transfer Caused by Implicit Taxation: The Cotton Sector
- The Payments Framework for Trade
- Recommendations for Trade Policy in the Transition

For the first two years after independence the government of Uzbekistan was very cautious in its approach to economic reform. It liberalized prices only partially, imposed a number of new taxes, eliminated import tariffs temporarily,¹ privatized only small shops and residential housing, and enacted preliminary banking, property, and foreign investment legislation. At the same time, the government maintained firm control over most trade activities including trade flows under the state order system, export licensing, bilateral trade and clearing arrangements, and access to hard currency. Within this policy framework, Uzbekistan's trade has suffered a major decline in real terms since 1990. Payments difficulties and recession in the countries of the former Soviet Union reduced interstate trade in 1993 to 30 percent of its 1990 level, while trade with the rest of the world amounted to 76 percent of its 1990 level.

In late 1993, as the economic situation deteriorated and Uzbekistan withdrew from the ruble zone, the government began to consider more comprehensive economic reform. A Presidential Decree of January 22, 1994, called for wide-ranging economic reforms from accelerating privatization and enterprise reform programs and encouraging private sector business activities to reducing reliance on state orders and liberalizing foreign exchange controls. While this decree represents a significant shift in the government's expressed policy toward the

pace and extent of reforms, in fact, little has been done so far to put these policies into practice.

Uzbekistan now faces a major challenge and opportunity to rejoin the world community on a multilateral basis that does not discriminate in trade treatment between the former Soviet Union and the rest of the world. In doing so, the country can set the foundation for economic recovery and long term growth through trade expansion.

The Macroeconomic Framework for Trade: Policy and Trends

Between 1991 and 1993 Uzbekistan's output (at 1990 prices) declined by 13 percent (table 10.1). Uzbekistan experienced a smaller economic contraction than other countries of the former Soviet Union largely because Uzbekistan was better able to diversify its exports beyond former Soviet Union markets. The government kept the centralized system almost intact, shielding the economy from market forces for the first two years after independence. Adjustment has been postponed, especially in the industrial and cotton sectors, where activities were still under control in mid-1994. Agriculture represents an important part of GDP (33 percent), so economy-wide adjustment, when reforms deepen, may be less severe than elsewhere. Moreover there was no significant deterioration in the terms of trade following the collapse of the Union. In fact,

stronger commodity prices in 1992 and 1993 led to modest improvements in the external environment for trade.

Disruptions in import availability have hurt production. In 1993 manufacturing output fell more than 15 percent. The largest drops in production occurred in the heavy industrial sectors most closely linked to other countries of the former Soviet Union. As a result, trade and payments flows have been disrupted. Agricultural production remained relatively stable while energy production rose by about 6 percent, led by an expansion of domestic natural gas production.

Prices, Wages, and Employment

Inflation accelerated in 1993 as measured by the GDP implicit price deflator. Inflation rates averaged about 915 percent (compared to almost 700 percent in 1992): about 1,200 percent in wholesale prices, and 850 percent in retail prices (compared with 530 percent in 1992). Prices rose steeply in the second half of the year, when demand was fueled by a significant growth in domestic credit. Increased subsidies on a range of goods partially offset retail price increases.

Since enterprises and collectives have not yet been significantly restructured or privatized, employment levels have been maintained by significant downward adjustment of real wages. The

Table 10.1 Macroeconomic Indicators, 1989-93

Item	1989	1990	1991	1992	1993
<i>Rubles per dollar (period average)</i>					
Official exchange rate	—	—	—	1.67	1,280.0
Market exchange rate	—	—	—	220.00	1,821.0
<i>Annual percentage change</i>					
Real GDP	4.5	4.3	-0.9	-9.5	-2.5
GDP deflator (average)	0.8	4.0	98	700	915.0
Retail price (average)	0.7	4.0	105	530	850
Wholesale prices (average)	2.1	7.3	147	1,400	1,200.0
Monthly wages (average)	6.5	11.1	246	550	1,000.0
Real wages	4.3	3.5	-39	-42	-22.0
Unemployment	—	—	—	—	0.5
<i>Percent of GDP</i>					
Total bank credit	52.5	41.6	47	97	107.0
Central government budget deficit	0.6	0.9	4.5	10	3.0

Source: Goskomprognostat, IMF and Bank staff estimates.

Table 10.2 External Trade 1990-93
(millions of current U.S. dollars and percent)

	1990	1991	1992	1993
<i>Value</i>				
Total exports	15,236	15,018	1,497	3,551
Former Soviet Union ^a	13,846	13,761	628	2,085
Rest of world ^b	1,390	1,257	869	1,466
Total imports	22,325	16,148	1,756	3,505
Former Soviet Union	20,108	14,100	827	2,225
Rest of world	2,217	2,048	929	1,280
Trade balance	-7,090	-1,130	-258	46
Former Soviet Union	-6,263	-339	-198	-140
Rest of world	-827	-791	-60	186
<i>Percentage distribution</i>				
Total exports	100	100	100	100
Former Soviet Union	90.9	91.6	41.9	58.7
Rest of world	9.1	8.4	58.1	41.3
Total imports	100	100	100	100
Former Soviet Union	90.1	87.3	47.1	63.5
Rest of world	9.9	12.7	52.9	36.5

a. Figures for trade with the former Soviet Union are derived from country data and World Bank staff estimates reported in national currencies using official or commercial exchange rates for 1990 and 1991 and annual average market exchange rates for 1992 and 1993.

b. The rest of the world refers to countries outside the former Soviet Union; figures are based on country data reported in U.S. dollars.

average real wage deteriorated by almost 45 percent in 1992 and by an estimated 22 percent in 1993, as did pensions and family allowances. Labor mobility is still very limited.

Fiscal Developments

In 1993 the government managed to limit the deficit in the narrowly defined "ruble budget" to 2.5 percent of GDP, primarily through improved tax collections and by shifting expenditures to extra-budgetary funds. The consolidated budget, which accounts for net lending, extrabudgetary funds, and other foreign currency transactions, shows a substantially higher deficit, of about 15 percent of GDP.

Subsidies constitute a large share of spending. In 1993, total budgetary spending on subsidies amounted to about 31 percent of GDP, almost a third of it (9 percent) going to consumer subsidies. The four main categories of subsidies are: consumer subsidies, of which direct budgetary food subsidies are the most important (60 percent), followed by residential gas, heating and public transportation (26

percent); agricultural input subsidies; energy price subsidies for industrial and household consumers; and credit subsidies from the central bank at below-market interest rates. Many of the subsidies, particularly on grain, energy products, and agricultural inputs, are provided by subsidizing imports.

Money and Credit

After failing to reach an agreement with Russia on a new ruble zone in 1993, the government decided to introduce a temporary new currency. Currency coupons (sum coupons) were introduced on November 15, 1993. On July 1, 1994, a full-fledged new currency, the sum was introduced.

Domestic credit to enterprises expanded substantially in 1993, through both direct government credit and the banking system. The central bank refinanced credits to agriculture and industry and also provided funds to the Ministry of Finance for the Turnover Fund (revolving credit to enterprises). Lending and deposit rates remained highly negative in real terms, transforming credits into grants subjecting deposits to very high implicit taxation.

Patterns of Trade

Measured in constant rubles, Uzbekistan's exports to the former Soviet Union fell by almost 19 percent in 1991, 35 percent in 1992, and 20 percent in 1993. Since demand for imports from the former Soviet Union fell more than exports did, however, Uzbekistan's trade balance with the region improved in real terms (table 10.3).

Cotton is the major export and dominates foreign trade transactions. In 1993, as in 1992, cotton fiber accounted for about half of Uzbekistan's export trade with the former Soviet Union, most of it through deliveries under bilateral trade agreements (Table 10.3). Natural gas accounted for 23 percent, a fourfold increase in volume over 1992 and electric power for 12 percent, a doubling of the previous year's volume. In 1993 cotton also represented almost half of total exports to countries outside the former Soviet Union (Table 10.4).² Most cotton exports are handled through state orders and state trading companies. The state sets production quotas and purchases 75 percent of the quota at a fixed price (approximately 15 percent of the world price). The state then sells the cotton domestically for about 20 percent of the world price and internationally at world prices (which are also used in calculating clearing and barter arrangements). Cotton producers may sell the remaining 25 percent of the

Table 10.3 Uzbekistan: Former Soviet Union Trade by Commodity
(billions of rubles)

	1992	1993
Total exports to the former		
Soviet Union	123.1	1,159
Cotton fibre	49.1	600
Natural gas	3.9	262
Electricity	0.1	142
Oil products	0.5	37
Metal products	16.3	59
Other	53.2	59
Total imports from the former		
Soviet Union	161.9	1,489
Wheat	4.6	38
Sugar & meats	14.2	52
Natural gas	7.6	118
Oil products	27.1	423
Metal products	32.0	128
Other	76.4	730

Source: Goskomprognozstat, World Bank staff estimates

Table 10.4 Uzbekistan: Hard Currency Trade by Commodity
(US\$ millions)

	1992	1993
Total exports	869	1,466
Cotton fibre	673	568
Metal products	58	34
Mineral fertilizer	39	35
Gold	—	547
Other	99	282
Total imports	929	1,280
Wheat	573	339
Meat & poultry	45	21
Sugar	44	83
Oil seeds	—	37
Tea, coffee & spices	10	64
Textiles & footwear	34	42
Machinery & equipment	—	83
Other	223	611

Source: Goskomprognozstat, IMF and World Bank estimates

production quota plus any over-quota output, but any international sales must go through state trading companies.

Wheat and food accounted for the largest share (42 percent) of Uzbekistan's hard currency imports in 1993, followed by machinery and equipment (12 percent), and textiles and clothing (6 percent) in trade outside the former Soviet Union (Table 10.4). A \$60 million deficit in 1992 was followed in 1993 by a surplus of \$186 million. Lower grain imports from hard currency areas in 1993 accounted for most of the turnaround, offsetting increased imports of other food items and sharply higher imports of capital goods (table 10.3). Uzbekistan's overall current account deficit increased to about \$380 million in 1993, up from to \$230 million. In 1992 a deficit in the balance of trade with the countries of the former Soviet Union more than offset the surplus in the balance of non-FSU trade when expressed in terms of US dollar equivalents.

Uzbekistan's main import from the countries of the former Soviet Union is oil, the bulk of which was gasoline and diesel fuel amounting to almost 30 percent of total imports from the region in 1993 (Table 10.3). Oil volume in 1993 was 30 percent larger than in 1992. Natural gas imports, part of a substantial transit trade from Turkmenistan through

the existing pipeline system, comprised 8 percent of total imports in 1993. Imports of metal products accounted for 9 percent of the total, down sharply, because of the disruption in external payments system, which also cut heavily into imports of other manufactured goods.

Trade Policy

Formal trade restraints, other than licensing of exports, are few and limited. Trade is nevertheless severely regulated through implicit controls implemented through state trading arrangements. The government is attempting to introduce uniform treatment of trade regardless of destination. Export taxes are now the same for exports to the former Soviet Union and to the rest of the world, and the number of goods subject to export licenses has been reduced from 74 to 26 as of March 1, 1994. Import tariffs have been lifted on imports from all sources, until July 1, 1995. In early 1994, the government

Table 10.5 List of Items Subject to Export Licensing (as of March 1994)

-
1. Electric energy
 2. Services on transporting electric energy
 3. Oil
 4. Car gas
 5. Diesel fuel
 6. Oil fuel
 7. Oil for technical uses
 8. Natural gas
 9. Services on transporting natural gas
 10. Lignified gas
 11. Gas condensate
 12. Coal
 13. Rolling of ferrous metals
 14. Steel tubes
 15. Copper and copper products
 16. Aluminum
 17. Chemical fibers
 18. Mineral fertilizers
 19. Wooden materials
 20. Cotton fiber
 21. Silk fabrics
 22. Tobacco
 23. Sugar
 24. Meat and meat products
 25. Wheat
 26. Zinc
-

Source: Ministry of Foreign Economic Relations

also removed the 35 percent tax on foreign exchange proceeds, the 15 percent surrender requirement at the official exchange rate and a 15 percent foreign exchange tax replacing them on April 15, 1994, with a 30 percent surrender requirement at the market exchange rate for all export proceeds. This surrender requirement does not apply to exports that do not yield hard currency receipts and thus remains discriminatory against hard currency exports.

Trade transactions are also affected by domestic taxes like the value added tax (VAT) and excise taxes, which are levied on the value added of resold imports but not on exports. The VAT (20 percent in July 1994) is the country's primary revenue source. Excise taxes are applied on a variety of domestically produced goods including alcoholic beverages, cigarettes, and jewelry, but not on imports.

Implicit Trade Taxes

Internal regulatory barriers. Until early 1994 the government was slow to relinquish control of the economy and international transactions. To maintain that control, the government established a complex system of internal regulations that discourages and distorts trade. For instance, most exports of key commodities to outside the former Soviet Union countries are strictly controlled through export registration and licensing requirements and the monopoly on trading rights for certain product lines held by state foreign trade organizations. All exports are also indirectly controlled through the state order system, which essentially reserves a large portion of domestic production for the disposal of the state.

The state order system is an impediment to the nondistortionary expansion of trade. Trade is taxed implicitly when the domestic price of goods imported and exported by state trading companies in Uzbekistan differs from the world price. It is possible to compute the implicit tax as the additional "wedge" between the domestic and world prices, taking into account transportation and other tariff factors.

Export licensing is clearly necessary to enforce the implicit export tax since a competitive,

**Box 10.1 Taxation of Exports and Imports in the Ruble and Foreign Currency Area
(as of August 1993)**

	<i>Ruble Zone</i>	<i>Foreign Currency Zone</i>
Export Taxes	<ul style="list-style-type: none"> • 10 percent on exports ^a (also levied on barter trade, but exemptions for state enterprises, centralized cotton exports, and other items). • Ban on barter trade from July 16, 1993 (except for listed products, mostly petroleum, building materials, and lumber). 	<ul style="list-style-type: none"> • 35 percent on hard-currency earnings, except for state orders, charitable contributions up to 1 percent, equity and portfolio investment, and purchases of foreign exchange on the currency market. ^b • Barter trade conducted after July 16, 1993, will be taxed in foreign exchange at the 35 percent rate. • Ban on barter trade from July 16, 1993 (except for listed products, mostly petroleum, building materials, and lumber.)
Customs Duties	Zero	<ul style="list-style-type: none"> • imports: abolished July 8, 1993. • exports: 2 to 40 percent. • plus a 1 to 3 percent administrative charge
Value Added Tax	Basic rate of 25 percent ^c (not levied on exports but on the value added for resold imports).	Basic rate of 25 percent ^c (not levied on exports but on the value-added of resold imports).

Source: World Bank Mission, Government of Uzbekistan. (The classification categories in Box 10.1 do not exactly correspond to Government categories.)

a. For the former Soviet Union, except on cotton fibre which has a 30% rate except for fibre exported by kolhozes taxed at the rate of 40,000 rubles/ton, and exported by other organizations which is taxed at the rate of 150,000 rubles/ton. Other exceptions include: natural gas: 20%, children's commodities: 20%, as well as tax on exports of agricultural goods: from 2,000 to 40,000 rubles per ton, which varies by product.

b. In effect since January 1, 1993 but collected only since June 6, 1993. Retroactive in principle to January 1, 1993.

c. Treatment differs for final and intermediate goods.

unlicensed exporter would be willing to pay a slightly higher domestic price for the good and export it at a slightly lower price, making a profit nearly equal to the rate of the implicit export tax. The system is intended to keep more raw materials and intermediate inputs within the country at a lower price than would be the case with free trade in those goods. Indeed, the profits to government agencies from the export of cotton and other inputs

are treated as excise tax revenue in Uzbekistan's fiscal accounts and constitute the second highest source of tax revenue. Product lines—accounting for the majority of foreign trade—must be handled through state foreign trade organizations within the Ministry of Foreign Economic Relations (MFER).³

Export registration and licensing. Until the beginning of 1994, when treatment was unified,

trade with the rest of the world had been more heavily regulated and controlled than trade with the countries of the former Soviet Union. Hard currency trade was regulated and controlled through registration and licensing requirements. All contracts had to be registered at the Ministry of Foreign Economic Relations. The signed contract then had to be submitted with other documentation, such as a certificate of registration as a legal enterprise and, for some products, health or other certificates, in a review process that typically took about five to ten days. Only six product categories required an import license versus seventy-three export categories. However, imports were further constrained by foreign exchange access restrictions. License approval takes approximately one week. Large state enterprises are eligible for general export licenses that permit annual exports up to a set amount.

Because a large proportion of trade is still conducted under bilateral agreements, export licenses are used to ensure that the government can meet its commitments. They are also used to control the exports of raw materials that are important to domestic production and to restrict the resale abroad of products priced below world levels domestically because of price controls or heavy subsidies. Though the precise economic effect of licenses depend on the circumstances in which they are applied, they are clearly highly distortive and pose a serious barrier to trade expansion. They discourage the production of exports and reduce foreign exchange earnings by breaking the link between domestic and world prices. Licenses also encourage rent-seeking behavior, which wastes resources.

Consumer subsidies on imported goods. As part of the government's subsidy program, state trading companies purchase goods abroad and sell them domestically at lower prices, obviously incurring a loss in the process. And because there is excess demand for the imported goods at the subsidized price, the state order system rations the quantity imported for sale in the domestic market. This artificial depressing of domestic prices discourages domestic production of those goods.

The Resource Transfer Caused by Implicit Taxation: The Cotton Sector

The massive resource transfers in the cotton industry provide a dramatic illustration of the impact of explicit and implicit taxes on the economy and trade. All cotton trade is subject to export licensing. And three-quarters of cotton production is subject to the state order system. For 1992 the implicit tax on cotton farmers that is transferred to the government is estimated at about \$1 billion.

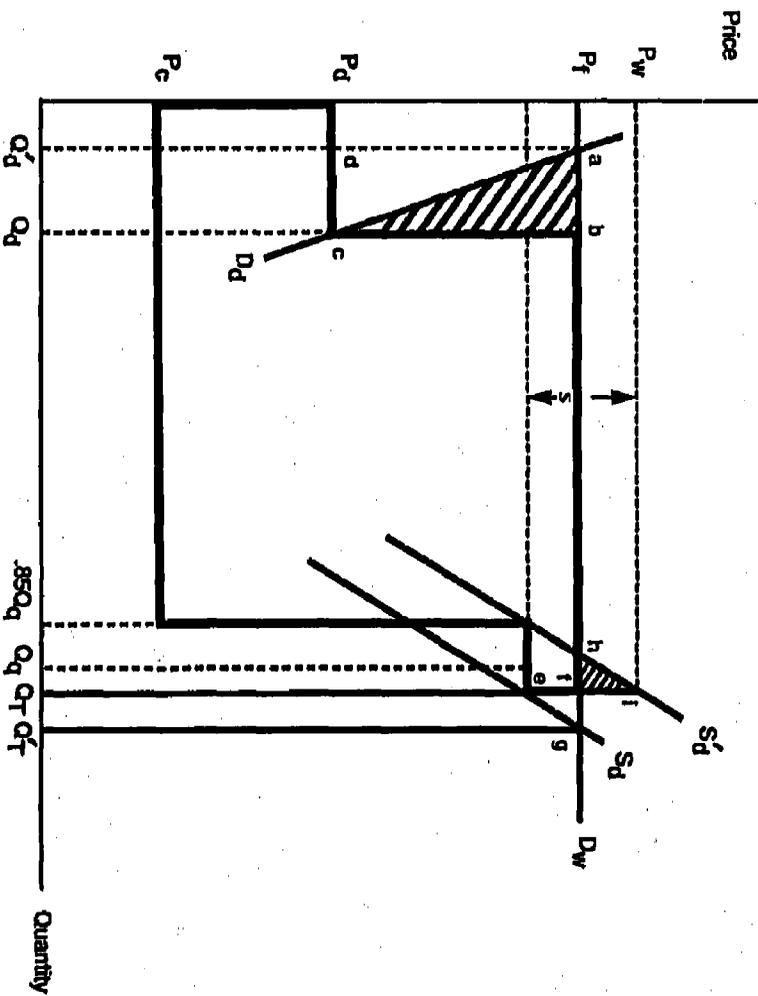
The \$1 billion transfer from domestic farmers to the government consists of two parts. One part is the income foregone in selling 85 percent (1992 state order) of the planned production to the state purchasing agency at the controlled price rather than at the world price. The other part is the implicit tax on export sales of the free quota and the over-quota production, which has to be sold through state trading organizations. A portion of the transfer to the government is used to subsidize domestic sales of cotton fiber, which is sold internally at a price slightly less than half the world price. These sales to consumers at below-world prices constitute a consumer subsidy equal to the value of the cotton consumed domestically less the value at domestic prices, representing approximately \$120 million.

On the other side of the ledger is the transfer back to farmers through the heavy subsidization of agricultural inputs, including water and imported inputs. An earlier estimate of agricultural subsidies calculated that cotton farmers received a subsidy of approximately \$670 million in 1992 (World Bank 1993). The net transfer out of agriculture—the implicit tax on farmers—was therefore approximately \$370 million.

The welfare cost of the implicit taxation of cotton is high. The government establishes annual production targets (quotas) for cotton farmers. Seventy-five percent of the quota amount must be sold to a state purchasing agency at a controlled price of approximately 12 percent of the world price fob Tashkent. A 5 percent export tax is imposed on any exports of the free-quota over-quota production.

Uzbekistan's market for cotton fiber can be depicted graphically (figure 10.1). D_w and D_d are

Figure 10.1 Income Transfers and Welfare Costs in Uzbekistan's Cotton Sector due to Production Quotas and State Order System, 1992 (U.S.\$ millions)



Income Transfers:

Estimates of:

Transfer to domestic textile mills

\$117

Gross transfer from producers to state order system

\$1,034

Input subsidies to cotton producers

\$667

Welfare Costs:

Deadweight loss due to sale to domestic textile mills at a subsidized price

\$31

Deadweight loss due to input subsidies

\$14

Box 10.2 Chronology of Main Trade Reforms, 1994

1994	
January 21	Significant reduction in the number of items subject to export licensing to 26 items (covering, however, the majority of the value of exports).
February	35% tax on foreign exchange proceeds that had been introduced in May 1993 was removed. A 15% surrender requirement at the official exchange rate and a 15% foreign exchange tax were temporarily introduced.
February	Import duties abolished temporarily until July 1, 1995.
April 11	The 35% hard currency tax on foreign exchange receipts eliminated by Presidential Decree (but a 30% currency surrender requirement instituted in its place. Given that the official foreign exchange auction undervalues foreign exchange by 80%, the implicit foreign exchange tax has been reduced to 24%).
April	A 30% surrender requirement at the official rate was introduced. Weekly foreign exchange auctions were implemented to determine the official rate. By June 1994, the implicit foreign exchange tax was therefore reduced to approximately 24% because the official exchange rate remained undervalued by about 80%.
June 24	Uzbekistan obtains observer status with the GATT.

the world and domestic demand for cotton fiber. For simplicity, it is assumed that Uzbekistan is unable to affect the world price of cotton fiber, so the world demand curve is drawn perfectly elastic at P_w . The domestic demand is also assumed to be elastic. Over 55 percent of textile mill products are exported and these external consumers are likely to have ready access to alternative supplies. However, D_d is not perfectly elastic.

Domestic farmers face two prices, which form a rising step function. The first price, P_c is the controlled price at which Uzbek farms were required to sell 85 percent of their 1992 quota output Q_q . This

is represented by a horizontal line at price P_c up to quantity $.85Q_q$. The second, higher price, P_f is the price for the free quota amount, or distance $Q_q - .85Q_q$ and the excess over the quota, distance $Q_T - Q_q$.

The total quantity of cotton fiber supplied, Q_T , is determined by the intersection of the domestic supply curve with price P_f . Domestic farmers increase sales until the marginal cost is equal to the highest price. The quantity of cotton fiber consumed domestically is determined by the intersection of the domestic demand curve with the controlled domestic price for textiles, P_d . Finally, total exports equal distance $Q_T - Q_d$.

It is relatively easy using figure 10.1 to describe the consumption and production effects of Uzbekistan's policies on the cotton sector. By reducing the price received by farmers at the margin from P_w to P_f , the 5 percent export tax causes sales of cotton fiber to fall from Q'_T to Q_T . The quantity farmers would supply at price P_w is Q_T . Domestic textile mills are charged a price below the world price. The quantity consumed locally rises from Q'_d to Q_d . The sum of these two effects (the reduction in supply and increase in local consumption) is the reduction in Uzbekistan's exports. The corresponding decline in export earnings is the sum of areas $P_w(Q'_d Q_d)$ and $P_w(Q_T Q'_T)$ (Note that the efficiency or deadweight losses to the country consist of the small triangles above the demand curve, abc , and under the supply curve, hif). The two transfers are shown by area $P_w b c P_d$, which is the consumption subsidy to domestic textile mills. The second is the area bounded from above by P_w and from below by the step function and distance ef , which is the resource transfer from farmers to the government.

The heavy subsidization of inputs also needs to be taken into account to get the full picture of resource transfers and welfare effects. These subsidies create an incentive to waste resources by obscuring the true resource cost of cotton production. The total cost of the resources used in producing additional units of cotton is reflected in curve S'_d . If farmers operated along this curve production would be at point h , where the curve intersects the world price. Now if farmers receive a per-unit sub-

sidy of s , then the supply curve S'_d shifts down by the amount of the subsidy to S_d , which is the farmers' new supply curve and reflects their (private) costs of producing an additional unit of output. Farmers expand production until S_d intersects P_w , and resources are wasted because too much cotton is produced. The waste of resources is reflected in the triangle above P_w and below S'_d , at the margin the cost of the resources embodied in the additional unit of cotton produced exceed the value of that additional unit on the world market.

The Payments Framework for Trade

Until 1994, the payments system posed yet another obstacle to trade expansion with large arrears, currency inconvertibility, and a reliance on barter and clearing arrangements. In 1994, Uzbekistan transferred some \$600 million in gold abroad as collateral for trade credits, allowing much of its trade to clear through payments in correspondent accounts held by the government in foreign Swiss banks. However, the inconvertibility of the sum still presents a major impediment to trade and to the achievement of macroeconomic stability.

The payments systems for trade among ex-Soviet republics collapsed as hyperinflation of the ruble led to a flight from ruble currency holdings. In the absence of a clearing mechanism and convertible currencies, the payments system ceased to function and clearing between the official correspondent accounts at the Bank of Moscow became a matter of bilateral negotiations.

Trade with Russia is governed by a bilateral trade agreement that provides for a technical balance to settle net trade transactions. Significant payments problems remain, however, because technical balances can be used only to settle the trade balance not individual transactions. Russia demands cash payment for many of its exports to Uzbekistan, while Uzbek products do not obtain similar treatment from Russian importers.

Preparations for the establishment of a multi-lateral clearing bank using the ruble as the unit of account came to a halt in early 1994. In its place remains the network of government-held correspondent accounts at commercial banks that use hard

currency and Russian rubles as vehicles to finance trade.

Recommendations for Trade Policy in the Transition

As part of the structural reform program, Uzbekistan should focus on providing a supportive incentive framework for trade that is free from the restrictions on exports and imports (state orders, state trading, and an export licensing system) that distort production and trade. What it needs is a policy framework that evens the playing field in all productive activities for domestic and foreign markets by moving toward market and international prices that maintain government revenue during the transition through privatization and the elimination of most import subsidies that integrates Uzbekistan into the world trading community by supporting its application to the GATT.

Revenue concerns can be met through privatization beginning with trading, telecommunications, and transportation companies; a land leasing program in agriculture; the imposition of uniform trade taxes (on imports or exports) with few exemptions; and the phasing in of a value added tax on imports. The design of a new legal framework will also be important, to ensure property rights, orderly bankruptcy, enforcement of business contracts. The introduction of a fully convertible currency and full access to foreign exchange will be critical along with a clearing up of international and domestic arrears.

To reduce the adjustment costs associated with the movement of resources from contracting to expanding sectors and to avoid the risk of short run reversal of the trade liberalization process, reforms should be phased in and should involve changes at various stages- immediate, medium term, and long run. But if the pace is too slow, opponents of trade reform have time to mobilize to undercut the program. High tax rates, explicit and implicit should be eliminated rapidly along with any exemptions. As tax rates are reduced, the tax base should be broadened and voluntary compliance encouraged so that fiscal revenues do not fall too dramatically during the transition.

Guiding the reform should be the objective of removing the state from trading activity. That would involve authorizing private trading companies and also abolishing the state order system, particularly for cotton. Producers should be allowed to sell cotton freely at market prices, both domestically and internationally, without state interference. A cotton exchange could be set up at the commodity exchange. The currency surrender requirement should be abolished, and foreign currency should be freely bought and sold by all banks at market rates. The auction of foreign currency at the central bank that is now restricted to few commercial banks should be reformed immediately. Membership in GATT should be pursued actively. There is not a path to growth through state control of trading activity for Uzbekistan. The history of many similar failed attempts throughout the world attests to that truth.

Annex: Data Used to Develop Estimates for the Cotton Sector, 1992

Given assumptions about the price elasticities of domestic supply ($\epsilon = -1.5$) and demand ($\eta = -2$), the various changes and transfers are calculated by the following formulas.

- Gross resource transfer from farmers to government: $[(P_w - P_c) 0.85Q_q] + [P_f(Q_T - 0.85Q_q)]$
- Subsidy from government to farmers: sQ_T
- Reduction in domestic consumption: $Q_d[1 - (P_w/P_d)e^\eta]$
- Consumer subsidy: $(P_w - P_d)Q_d$
- Increase in domestic production: $Q_T[(P_w/P_f)e^\epsilon - 1]$
- Increase in export earnings: $[P_w(Q_d - Q'_d)] + [P_w(Q'_T - Q_T)]$

The data used in these formulas are as follows:

- $P_w = 1,171,500$ rubles per ton f.o.b. Tashkent.

To estimate P_w , we began with a price of \$1,065 per ton, based on Ministry of Agriculture figures of \$1,060 and \$1,070 per ton for 1992. These prices reflect a \$40 and \$148 per ton discount due to uncertainty of quality and delivery. (These discounts are consistent with the \$88 per ton discount reported in World Bank 1993a. The dollar price was converted to rubles using an exchange rate of 1,100 rubles per dollar. [Source: Ministry of Agriculture].

- $P_d = 500,000$ rubles per ton.

This estimate is the midpoint of three different estimates provided to the World Bank mission by the Ministry of Trade: 400,000 rubles, between 500,000 and 600,000 rubles, and between 400,000 rubles and 600,000 rubles.

- $P_c = 141,000$ rubles per ton

Based on an average of prices from May 1 to June 28 for grade 1 cotton fiber provided to the agricultural trade mission by the Ministry of Agriculture.

- $P_f = P_w(1 - t_f) = 1,112,925$ rubles per ton.
- $t_f = 5\%$ export tax.

Cotton farmers pay an export tax of 5 percent on export sales of the free-quota output and the excess over quota output. This price is consistent with the price of 950,000 rubles per ton provided to the agricultural mission by the Ministry of Agriculture. The 5 percent export tax was still applied as of August 1994.

- $Q_q = 1,281,100$ tons.
- $Q_T = (1.05)Q_q = 1,345,000$ tons.
- $0.85Q_q = 1,088,000$ tons.

The Ministry of Agriculture provided an estimate of the total production of raw cotton fibre (Q_q). There is no information on the quota amount or the excess over quota; the excess over quota was assumed to be 5 percent of the quota amount.

- $Q_d = .15(Q_q) = 192,000$.
- $Q_d^i/Q_d = (P_s/P_d)^{\epsilon^{\eta}}$
- $Q_d^i = 3,456$.

Calculating the change in domestic consumption requires an estimate of domestic consumption and of the own-price elasticity of demand, η . Domestic consumption is approximately 15 percent of reported output, and is assumed to have a value of -2, a modest estimate since over 50 percent of textile products are exported to consumers having alternative supply sources. The formula is simply the definition of the own-price elasticity of demand:

- $Q_T^i/Q_T = (P_w/P_f)^{\epsilon^{\epsilon}}$
- $Q_T^i = 1,447,000$ tons.

The production level under free trade is derived in a similar fashion. The formula is the definition of the elasticity of domestic supply, in light of the economy's structural rigidities (the state order system), we assume a modest supply elasticity of 1.5

- $s = \$496$ per ton.

To obtain an estimate of the subsidy per ton of cotton fiber, we began with an estimate of the subsidy to agriculture as a whole developed in World Bank (1993a). Next, we assumed that the cotton subsector's share of the total subsidy would equal its share of the total transfer out of agriculture, which for 1992 was 78 percent. The total subsidy to cotton was then divided by the total 1992 production to obtain a per ton estimate of \$496.

Notes

This chapter draws on work of a World Bank mission led by the authors and comprising José Mendez (Arizona State University), Helga Muller (World Bank), Refik Erzan (Bogazici University), Carlos Rodriguez (Center of Macroeconomic Studies, of Argentina) and Hong Wei (World Bank). The authors benefited from helpful substantive comments from Dani Rodrik, Michael Michaely, Alan Winters, Costas Michalopoulos and David Tarr. Anthony Aylward and Stefano Bertozzi assisted in its preparation.

1. Mainly, we believe, to lower domestic prices of imported foodstuffs and energy.

2. Note that in 1993, hard currency exports included significant gold sales which were previously reflected as foreign reserves.

3. INTERALOKA handles all foreign trade (export/import of consumer goods, equipment, rice and tea) with countries in the far east (e.g. China, Indonesia) and those near the border (e.g., Afghanistan); UZAGROIMPEX handles trade in agricultural goods; INNOVATSIA handles all technology transfers by, for instance, assisting joint ventures or conducting feasibility studies; UZMEDIMPEX handles imports and exports of medical equipment and medicine; UZPROMMASHIMPEX handles exports and imports of raw materials, gas and oil; UZLEGIMPEX handles the export and import of light industry products which consist largely of textiles; and PROMSYRYO handles the export and import of industrial raw materials. Four companies handle international transportation: UZINTRANS and UZVNESHTRANS (now a German-Uzbek joint venture known as Central Asia Trans) provide transport services for all types of products to foreign and CIS countries, while two companies limit themselves to agricultural products: UZAGROPROMTRANS and UZPLODOVOSVTRANS.

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Institutional Policies for Export Development

John Nash

In recent years most developing countries have come to recognize the importance to their development prospects of a successful export strategy. Among the benefits of a more robust export sector are stronger links with the world economy that allow for the transfer of technology to improve productive efficiency and increased foreign exchange earnings with which to purchase needed imports. From the "tigers" of East Asia to the more recent success stories in the Western Hemisphere, all countries that have attained and maintained high growth rates have done so on the basis of rapid expansion of exports.

Many policies of the Soviet Union had the opposite effect of discouraging exports. The orientation of the central planning apparatus toward self-sufficiency led to managed trade, supported by various implicit and explicit taxes and restrictions on exports. These included controls on domestic prices to keep them below world price levels, quantitative barriers, and exchange controls. The price differentials created by these controls have led to large-scale illegal exports, accompanied by massive corruption.

While some successor states have reduced or eliminated such restrictions, many have continued the old policies, sometimes with slight modification. The problem is especially severe for raw materials, but is also serious for manufactured exports. Meanwhile, trade and payment arrangements have broken

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down. As a result exports have been declining rather than growing, and much of the remaining trade has taken place through inefficient mechanisms such as barter.

The experience of countries around the world shows that many of the most important policies for encouraging exporters are not specific to the export sector. Though it is important to ensure that exporters receive duty-free and restriction-free access to imported inputs, it is even more important to ensure a realistic exchange rate and overall macroeconomic and trade policies that are conducive to stability and growth in the economy as a whole. To promote exports, priority should be given to eliminating gross macroeconomic distortions. Even the best policies for promoting exports cannot fully offset the antiexport bias of unsatisfactory general economic policies. Since taxes or restrictions on exports are still prevalent in the countries of the former Soviet Union, the most urgent tasks are to remove these, stabilize macroeconomic imbalances, and reform the exchange systems (chapter 13 of this volume). Next, in the context of an appropriate general policy framework, certain institutional policies aimed at supporting the export sector will become important. This chapter focuses on issues of greatest relevance for manufactured exports.

Exporters to world markets face a very competitive environment. Most exports from developing countries are produced in accordance with the specifications of the buyer. Buyers want products to be shipped ready for sale or use upon arrival, with little or no further preparation (Keesing 1983, 1991). That means that the exporter must have available everything needed to bring the product to this point. Buyers change specifications quickly to meet changing demand in the world market, and they require on-time delivery. Thus, exporters must also be able to adjust quickly. To be competitive, then, exporters must have access to all necessary imported inputs at world prices, without delays, and on a reliable basis. Ensuring that access is the purpose of the various duty exemption and drawback schemes described in the next section.

Production of exports also requires nontangible inputs, such as financial, marketing, and informa-

tion services. Successful export policies facilitate access to these productive inputs. The third section discusses how this should be done.

Ensuring Access to Imported Inputs

Countries have several options for ensuring exporters quick, reliable access to imported inputs at world prices. These are across-the-board duty-free imports, duty exemption or drawback schemes, and export processing zones (and related schemes).

The Duty-Free Option

One way to ensure exporters access to imported inputs is to make the whole economy a duty-free zone, by imposing no duties or other restrictions on imports (except goods restricted for security or public health considerations). There can also be no controls on access to foreign exchange for imports. Hong Kong and Singapore,¹ two of the most successful exporting economies, have taken this approach. This has the obvious advantage of eliminating the antiexport bias inherent in restricting or taxing imports. It also has the virtue, not shared by the other schemes discussed below, of imposing little administrative burden on the government and almost no paperwork requirements on exporters. It gives exporters more flexibility about where to locate (they are not tied to one location, as they are with some other schemes) and what and when to produce (they can try to export something new without fear of having to pay import duties and penalties if they find themselves unable to export the shipment within the allowed timeframe).

Although they continue to maintain many other restrictions on trade, some countries of the former Soviet Union have very low tariffs on imports. Some, such as Uzbekistan² and the Kyrgyz Republic, appear to be following the Hong Kong and Singapore model by eliminating (or refraining from imposing) tariffs on imports altogether. Most of Ukraine's tariffs are between zero and 10 percent, though a few are as high as 30 percent. But most imports are exempt or enter under preferential arrangements that subject them to rates of only 2 to 5 percent. Russia's tariffs are not very low, but it has a free-trade agreement with all the other coun-

tries except the Baltics and Ukraine, and it charges no tariffs on imports from Ukraine (IMF 1993). Some central Asian countries have entered into their own free-trade agreements, as have the Baltics. Even on imports from the rest of the world tariffs are relatively modest in most countries, between 5 and 15 percent.

These tariff regimes were not motivated by a desire to provide free-trade status for exporters, and other controls are in place that restrain trade. But the relatively low rates imply that, in contrast to many developing countries, some of the countries are not relying heavily on import duties for revenue or for protection for inefficient domestic producers. That puts these countries in an excellent position for adopting free trade as an export strategy, though there will be some revenue implications. For most countries, even those that currently have low tariffs, adopting this strategy would still imply an important policy shift, since it would require eliminating exchange controls, at least for current account transactions. Ukraine, for example, has low tariffs on most imports but uses stringent exchange controls, which are especially damaging to small firms (see chapter 3 of this volume).

For economies without tariffs, and for those with very low input tariffs, the issues discussed in this section are not of crucial importance compared with other problems in trade policy. As currencies in some countries have appreciated, however, there has been increasing pressure to raise tariffs. Latvia and Lithuania recently raised their tariffs, though, even so, they remain moderate by the standards of developing countries (*Baltic News*, October 15-22, 1993). In any case, as tariffs increase, having a scheme for exempting exporters becomes more important.

Duty Exemption and Drawback Schemes

Duty exemption and drawback schemes exempt exporters from paying tariffs on imported inputs used in the production of exports, or allow them to get a rebate, whether the exports represent all or a fraction of their total production. Thus, unlike the export processing zone and in-bond manufacturing arrangements discussed below, produc-

ers do not have to export 100 percent of their production to qualify. The systems should also provide for exemption or rebates on indirect taxes paid on inputs into exports, which requires estimating the fraction of imports that were incorporated into the exports.

Countries have successfully used several variants of this approach (Keesing 1991). Indonesia, Thailand, and Korea (before 1975) used exemption schemes. Korea now uses deferred drawbacks, while Mexico uses a temporary admission arrangement that is similar to exemption. In Indonesia exporters present an export plan showing the technical input coefficients for the imported inputs they need, with a bank guarantee for the tariffs on the imports. If the products are not exported within a set period, the manufacturer or the bank is liable for the duties. Similarly, in Taiwan, major, regular exporters can put their duty liabilities "on account" with a bank guarantee, and the liabilities are canceled upon proof of export within eighteen months. Firms that do not export all of their production and are not eligible for this scheme must pay duties, but they can get rebates quickly.

Several practical lessons from experience with these schemes in other countries are relevant for the countries of the former Soviet Union. First, if implemented properly, duty exemption and drawback schemes are the most useful tool for improving exporters' access to imported inputs where imports are taxed. Their big advantage is versatility. Unlike export processing zones or bonded warehouse systems, they can be used by all exporters. This is an especially valuable characteristic for small and first-time exporters, who are likely to be local entrepreneurs. Consequently, these, more than other schemes, can encourage the development of a domestic entrepreneurial base, which is needed in the former Soviet Union.

A second lesson is that they are not easy to implement successfully. Although most countries have exemption or drawback programs on the books, they are widely used by exporters in only a few countries outside of Asia. To be successful, a scheme must meet two partially conflicting goals. On the one hand, it must ensure that exporters get

all the imported inputs they need quickly and reliably and that they do not pay duties. On the other hand, it must protect against "leakages," in the form of goods sold illegally in the domestic market or tariffs illicitly evaded. The one goal argues for keeping documentation requirements and bureaucratic procedures simple, while the other objective requires more control. The more protected the domestic market (the higher the tariff structure), the greater the incentives to cheat, and so the more difficult it is to reconcile these conflicting goals. For better or for worse, most countries have tilted the balance toward guarding against leakages. As a consequence, exporters consider the systems as unduly burdensome and slow and do not use them.

Third, the successful schemes in Asia and a few other countries are generally based on technical input-output coefficients that show how much of a given input is used in manufacturing a given product, on average. With coefficients available for a large number of commonly exported products, computation of exemption and drawback entitlements can proceed rapidly, without the need for separate documentation for each shipment. (In Taiwan, China, coefficients for about 6,000 export products are published and revised yearly.) Ideally exporters should be entitled to an automatic exemption or rebate based on these coefficients, but with the option of documenting that their product or shipment used more input than the coefficients imply. Clearly, this arrangement is quite intensive in its administrative machinery, which could make implementation of this kind of scheme difficult in countries of the former Soviet Union.

Fourth, subject to the caveat below, exemptions are generally preferable to drawbacks. Drawback systems typically do not allow exporters to automatically circumvent nontariff barriers to imports, whereas exemption or temporary admission schemes do. Also, from the point of view of the exporter, it is costly to have funds held by the government — particularly in an economic environment of high inflation and interest rates and a shortage of trade finance, as is common in much of the former Soviet Union. Of course, even with a well-functioning exemption scheme based on standard

technical coefficients, it may be useful to have a drawback scheme for exporters of products for which coefficients have not been documented. The caveat is that it may be easier to guard against abuse of a drawback system, since funds are reimbursed only upon proof of actual exports. In cases where institutional weakness would lead to rampant abuse of an exemption scheme, and where tariff revenue losses would be a serious problem, there is a stronger case for using a drawback scheme until the enforcement machinery can be strengthened.

Fifth, if possible, there should be some provision for indirect exporters (sellers of domestically produced inputs to exporters) to get exemptions or drawbacks for duties and indirect taxes on the imported inputs used in the supplies they sell to export producers. Including indirect exporters is very demanding administratively, however. Taiwan (China) used a system that minimized the burden on government administration by giving the full amount of the drawback (for duties paid on inputs used directly and indirectly in the exports) to one party, leaving distribution to the parties involved (Wade 1988). But many other countries have been unable to develop a workable system.

Finally, exemptions and drawbacks should be available on a nondiscretionary basis to all exporters. In some countries, entitlements to exemptions and rebates are granted as part of a fiscal incentive package after a firm presents an application to a ministry. In these cases, they are often given to import-substitute producers, undermining the objective of the system. This arrangement also provides an opportunity for producers to limit competition by lobbying against giving incentives to new entrants.

Export Processing Zones and Bonded Warehouses

Export processing zones (EPZs) and bonded warehouse facilities allow exporters to import inputs duty-free and without restriction and use them for manufacturing exports in one geographical location.³ The products made there cannot generally be sold in the domestic market, though some countries allow a small fraction of output to be sold locally. An EPZ differs from a bonded warehouse

in that it is usually an industrial estate, with infrastructure and factory space that is rented to tenants. Also, EPZ tenants are often exempted from non-trade taxes and from regulations related to labor (foreign and domestic) and foreign exchange. These systems are of interest only to exporters who plan to export all, or nearly all, of their production. For this reason, most of the users of such facilities are foreign investors who are not interested in local sales.

The major advantage of EPZs and bonded warehouses is that the policy regime can be set up relatively quickly. The administrative requirements and prerequisites are not as great as for exemption or drawback schemes, mainly because the required modifications of customs procedures are not as extensive.

However, their importance in the overall package of policies for economic development should not be overestimated. The performance of EPZs has not been very good when other policies have been antithetical to exports. At best, they can serve as a small part of an export-oriented policy package. Some 4 to 5 percent of developing countries' exports come from EPZs and somewhat more from bonded warehouses (World Bank 1991). EPZ exports are generally intensive users of imported inputs; most EPZ firms are assembly operations for electronics or garments. The local value added is usually less than 25 percent, and net foreign exchange earnings only 15 to 20 percent of gross export proceeds. And at least part of the net earnings are held in foreign currency accounts by the foreign-owned EPZ firms (Warr 1989). That means that the linkages with the domestic economy are limited, a major limitation of EPZs even in economies with otherwise successful EPZs, like Mauritius (Hachette and Nash 1993). The nature of the operations also means that opportunities for transferring technology to local entrepreneurs are limited. And, for reasons discussed below, the tax contributions of EPZs to the host country are also quite limited.

The administrative simplicity of establishing EPZs does not imply that they are easy to make successful. About sixty of the eighty-six EPZs in twenty-seven developing countries have been operating

long enough to make judgments about their effectiveness. About twenty-five (42 percent) of the sixty are largely successful as measured by the employment and exports generated and cost involved, eighteen (30 percent) are failures, and the rest somewhere in between (World Bank 1992). Most of the successful ones are in Asia, with a few others in Costa Rica, the Dominican Republic, and Jamaica.

The unsuccessful cases have low occupancy rates and impose a high cost on the government (infrastructure investment, operating cost, or both). The underlying problems are often a poor policy environment (interventionist regulations, for example); inadequate implementation of EPZ regulations, resulting in slow customs clearance and excessive paperwork; poor choice of location; and bad management, often including overbuilding based on unrealistic projections of demand for space.

Two features of the policy regimes in countries with successful EPZs stand out. One is that the countries all have relatively stable macroeconomic environments, with moderate inflation and exchange rates favorable to exporters. EPZs cannot attract investors to a country whose other economic policies are unsatisfactory. The second is that the best EPZs are run by an exceptionally efficient public body along business lines (the East Asian EPZs) or are privately owned (recently developed EPZs in the Western Hemisphere). Often, publicly run EPZs succumb to the problems cited above. Public officials are often under pressure to locate the zone in outlying, underdeveloped regions of a country, areas with the worst infrastructure and highest-cost transportation, making it hard to attract investors without high subsidies. And in most countries public sectors are inflexible in matters of hiring, firing, contracting, wages, and other personnel matters and often have salary scales that make it hard to compete with the private sector in attracting good managers.

Governments in a number of countries of the former Soviet Union have shown an interest in establishing EPZs or bonded warehouses. The government in Latvia is considering a proposal for an EPZ (*Baltic Business Report*, February 1993). In

Lithuania, there is an association of EPZs, though the law is only now being drafted and none has actually begun operation (*Baltic News*, December 18-24, 1993).

In Russia, where import duties pose a problem for exporters (chapter 2 of this volume), the government is developing EPZs. Draft laws on EPZs have been discussed, but not passed, and the new customs code includes provisions on bonded warehouses (as well as exemptions and drawbacks), and implementing regulations are being drafted. Several areas have been declared free economic zones (FEZs), essentially making them large EPZs. Among them are areas in Nakoddka, the Kurile Islands, and Moscow's Sheremetyevo Airport; several others are in the planning stage (*East European Investment Magazine*, Fall 1993). Each one seems to have its own package of incentives, with most including simplified customs procedures, direct local registration of joint ventures, guarantees for foreign investors, and some tax breaks.

Lack of coordination and agreement between federal and regional authorities, has been a problem however. For example, the first FEZ, at Nakoddka, was technically begun in 1990, and in October 1992 the Nakoddka FEZ Committee adopted the necessary regulations to allow duty-free import for export. But after only a month the Federal Customs Service suspended the duty-free regime, claiming that the regional authority could not act unilaterally. But the federal authority had no alternative duty-free regime, since the federal law on EPZs has yet to be implemented. The Nakoddka zone finally opened officially in May 1993. Some eighty firms from the Republic of Korea have announced plans to begin operations in an area of the zone allocated to that country, making consumer goods, electronic products, and food products. Over 240 joint-venture firms have also expressed interest.

In the Baltics proposals for EPZs appear to be based on the private ownership model (*Baltic Business Report*, February 1993). In Latvia (and perhaps other countries) negotiations over whether and under what conditions to grant permission to build an EPZ appear to involve a single potential investor, whose plan would give the EPZ developer

exclusive rights to develop future EPZs as well. Such a legal monopoly could have large costs in the future, if the initial developer turns out to be a poor manager or to have limited funds to invest in Latvia. The government is also reported to be using site selection as a criterion for deciding whether to accept the proposal, which could eliminate one of the main advantages of private ownership (site selection based on economic and financial criteria rather than political). Overall, a better approach to the EPZ legislation would be to put in place a transparent framework for approval of EPZ proposals, with automatic approval for proposals that meet the criteria, rather than negotiating with investors on a case-by-case basis.

Most countries of the former Soviet Union ought to promulgate laws to facilitate the establishment of EPZs and bonded warehouses, but with careful attention to the lessons of experience elsewhere and only as a small step in an overall export strategy. The development of EPZs should not steal attention from more important reforms to improve the overall business environment. The sources of comparative advantage for these countries appear to be their highly educated populations and natural resource endowments. These favor the development of industries requiring skilled labor or those based on resource processing. The industries usually attracted to EPZs are low-skilled assembly operations. For this reason, no one should expect spectacular results from EPZs alone.

EPZ laws and regulations should be based on private ownership and development of the zones, including the infrastructure of the zone. That will lessen the problems related to site selection and management, as well as the government's exposure to financial risk. The government's financial involvement, if any, would be limited to investment in infrastructure in the surrounding area and the tax revenue forgone through tax exemptions to zone tenants and developers. This government involvement should be kept small, commensurate with the limited benefits expected for the rest of the economy. In particular, the government should look skeptically at any proposal for expensive public investments for the zones that it would not make otherwise.

Successful EPZ legislation elsewhere has ensured that firms locating in EPZs (including the EPZ management) enjoy certain rights. These include the right of 100 percent foreign ownership and 100 percent profit repatriation, exemption from all foreign exchange controls, rapid customs clearance (which may require locating customs facilities in the EPZ and allowing customs officials to be paid by the EPZ to work overtime), rapid response to investment applications, and minimal regulatory control, especially over hiring and firing decisions.

Although tax incentives (in addition to exemptions from import duties) are usually included in EPZ promotional packages, surveys have indicated that investors consider other factors that create a favorable business environment to be more important to their location decisions. Tax breaks, if any, should be modest and should be in the form of low rates over a long period, rather than a zero rate for a short period ("tax holidays"). Tax holidays tend to attract industries and firms that invest little up front and therefore realize their profits early in their existence. After the tax holiday expires in one country, such firms, because of their low fixed costs, can easily move to another, or more commonly, threaten to relocate to get essentially permanent tax-free status (Warr 1989). Countries of the former Soviet Union should avoid tax holidays and should develop a harmonized policy on tax incentives to avoid bidding wars for foreign investors. Even so, not much tax revenue should be expected from EPZ firms, since experience shows that they are adept at transfer pricing with parent companies to minimize their tax liabilities.

Treatment of Value Added Taxes

In the confused economic environment that followed the breakup of the Soviet Union, many of the new independent countries established a value added tax (VAT). One of the VAT's major advantages over other types of taxes is its neutrality: it creates no artificial incentives relative to a regime without a VAT. Another is its broad base, allowing the government to collect a lot of revenue with a relatively low tax rate. But both of these advantages are undermined when the tax is applied in a dis-

criminatory manner. Exempting imports, for example, creates a bias against domestic producers who must pay the VAT and then sell their products in competition with imports that do not pay the tax. Likewise, the failure to give appropriate treatment to exports creates a bias against export sales.

In Ukraine, for example, there have been several changes in the way the VAT treats exports. The current method clearly creates problems for exports by differentiating treatment according to destination and type of transaction. Exports to hard currency destinations are not charged the VAT and are apparently eligible for rebate of the VAT paid on inputs. Imports in these currencies are charged the VAT, but only on the difference between their border price and their domestic selling price (the "margin"). Exports to other countries of the former Soviet Union are not charged the VAT, but neither are they eligible for rebate of the VAT paid on inputs; imports from these countries are not charged the VAT. The VAT is assessed on all barter trade, with no rebates for VAT paid on inputs, creating a double bias against barter exports.

Russia levies the VAT on imports (their full value), but not on exports, and exports are eligible for rebate of the VAT paid on their inputs. However, around one-third of all imports seem to be exempt from the VAT. The VAT is not charged on imports from other countries in the former Soviet Union with which Russia has negotiated free-trade agreements. Such exemptions exacerbate the transshipment problem inherent in free-trade agreements; countries that are not parties to the agreement will try to ship goods to Russia through a country that has low (or poorly enforced) tariffs to avoid paying Russian tariffs and VAT.

Inconsistency in how the VAT is applied to trading partners can create a bias against exports. For a VAT designed on the destination principle, as it is in most countries, the full rate should be charged on the value of imports, and the same rate should be applied to domestic producers' value added (the difference between the value of their production and their cost of inputs). All exports should be eligible for an exemption or a rebate for taxes paid on inputs (imported or domestically produced) for their

exported production. Administratively, this should probably be handled as part of the duty drawback or exemption system. If the VAT is applied in this way, the domestic relative prices of import-competing goods, domestic goods, and exportables will be the same as they would be without a VAT.

Some countries of the former Soviet Union applied the VAT on an origin principle. The tax is charged on the value added of all goods produced in the country, both those exported and those consumed domestically. Like in a destination-based system, the effect is internally neutral (domestic relative prices stay the same). But exports to countries that use a destination-based VAT are taxed twice. To eliminate this problem, countries of the former Soviet Union ought to harmonize the way they apply the VAT.

Services for Export Development

Through links with parent companies abroad, foreign investors in the export sector of an economy typically have ready access to assistance producing or marketing their products on world markets. They also have access to international capital markets to finance their investments and fill their need for trade finance. Indigenous investors in developing economies are not usually nearly as connected—certainly not those in the former Soviet Union.

Information and Commercial Services

To sell their goods successfully in a rapidly changing world economy, exporters need to have ready access to information on the demands of potential buyers, on how to run their businesses so that they can meet those demands at competitive prices, and on how to get information on their products to the buyers in the outside world. Exporters need to know what buyers are looking for, what they expect exporters to do, and how to contact them (Keesing 1991). They also need to know how to manage their firm and organize their technical processes to produce in the most efficient way possible.

Some of the many service providers that exporters find useful are accounting and auditing firms, business publishers, credit rating and checking firms, customs expeditors, design and product

development consultants, engineering and production consultants, export market research and analysis firms, foreign firms' buying offices and agents, foreign trade consultants, management consultants, marketing consultants, procurement and purchasing agents, product inspection and quality control firms, shipping agents and freight forwarders, testing and certification laboratories, trading (import-export) firms, and warehousing and storage firms (Keesing and Singer 1990). Some of these services are important only for relatively mature export industries. (Product design advice, for example, is useful only for firms that are not producing according to buyers' specifications.) But most of these services are needed by exporters at all stages of development. These services have been readily available to exporters in each of the Asian "Tigers" (Keesing 1988).

They seem to be largely unavailable in the former Soviet Union. Even in Latvia, one of the more business-friendly of the countries, the low quality—or absence—of service providers has been identified as an important constraint on export expansion (chapter 6 of this volume). One of the few service providers is the Chamber of Commerce, which maintains a small information center based on reference books and information from its members and clients. For a small fee the chamber also facilitates the issuance of certificates of origin, which are required under the free-trade agreements with EFTA and for Generalized System of Preferences (GSP) access. The Chamber of Commerce in Lithuania also provides general business-related information, but it is not adequate to serve the needs of exporters.

The Estonian Export Council has been more active in providing export services. A joint public-private enterprise with membership fees and service charges, it is 80 to 90 percent self-supporting. It carries out research tailored to individual client's needs, provides information on firms to potential buyers, organizes trips to trade fairs, and issues a monthly publication on trade-related matters, including an excellent summary of laws and regulations. It has been investigating the possibility of establishing a "Trade Point," a contact for potential

traders to get information through an automated information retrieval system linked to other countries around the world, as recommended by UNCTAD (UNCTAD 1993). In addition to the council, exporters have access to information from the Euroinfo Center, an EC network of 1,000 business information offices, which has been working in Estonia under the Ministry of Foreign Affairs for over two years. Exporters and importers can also avail themselves of the services of more than 100 private companies registered as customs clearance agents.

In Russia marketing problems rank high on the list of obstacles for exporters. One critical problem is that potential exporters lack information on standards related to sanitary or safety concerns in external markets. While most exports of "strategic goods" are marketed through foreign trade organizations, manufactured products seem to be marketed largely through links with foreign partners. The foreign trade organizations have not generally developed overseas marketing capabilities, since the goods they have dealt in have not required much marketing. The Russian Chamber of Commerce has not given much overseas marketing support either, other than to organize some trade fairs overseas for exporters. The Chamber has been more active in sponsoring fairs in Russia. It also provides inspection services for imports and exports and helps resolve trade-related disputes.

There are a number of approaches for providing needed services to exporters, through both the public and private sectors. Most of the services, including much of the information needed by firms, are firm-specific. For all the reasons that the private sector is the best supplier of other firm-specific goods and services, it is likely to do a better job than the public sector in meeting these needs of exporters. There are generally many sources in the private sector, including firms that supply the services commercially, chambers of commerce, and trade associations. In the successful exporting economies of East Asia most of the information flow was within the private sector (Keesing 1988). Private trading companies even maintained their own overseas offices for marketing and intelligence services.

Firms in the former Soviet Union that have links with international partners can rely on their know-how for many of their marketing and other service needs. Some firms in Russia are doing that now. This is one of many reasons why such links are valuable and should be encouraged as a matter of policy.

Exporters that are just getting started and that have no foreign partners will be likely to purchase services from other providers, rather than going "in house." Government policy should facilitate the development of local providers and exporters' access to foreign providers. To a large extent, the first objective can best be met by establishing a generally probusiness environment and then letting providers set up shop to meet the needs as they arise. That is how customs facilitators sprang up in Estonia, for example. For many kinds of services, however, international companies will be far better prepared than local ones to meet exporters' needs. The government should allow foreign companies to establish branch offices locally. Also, for countries that do not yet have convertible currencies, exporters need to be allowed easy access to foreign exchange to pay foreign consultants and to travel abroad themselves.

On the public sector side a potential source of services to exporters is the official trade promotion organization. Most developing countries have such organizations, but nearly all of them have been ineffective (Keesing 1991). The bad overall policy environment in many countries has diminished their usefulness. Their success in East Asian countries was due at least partly to their establishment after the pro-trade policy framework was in place (Keesing 1988). Also, these organizations were started on a scale smaller than those in many developing countries recently—and they remained several orders of magnitude smaller, relative to their economies' exports.

There is a good case for providing some services through an official trade promotion organization. Services with characteristics of a "public good"—when provided for one firm, they provide benefits for other firms as well or for society at large—may, in principle, be most efficiently pro-

vided through a public agency. However, the services that meet this definition are quite limited. One problem with some trade promotion organizations is that they are overextended, trying to provide services that could be better provided by commercial firms, rather than restricting their activities to the provision of true public goods. Tasks that have some public goods characteristics include maintaining commercial representation abroad for promoting the country's image and business climate for investors and buyers, facilitating participation in trade fairs, collecting information of widespread interest on outside markets, and matching firms to potential buyers in a nondiscriminatory way.

International experience shows that it is easy for trade promotion organizations to become a drain on the treasury while providing little help to exporters. Some lessons are implicit in the discussion above: start small, keep the list of responsibilities short, and do not expect positive results if policies are unsatisfactory. At the current stage of export development in most countries of the former Soviet Union, small-scale public-private information collection and dissemination efforts along the lines of the Estonia model may well be sufficient.

Successful trade promotion organizations also share certain characteristics. Among them: substantial autonomy from the government bureaucracy (they are not part of ministries), competition from the private sector (they are not monopoly suppliers of services), and specific mechanisms to ensure private sector involvement in how they are organized and what they do (Graubart 1992).

In general, trade promotion organizations should charge fees that cover most of their costs, as is the case in Estonia. Despite some practical limitations, fees should be graduated to the extent feasible to reflect the degree of public good character of each service. For example, since market research may have spillover effects for many firms, even if primarily useful to one, there is some case for partially subsidizing it. But if there is some reason to subsidize a service, that is better done through a scheme that gives exporters vouchers that can be used in partial payment to the supplier of their choice, rather than through direct public sector pro-

vision of the service (Keessing and Singer 1990). Services to individual firms, if provided at all, should be charged on a full cost-recovery basis. For the most part such services should be left to private suppliers.

Financial Services

Like other commercial enterprises exporters require two kinds of financial services: one is credit for working capital and to finance their purchase of capital equipment, and the other is payment facilitation for transferring funds from buyer to seller.

Trade Finance in the Former Soviet Union

Both types of financial services are inadequate in the former Soviet Union today.⁴ In interviews with enterprises in Russia, the lack of financing for importing components and machinery was ranked as the second most important constraint (after problems with marketing capacity) on their ability to enter world markets. More than half the enterprises indicated that the most important source of financing for these imports is export earnings; more than half their export earnings are used this way. Commercial attaches in the interviews considered poor banking services and delays in financing for trade activities to be significant problems.

Though it had other serious flaws, the mechanism for financing trade in the Soviet Union had one virtue in common with modern systems: the role of banks in insuring buyers and sellers against the risk that the other party in the transaction did not perform as planned. For trade within or among republics, the seller's bank paid the seller 85 percent of the transaction amount upon shipment, then collected full payment from the buyer's bank, which in turn debited the buyer's account upon delivery or (if funds were insufficient) extended a loan. The seller's bank then remitted to the seller the 15 percent still outstanding. For exports to CMEA partners, the process was different, but the exporter was still paid upon shipment. For trade with partners outside the CMEA, Vnesheconombank (VEB) provided letters of guarantee for Soviet Union importers if requested by foreign sellers and usually required guarantees from foreign banks for the sale of

exports. The major problem with this system was that it guaranteed that any losses incurred by the banks would ultimately be absorbed by the central budget, thus eliminating any incentive to take actions to minimize risk. (For details, see the annex to this chapter).

With the collapse of the Soviet Union, a new bank was created to replace the defunct VEB. The continuation of the old payment request method fueled a growth in interenterprise arrears since it did not encourage suppliers to check the credibility of their partners. Suppliers still expected the banking system to collect payments from buyers. But the new commercial banks did not want to finance the arrears and shifted the burden to the trading enterprises. In response the Central Bank of Russia prohibited commercial banks from debiting the accounts of their clients without receiving permission from the owner of the account (a "payment order"). Under this system banks react to enterprise requests to make payments to sellers, without concern for the underlying trade contract. The critical role of banks in helping to ensure that payment was made as the goods were delivered was eliminated. Mistakenly, the Central Bank of Russia did not take any initiatives to encourage banks to facilitate the enforcement of trade contracts or to provide trade transaction-based finance. The result was that enterprises were forced to use riskier methods to finance trade transactions.

The most common method has been advance payments forced by monopoly sellers, with buyers bearing the risk of sellers' nonperformance. The second most widely used method of finance—imposed on weak sellers with huge inventories by buyers short on working capital—has been a combination of cash on delivery and deferred payments. Interenterprise arrears is another common method of trade finance. Also, a significant portion of trade between ex-Soviet republics has been carried out outside the banking system through barter and direct cash payments. There are no reliable hard numbers, but the best estimates of informed observers suggest that barter trade probably constitutes more than half of interstate trade, and that cash and other means of direct payment settlement make

up another 5 to 10 percent of interstate trade. This would imply that only about one-third of interstate trade was carried out by the banking system.

The mechanisms of fund transfer were changed in 1991 after the monobank system was abolished and commercial banks were allowed to operate. Banks in Russia now have to go through cash settlement centers to clear every transaction, dramatically slowing the clearing process. Large noncash transfers rely on paper delivery and in a country as large as Russia, the result is delays of three to four weeks in intercity payments within Russia, compared to three to seven days in 1991. Delays in interstate transfers are even longer and result in a huge credit float in favor of the Central Bank of Russia. In a highly inflationary environment such delays are disastrous for the liquidity of enterprises and confidence in trade contracts.

A decree of July 1992 prohibited direct fund transfers between regional cash clearing centers of the countries of the former Soviet Union, but the restriction was relaxed as countries created their own currencies. The wider use of commercial banks' direct correspondent accounts and more mechanized facilities has reduced some intercity and interstate fund transfer delays. Russian commercial banks may now maintain correspondent accounts in Ukrainian commercial banks, and vice versa. Clearing transactions through these accounts can reportedly take as few as three days.

Commercial banks have not yet established a system of granting loans based on careful screening for project profitability or loan payback criteria. Nor have they begun to grant loans based on self-liquidating trade transactions, even though this would be one of the best ways to select loans. So far Russian banks have granted loans mainly under pressure from shareholders, when the loans were backed by collateral, and when the central bank extended a directed line of credit for on-lending for specific industries or purposes.

Data are not generally available on exactly how trade with countries outside the former Soviet Union is being financed. Various assessments suggest that foreign banks provide from 10 to 40 percent of payment services for Russian enterprises

trading with third countries, not counting the official credit lines of Western government and multilateral credit agencies. For Russian enterprises almost all import payments made from offshore accounts are advance payments, while a fairly large percentage of offshore export payments are cash-on-delivery. The bulk of settlements made from Russia were undertaken by two banks—Vneshtorgbank (VTB) and the International Moscow Business Bank.

Some 60 percent of export payments are cash-on-delivery, about 30 percent are sight letters of credit, and the rest are usance letters of credit (bank guarantees that payment will be made over time). The low share of usance letters of credit is due to the small share of manufacturing exports, which usually require sales on a deferred payment basis, and the inability of the banking system to finance exporters who are willing to sell on credit. Russian exporters for their part, are so desperate to sell their often uncompetitive manufactured goods for hard currency that they are willing to take the risk of nonpayment even when exporting to areas of higher commercial risk (such as to developing countries and Eastern Europe).

Policy Implications

The breakdown of the old payment request system has enormously increased the risk of commercial transactions for both buyers and sellers. The risks are magnified by the lack of a well-functioning system of contract enforcement. The problems are particularly acute for international trade, though domestic trade is encumbered as well. These problems will only be fully resolved with the development and enforcement of a modern commercial code. But some things can be done in the short term to ameliorate them. What is needed are steps to encourage the development of a system of trade finance intermediated through the banking system, similar in some respects to the payment request system, but based on modern documentary payment methods. These would be most useful in facilitating trade within and among countries of the former Soviet Union, but would also improve the system of trade with other partners as well.

The first stage, which could be implemented immediately, would be a document against payment scheme. Getting it started will simply require changes in the order of payment and paper flow in the banking system. The paper flow will be the same as in the old payment request method. The supplier's bank takes the shipping documents and payment request from the supplier, mails them to the buyer's bank, and instructs the bank on the terms of releasing the documents to its client. (Any fees can be split by the banks.) The buyer's bank ensures that the buyer obtains title of ownership only against payment. Unlike in the old scheme, however, the buyer's bank does not take responsibility for payment collection. The attractiveness of the scheme is that it can be introduced immediately by decrees of the central banks, and commercial banks will have few problems with implementation, since they are already familiar with the scheme's basic elements.

Since the scheme does not allow suppliers to sell on credit—which is critical for many enterprises producing manufacturing goods (especially those under conversion)—the second step could be building a documents against acceptance scheme. This will require creating a legal instrument of enterprise-to-enterprise debt that banks can use as a "promise to pay"—a promissory note or bill of exchange. Until the 1930s bills of exchange (and promissory notes) were used extensively for domestic and international trade payments in the Soviet Union. The 1937 law on bills of exchange is still effective, and therefore provides a legal basis for implementing the system immediately, at least in Russia. The benefit of both the document against payment and document against acceptance schemes is that the buyer is protected from the risk of non-performance because goods are received prior to payment, and the supplier is protected from the risk of nonpayment because the bank will not release documents to the buyer unless the latter pays (document against payment) or accepts the shipment with a legally enforceable promise to pay later (document against acceptance).

Documentary collection methods do not protect suppliers from the risk that buyers will not

accept the merchandise when it is delivered. To lessen this risk, a documentary letter of credit method of payment should be developed. The major difference between documentary collection and documentary credit is that the bank, not the buyer, guarantees that payment will be made (if the supplier performs). As in documentary collection, it is easier to begin by building a mechanism whereby the bank guarantees immediate payment on delivery (sight letter of credit). As banks accumulate the credit history of their clients, they will be in a position to guarantee payments of their customers at a future date (usance letter of credit).

A two-step approach might be considered for introducing sight letters of credit. At first, if a supplier trusts the buyer's bank, the letter of credit scheme can be considered as a modified version of the existing payment request scheme. The buyer's bank would open sight letters of credit by blocking the relevant funds on the current account of the buyer. The issuing bank would require a full deposit from the buyer, remit payable funds to the supplier's bank, and deposit them in on-call correspondent accounts. This scheme ties up the funds of the buyer (which would have occurred anyway in the case of advance payment), but offers protection from the seller's nonperformance risk. As a second step, as trust between reputable banks is built, these banks will be in a position to confirm each other's letters of credit without asking for prior deposit of funds.

The most important policy role in the development of such a system is that of the central bank in each country. In place of the direct credit lines now being extended, each central bank should develop rediscount facilities for these short-term, self-liquidating trade finance instruments, which will encourage commercial banks to participate in financing domestic and international trade. To avoid discounting nonperforming loans, only loans backed by export or domestic letters of credit, bills of exchange, and other negotiable instruments should be included in the facility. These are relatively secure forms of financial instruments, because each is backed by an underlying transaction and is self-liquidating. The Federal Reserve System of the

United States, as well as the Bank of England, have long used such "bills" as the basis for their credit facilities. This rediscount facility should largely replace the current practices of some central banks, which issue credit mainly through credit lines directed to selected enterprises or sectors.

Each central bank should support the development of letter of credit mechanisms by issuing criteria and regulations clearly defining what kind of instruments are eligible for rediscounting. This will, in turn, encourage the standardization of the documents and contracts. The criteria should aim to make the instruments widely accepted. For instance, the Central Bank of Russia could revise its decree of July 1992 so the letters of credit are in line with standards of the International Chamber of Commerce, which would make them internationally acceptable.

Ultimately, all commercial bankers must be asked to handle modern methods of payments and related trade finance mechanisms. In Russia, however, the use of rediscount mechanisms should be limited initially to international standard banks in order to reduce the risk of misuse of the mechanism.⁵

Other measures, most requiring legislative action, could improve the foundation for the trade finance system. For example, several measures could be taken to strengthen contract enforcement: passing a bill of exchange act allowing bills of exchange to be backed by property, creating private notary offices that offer certification of protested bills of exchange, creating an interstate arbitration court (encompassing disputes about bills of exchange), obliging commercial banks to expedite collection of payments from clients deemed liable to pay under court decisions, and creating a special file of the collection orders issued by courts or arbitration bodies and instructing banks to debit the accounts of their clients to fulfill such orders.

Interstate Clearing Arrangements

Interstate trade has been disrupted not only by the breakdown of the banking system, but also by fears that exports to countries with inconvertible currencies would result in the accumulation of unwanted balances in these currencies, uncol-

lectible arrears, or transshipment of the products to hard currency areas. These fears have kept alive the system of bilateral trade agreements with provisions for compulsory delivery and agreements on maximum volumes of goods that may be traded without restriction.

The reestablishment of a viable system of trade finance based on correspondent banks and trade conducted in a mutually acceptable currency is one step in resolving these problems. Another might be to establish a multilateral clearing facility, either a clearing union or a payments union. Both types of facility would allow interstate trade to be transacted through any bank, even one without a correspondent account in the partner country. At each end of the transaction (payment or receipt of payment) the buyer and seller would deal with their own domestic bank. Each bank would pay or receive payment in domestic currency from its central bank. Each central bank would maintain an account in the clearing facility, which would be debited or credited for each transaction in some clearing unit of account. (This could be dollars, SDRs, or even rubles, if they stabilized enough to become a good store of value.) At some established interval each central bank's account in the clearing facility would have to be settled in the clearing unit of account or some other mutually acceptable currency. In the former Soviet Union, it might make sense to adopt the ruble as the currency of settlement. A clearing arrangement should complement, not substitute, for the use of correspondent accounts. A trader should have the option of carrying out a transaction through either mechanism.

The major difference between a clearing union and a payments union is how soon accounts must be settled. The settlement period is short for a clearing union—generally no longer than a month—whereas a payments union allows countries to accumulate deficits over a prolonged period. Therein lies its danger. In other payments unions, countries with the worst macroeconomic policies, which usually are also running the biggest trade deficits, have been rewarded by being allowed to run up sizable arrears. To avoid this perverse incentive structure, a clearing union is preferable to a payments union,

especially in the economic context of the former Soviet Union. A proposal for a multilateral clearing facility under the Interstate Bank garnered some interest, but appears to have foundered in early 1994 for reasons discussed by Gros in his comment on this chapter.

Longer-Term Issues

Some governments, concerned about the problems exporters face in receiving credit, especially long-term post-shipment credit that would allow manufacturers to offer deferred payment to buyers, are contemplating establishing government agencies to grant or guarantee such credit. For example, the Russian government's *Manufactured Export Development Strategy Paper* proposes creating an agency to provide insurance and guarantees for export credit, as well as an export-import bank to finance exports of turnkey plants and heavy equipment on credit. Creation of shorter-term credit lines is also being considered. Likewise, the Ministry of Economy in Estonia is studying the establishment of an export credit program.

These steps are probably not the highest priority for export policy right now. Operating such schemes properly will require a great deal of institution-building first. Attention now would be better directed to getting the financial system as a whole on sounder footing, while promoting exports through some of the steps outlined in earlier sections of this chapter.

Even in the longer run, it is debatable whether these schemes are the best way to develop exports. Experience in other countries (such as Mexico and Zimbabwe in the past or, more recently, Bulgaria and Slovenia) shows that revolving funds for exporters to use for importing inputs have often proved to be unneeded or wasteful (Keesing 1991). A major problem is that they do not revolve—they are steadily eroded by exporters who do not repay the loans. Automatic preshipment credit guarantee schemes like those used in Korea have yet to work well outside that country.

The conclusions of one in-depth study of export credit and insurance schemes in a number of OECD and developing countries also cast doubt on

the efficacy and desirability of these programs (Fitzgerald and Monson 1989). The programs generally support only a small fraction of exports—less than 10 percent of exports in nine out of ten countries studied. Despite providing modest support to exports, in most cases, these schemes are financially unprofitable and require subsidies. One reason is that exporters are probably better than the agencies at distinguishing risky from nonrisky transactions, so they will choose to insure only the worst risks (“adverse selection”). Another problem is that the availability of subsidized insurance undermines the development of other market-based risk reduction instruments, such as letters of credit, private insurance, and self-insurance. And any official guarantee program is likely to find itself in commercial disputes over whether suppliers have met the terms of their contracts.

Concluding Remarks

The countries of the former Soviet Union face the formidable but necessary task of replacing trade policies that discourage trade, especially exports, with policies that recognize the benefits of enhanced trade links with the rest of the former Soviet Union and the outside world. To successfully meet this challenge, they will need to move on many fronts. The most important actions will be macroeconomic, but institutional policies are also important.

Exporters, especially of manufactured products, need duty- and restriction-free access to imported inputs, including capital equipment, raw materials, and intermediate goods. One way to ensure this access is to open the economy for everyone. This approach has the important advantage of eliminating all antiexport bias, even that which comes indirectly from import restrictions on products not used by exporters. It also avoids the administrative problems that come from giving exporters a special status. If tariffs or restrictions are imposed on some imports, exporters must be exempted or allowed to recoup their duty payments. Here, there are tradeoffs. Exemption and drawback schemes are more versatile but more difficult to administer than schemes based on export processing zones or bonded warehouses.

Exporters also need access to services. Most information and marketing services are best provided by the private sector (domestic or foreign), and there are already signs that private firms are springing up in some countries of the former Soviet Union to provide some of these services. For services with some public goods characteristics, it may be advisable to provide them through an official organization or to provide a modest subsidy for their provision by the private sector. Experience of other countries counsels caution, however. If official trade promotion organizations are set up, their goals should be limited and well-defined, their structures should ensure private sector involvement, and they should be funded at least in part by user fees for their services.

The breakdown of trade links among the countries of the former Soviet Union was both a symptom and a cause of the breakdown of the trade finance system. One part of the trade finance system is gradually being reestablished as banks set up correspondent accounts in other countries of the former Soviet Union. Another step that would facilitate trade is the creation of a system of documentary collection that would evolve into a trade finance system based on letters of credit, as used in the West. Until then trade links could be strengthened through a clearing union among the countries.

Annex: Trade Finance in the Soviet Union Before Mid-1992

Trade among countries of the Soviet Union was based on the payment request method of finance. The supplier shipped goods to the buyer, but released shipping documents to the buyer's bank along with the request for collection of payment (payment request). To ensure immediate payment to the seller, the seller's bank automatically granted a post-shipment loan at the time the payment request (backed by shipping documents) was submitted by the supplier. The postshipment loan was up to 85 percent of the invoice value (meant to reflect the underlying cost of the merchandise). The supplier's bank extinguished the loan on receipt of actual payment from the buyer and credited the remaining 15 percent of the proceeds to the supplier's account.

The buyer's bank took one of three actions on receipt of the payment request. First, the buyer's bank automatically debited the buyer's account if it had sufficient funds, released the shipping documents (confirming title of ownership for the goods) to the buyer, and notified the supplier's bank that the payment request had been honored. Second, if the buyer had insufficient funds but was within credit ceilings, the buyer's bank extended a purchase loan (by honoring the supplier's payment request), released the shipping documents, and notified the supplier's bank that the payment request had been honored. Third, if the buyer had insufficient funds and was above the credit ceiling, the buyer's bank held the shipping documents (along with the payment request) and did not honor the payment request of the supplier. In this case the supplier's bank had to roll over the postshipment loan to the supplier until the buyer was in a position to pay. The third option was rarely used because the buyer's bank usually provided a loan, under pressure from the planning authorities.

In theory, the payment request method protected both trading partners from risks of nonpayment and nonperformance. Buyers were protected because settlement was tied to satisfaction in terms of delivery and quality of goods, and suppliers were protected because the buyer's bank was responsible for collection of payment and released documents to the buyer only against payment or a loan. One of the banks in the transaction absorbed the risk, but any bad debt accumulated by the banks was written off by the State Bank and ultimately absorbed by the government budget.

This system automatically provided preshipment and postshipment finance based on the trade transaction. Other preshipment financing needs of enterprises were met by their own working capital (the share of working capital in total capital was usually 50 to 60 percent).

Trade between the Soviet Union and other CMEA states was based on annual bilateral protocols in which governments agreed to supply certain quantities of listed goods. The International Bank for Economic Cooperation (IBEC), created to finance CMEA trade, counted each transaction in

transferable rubles, crediting and debiting correspondent accounts held in the IBEC by authorized national banks. If required, IBEC provided automatic short-term crediting (which could subsequently be rolled over and even converted to medium- and long-term loans) in transferable rubles of any overdraft run by a member country as a result of unbalanced bilateral trade. The main method of payment used by Soviet foreign trade organizations in trade with CMEA partners was similar to that used in domestic trade—a payment request with subsequent acceptance.

After the shipment of goods to a foreign buyer by a domestic producer, the foreign trade organization created its own invoice based on CMEA prices and submitted it along with the shipping documents to Vnesheconombank (VEB). VEB immediately paid rubles to the foreign trade organization at the official rate between the transferable ruble and the ruble; the payment was then passed on to the exporter. At this stage the transaction was over for the exporter. VEB immediately sent documents to the bank of the importer, the national central bank. In turn, the importer's bank automatically debited the invoice value in local currency (at the official exchange rate) from the importer's account and subsequently passed on the shipping documents. The claims of VEB against the importer's bank were settled by IBEC by crediting VEB's correspondent account against the authorized bank of the importer in transferable rubles. After receiving documents from the authorized bank, the importer had the right to deny payment within fourteen days.

Non-arms length trade with countries outside the CMEA (China, Finland, India) was financed through bilateral clearing agreements and did not rely on any multilateral credit institution such as the IBEC. Any bilateral overdraft beyond certain limits was settled either in convertible currency or in additional merchandise. The same payment request method was used in bilateral clearing agreements with other socialist countries, as in trade with CMEA. When enterprises shipped goods (usually machinery, equipment, and military hardware) to their counterparts in allied countries on the basis of intergovernmental credit agreements, VEB received

ruble payments directly from the Ministry of Finance immediately after the shipment. Importers were meant to pay their governments, which in turn settled with the Ministry of Finance of the Soviet Union. The Ministry of Finance authorized the foreign trade organizations to collect payments in kind and to distribute any received goods (such as tropical fruits and sugar) among final consumers at domestic prices.

Only 15 percent of Soviet trade was undertaken with hard currency partners. This trade was usually financed through modern methods of payments and settled by documentary collection. VEB usually required letters of guarantee from reputable banks to support bills drawn on foreign buyers. The VEB provided such letters for buyers in the Soviet Union upon request from foreign suppliers. A small part of this trade was conducted on the basis of documentary credit. International partners viewed the financial obligations of foreign trade organizations and VEB as undertakings of the government and usually did not require anything in addition to acceptance by foreign trade organizations. Letters of credit were usually required if the length of credit provided to buyers exceeded the usual three- to six-month terms. Suppliers were satisfied with letters of credit opened by the VEB and usually did not seek confirmation by foreign banks.

Trade with these countries was monopolized by foreign trade organizations and trade finance was monopolized by the VEB. Unlike industrial enterprises, foreign trade organizations did not have their own current assets and had to rely entirely on loans from the VEB, although these were usually disbursed automatically. In practice, VEB worked as a single clearing and crediting unit for all foreign trade organizations.

The VEB provided regular short- and long-term postshipment and import finance for foreign trade organizations and, in the late 1980s, for large state-owned enterprises. Because the share of manufactured goods in exports to hard currency markets was small, the percentage of export letters of credit in total trade was negligible. Long-term postshipment finance was provided by the VEB for the sales of munitions and construction of military installations.

Long-term loans constituted the bulk of trade finance. The risks of nonpayment by buyers in industrial countries were low, because foreign trade organizations dealt with large reputable companies that had long-term traditional relations with the former Soviet Union. The risks of nonpayment by the buyers from developing countries were somewhat higher, but the government exercised political pressure to enforce payment. All risks of nonpayment were internalized by the VEB (and thereby the budget).

Notes

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1. Other more recent successful exporters, such as Chile and Malaysia, have low tariff rates of about 10 percent.
2. Uzbekistan temporarily lifted import tariffs until mid-1995.
3. Under a bonded warehouse system, a firm can import without paying duties and store the imports "under bond" until they are re-exported or used in making products that are then exported.
4. This section draws heavily on World Bank (1993).
5. The World Bank has recently recommended that international standard banks form the core of the new financial system in Russia. These banks would finance successful private firms and highly creditworthy public enterprises under a special incentive structure applied to carefully selected banks. One of the important requirements that individual banks must meet in order to qualify as international standard banks should be the potential and willingness to build the capability to implement modern methods of payment and the related trade finance mechanisms.

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Comment on Chapter 11

The Genesis and Demise of the Interstate Bank Project

Daniel Gros

By the end of 1993, within two years of the collapse of the Soviet Union, all former republics had introduced their own currencies.¹ While most economists had expected this outcome, there has been

considerable controversy about the speed with which the ruble zone disintegrated and about whether it would have been useful to create some transitional arrangement to minimize the disruption that came with this monetary disintegration.

The dissolution of the ruble zone, which lasted for most of 1992 and 1993, was very costly in economic terms. Payments within the former Soviet Union became very difficult as the official channels on which enterprises and banks had to rely at the beginning were quickly blocked. The difficulties that arose within the ruble zone were mainly macroeconomic: Russia did not want to run surpluses with the rest of the CIS and started to block payments when it discovered in early 1992 that the accounts of the other central banks with the Central Bank of Russia showed large imbalances. This led to a period during which most payments were organized bilaterally between central banks. Had there been immediate full convertibility, payments could simply have been switched to commercial banks. But convertibility was established only gradually, and for a variety of technical reasons it took commercial banks some time to establish a rudimentary network of correspondent banking relationships.²

As a response to the difficulties of 1992, ten CIS states agreed toward the end of the year to create a multilateral payments system to be operated by a joint institution, the Interstate Bank. However, the Interstate Bank agreement was never implemented.

A Brief History of the Interstate Bank

When the USSR broke up, the ruble became the common currency of fifteen independent countries. Each country had an incentive to create as much ruble credit as possible since the inflationary impact would be borne by the others. Russia recognized this problem and, in July 1992, started to control flows of funds from the other new independent states through a system of correspondent accounts with the other central banks. For these correspondent accounts were bilateral, it became impossible to offset deficits and surpluses on a multilateral basis. Moreover, with the other new independent states running large deficits with Russia, the Central Bank of Russia felt that it had to block payments. The result was a severe payments crisis, increasing dollarization, and a rise in barter trade and cash transactions.

After several failed attempts to reconstitute a true ruble zone with a common central bank, the

CIS heads of state, meeting at the CIS summit on October 9, 1992, in Bishkek, the Kyrgyz Republic, concluded an agreement on a single monetary system and on a concerted monetary, credit, and exchange rate policy for states still using the ruble. The aim of the Bishkek agreement was theoretically to establish a clearly defined ruble zone. That explains why some countries insisted during negotiation of the Interstate Bank (October-December 1992) that it should be a joint central bank with common decisionmaking on the basis of one state-one vote. It also explains why the eventual agreement establishing the Interstate Bank still contained vague references to central bank tasks.

However, a decision by the heads of state at Bishkek summit called for establishment of a CIS working group "to prepare specific proposals on the activities of the Interstate Bank, first and foremost on the creation of a payments mechanism." In the final months of 1992 negotiations on the Interstate Bank in which IMF and EU experts participated, focused increasingly on the bank as a multilateral payments mechanism, and the idea of a joint central bank was moved to the background. The clear focus on multilateral clearing and settlements enabled Ukraine, which was introducing its own currency at the time, to join the negotiations and sign the agreement establishing the Interstate Bank together with nine other countries on January 22, 1993.

The most contentious issues during the negotiations were the subscription quotas, the credit element, the currency, the decisionmaking procedure, and membership. (See annex 1 for details.)

After agreement had been reached on most of these issues at the expert level in December 1992, the treaty establishing the Interstate Bank was finalized at the CIS summit of January 22, 1993. The treaty languished thereafter, and no concrete steps were taken to actually set up the Interstate Bank for nearly a year. Ratification by national parliaments began only in June 1993 and was never completed. The Ukrainian parliament never got around to voting on the treaty though most other countries (including Russia, Belarus, and Kazakstan) did ratify the treaty in the end.

The main reason for the delay was that the fate of the Interstate Bank was linked to that of the ruble zone. Although the clearing mechanism of the Interstate Bank had been designed to work as well with separate national currencies as under a ruble zone, some people argued that as long as the reconstitution of a (possibly smaller) ruble zone remained on the agenda, the Interstate Bank should not be set up. This argument was no longer tenable after Russia introduced its own ruble banknotes in August 1993 and after the ruble zone was effectively removed from the political agenda because all countries (except Belarus and Tadjikistan) had rejected the offer to create a new type ruble zone. The Interstate Bank could then be viewed as a solution for some of the problems created by the disappearance of the ruble zone, the limited convertibility of the new currencies, and the lack of an efficient payments system.

The Interstate Bank intended to run a multilateral payments mechanism on the basis of the Russian ruble among the member states' central banks. The central bank would inform the Interstate Bank each day of the amount of imports from the other states that they wanted to pay for. The Interstate Bank would provide a multilateral clearing service and inform member states of their cumulative debtor or creditor position. The system was to run on an initial credit line from the Central Bank of Russia (fixed at 300 billion rubles), but there would be no additional credit. Central banks running up against their debt limit were expected to hold the amounts of imports they wanted to pay through the system to the exports declared by the other partner countries (or face expulsion). It was explicitly foreseen that the Interstate Bank would operate in parallel to the commercial banking system and would never be made obligatory. (See annex 3 for details.)

The first decisions implementing the Interstate Bank agreement were adopted at a meeting of the central banks of the member states in Moscow on December 8, 1993. (The timetable of the official negotiations and other events related to the Interstate Bank is briefly set out in annex 2). Following that, no additional steps were taken to set

up the Interstate Bank. Moreover, in the meantime, considerable progress had been made toward convertibility and the creation of an acceptable payments system in Russia (and some other small CIS countries). So the rationale for setting up the Interstate Bank is disappearing fast, and if such developments continue, it will no longer make sense to set up the Interstate Bank.

Reasons for the Demise of the Interstate Bank

Why was the Interstate Bank never set up? One reason is that most CIS states were interested only in obtaining further cheap credit or cheap oil from Russia. The leaders of many CIS states were not really interested in creating an efficient multilateral payments system.

To the extent that the advantages of an efficient payments system were only dimly perceived, there was a typical free rider problem. No individual CIS country had a large incentive to invest political capital in pushing for the Interstate Bank since the institution would work only if everybody participated and the benefits would accrue to all member countries.

Finally there was, and still is, a deep-seated tendency in many CIS countries to wait for Russia to take the initiative. But, Russia never took the necessary steps to set up the Interstate Bank because it had little political reason to do so. Russian leaders believed, correctly, that Russia did not need such an institution since it ran a surplus with all CIS countries. Convertibility was viewed as the first-best solution and attainable immediately, so there was little need to discuss anything else. There was also considerable opposition to any official payments mechanism from some of the radical reformers in the Russian government, who feared that establishment of the Interstate Bank would lead to more pressures on Russia to extend cheap credit.³ This was basically a political judgment, since the Bank's charter explicitly excluded any further credit. In Russia, where creating any type of public institution is difficult, this weak opposition was sufficient to halt all the practical steps that would have been needed to set up the Interstate

Bank, particularly since any benefits for Russia appeared so modest.

Was the Interstate Bank a Good Idea?

The payments mechanism embodied in the Interstate Bank was intended to allow enterprises and banks throughout the CIS to make payments using familiar procedures so that the introduction of new currencies or other macroeconomic developments would cause no trade disruptions. In the absence of a multilateral clearing mechanism the opposite happened. Additional restrictions were placed on trade and payments, and many trade ties were broken. At first (in late 1992 and early 1993) payments continued to be channeled through the accounts of central banks, with the result that countries (except Russia) introduced various convertibility restraints on imports from other CIS countries in order to achieve bilateral balance with each partner. The Interstate Bank, by providing a multilateral clearing mechanism, would have eliminated the problems of partial convertibility and would have made it easier for firms to live in this environment.

A lot of anecdotal evidence suggests that large enterprises (mainly in Russia) with dollar accounts abroad were able to continue to do business within the CIS because they could transact business in hard currency. But most enterprises were not able to follow this route. The transaction costs were enormous. In 1992 and early 1993 business newspapers in a number of CIS countries carried the advertisements of financial firms offering to make payments within the CIS (mostly to Russia) for fees in the range of 20 to 30 percent of the value of the transaction.

Over time, the importance of the central bank correspondent accounts declined, and commercial banks were apparently allowed to deal directly with each other. Slowly, new payments channels were established through the nascent commercial banking system. However, this took time and implied very large transaction costs in some cases⁴ if the many stories told by bankers in Russia are to be believed. One simple, additional, technical reason why the Interstate Bank would have been useful is that it could have processed a large volume of pay-

ments, yielding economies of scale not available to the small correspondent account networks that have sprung up so far.

What were the economic costs of the absence of a clearing and payments mechanism in 1992 and 1993? It is of course difficult to say exactly what would have happened had the Interstate Bank been created speedily. But there are at least two reasons to believe that the cost of the disorderly disintegration of the ruble zone was substantial: one has to do with the effect of shrinking trade on output and one with the growth of bilateralism and its negative impact on trade.

Though there is still great controversy about this argument, simple analysis of the output decline across a number of Russian industries suggests that the decline in interstate trade within the former Soviet Union had a significant impact on output. Duchene and Gros (1994) regress the output decline of almost 100 products or sectors of the Russian economy against a number of sectoral indicators, such as the share of oil input, the share of output going to the military, the increase in profitability resulting from a switch to world market prices, to name the most important. Most of these indicators are not significantly correlated with the decline in output between 1990 and 1992. The one indicator that shows a robust and significant relationship is the share of gross output going to other former republics (the estimated coefficient was 0.35 to 0.39). With an average of 18 percent of output going to other republics of the Soviet Union in 1990, a reduction in that trade of 50 percent could explain a fall in output in Russia of about 3 percent. The actual decline in interstate trade was probably much larger than that, but the amount is impossible to document. While this is only a fraction of the overall drop in output in Russia, it is still a substantial cost that might have been avoided or mitigated. For the other countries of the former Soviet Union the costs must have been much higher because their economies were more dependent on interstate trade.

The Interstate Bank would have allowed the CIS countries to overcome the bilateralism in trade that was so prevalent in 1991-93. Gros (1993) used data on trade flows among the countries to quantify

the gains from multilateralism, asking: by how much would trade have to contract if all former republics tried to achieve bilateral balance? It was found that the forced reduction in trade would be equivalent to about 4.5 to 6 percent of the income of the CIS countries other than Russia. For Russia the impact would be equivalent to only 1.5 percent of income. By comparison, the same exercise for the EC countries at the time Europe returned to convertibility in 1958 shows a gain ten times smaller in terms of GDP. Multilateral trade was thus much more important to the countries of the former Soviet Union than it was for the EC countries in 1958. Since the EC countries constituted the bulk of the members of the European Payments Union, this implies that the Interstate Bank might have been much more important for the CIS than the European Payments Union was for Europe in the 1950s.⁵

The argument that all interrepublican trade should in any case be allowed to fade away since it was dictated by central planners rather than comparative advantage was shown by Gros and Dautrebande (1992) not to be valid.

Conclusions

An efficient multilateral payments system could have slowed the collapse of inter-CIS trade, with significant positive effects even for Russia, which depends less on such trade than the other CIS countries. At any rate, the creation of the Interstate Bank could have done no harm since it would not have halted or even slowed the move toward convertibility. The opposition from radical reformers in the Russian government (and some Western advisers) was mistaken. As long as the first-best solution, generalized immediate convertibility, was not in the cards, a second-best solution in the form of the Interstate Bank would have been appropriate. Moreover the argument that the Interstate Bank would have resulted in more cheap credit from Russia is also not tenable in the face of the clear rules on settlement in the Interstate Bank agreement, which included strict limits on available credit. These rules would have forced member states to bring their overall trade with the other members into balance (or face expulsion from the system), by

adjusting their exchange rate or by pursuing tighter monetary and fiscal policies. This mechanism would have been preferable to the ad hoc technical credits given by the Central Bank of Russia.

The Interstate Bank, however, never became operational. The other CIS states did not really understand the importance of multilateral trade and always waited for Russia to move first. No individual CIS country was ready to use its political capital to push for the Interstate Bank since it would have received only a small share of the economic gains.⁶ Russia never took the necessary steps to set up the Interstate Bank because its leaders felt no need for such an institution since Russia ran a surplus with all CIS countries.

Annex 1: The Main Issues during the Negotiations

Five main issues emerged during the negotiations on the Interstate Bank treaty that were conducted at the expert level between October and December 1992 by representatives from all CIS states:

- *Subscription quotas to the capital of the Interstate Bank* (ISB Agreement, Art. 4). Should the quotas be of equal size or linked to each member's foreign trade turnover? This issue turned out to be not very important since the bank would only clear payments. It was never to have any net position. The capital would only be used to pay for buildings and the like. The initial capital was eventually fixed at 5 billion rubles.
- *Credit element* (ISB Agreement, Art. 6). Credit might be extended to cover deficits up to a certain (cumulative) ceiling. Discussion focused on whether to set the credit ceiling for each country as a function of trade turnover or of actual receipts for one or two months. Since Russia would provide most (probably all) of the credit, the discussion on this point was somewhat academic: if Russia does not want to provide credit, the others cannot force it to do so, and if Russia wants to provide ample

credit, the others will not decline the offer. The final wording is not clear, but there is an upper limit equal to one month of exports.

- *Currency in which settlements should take place* (ISB Agreement, Art. 1). The Western experts advised the creating of a new accounting unit; most states (except Russia, Ukraine, and Belarus) wanted to use the ruble. In the end, the ruble issued by the central bank of the Russian Federation was chosen.
- *Decisionmaking procedure* (ISB Charter, Art. 7). Russia argued, for obvious reasons, for weighted voting (the Western experts supported this); the Central Asian representatives insisted on one state-one vote. Weighted voting won out.
- *Membership* (ISB Agreement, Art. 1 and 9). The October 1992 Bishkek agreement provided for the possibility of establishing a payments union with non-ruble zone countries (Bishkek Agreement Art. 13). This happened within the context of the Interstate Bank, as non-ruble zone countries became founding members. Moreover, other, non-CIS countries could participate in the multilateral clearing as nonmembers simply by opening an account with the Interstate Bank.

Annex 2: Time-Table of Negotiations and other Official Acts

1992

- October 9 Agreement of CIS heads of state "on a single monetary system and a concerted monetary, credit and exchange rate policy of the states which have retained the ruble as legal tender" (Bishkek agreement) concluded at Bishkek, Kyrgyz Republic; decision of CIS heads of state at Bishkek to set up a working group on the Interstate Bank.

Oct-Nov Russia, with the help of EC experts, prepares draft "Agreement establishing the Interstate Bank."

Nov-Dec Russia, with help from the IMF, prepares a draft charter for the Interstate Bank, three meetings of CIS working group of experts with participation of IMF and EC experts result in final draft agreement and charter for the Interstate Bank.

1993

January 22 Approval by heads of state of draft agreement initialed at expert level with two changes: unit of account is the "ruble issued by the Central Bank of Russia," and votes on the council are distributed as follows : Russia 50 percent, other members' weights to be fixed on the basis of intra-Soviet trade in 1990.

March Joint IMF/EU working group begins preparations and consultations on technical aspects of clearing and settlement system.

April 21 Seven contracting parties decide to set up "Organizing Committee" at the level of central banks, chaired by Mr. Savanin of the Bank of Russia.

May 14 CIS heads of state "recommend" that the Interstate Bank agreement and charter be ratified in member states and preparations be made by July 10 for the Interstate Bank to begin operations on October 1.

June 30 Ratification in Russia; Belarus and Kazakhstan had already ratified; a number of other countries follow.

August 20 First meeting of the Interstate Bank board in Moscow to make decisions implementing the Interstate Bank

agreement; no decisions taken because a qualified majority was not present.

Nov. 15 CIS Consultative Coordinating Committee reiterates strong support for Interstate Bank and calls for "organizational" meeting of Interstate Bank board by December 10.

Dec. 8 First full "organizational" meeting of Interstate Bank Board in Moscow concentrates on personnel matters: Mr. Gerashchenko elected chairman of the Interstate Bank board and Mr. Savanin appointed president of the Interstate Bank.

Annex 3: The Payments Mechanism of the Interstate Bank

The basic principle of the multilateral payments mechanism of the Interstate Bank was that a participating country, say country A, would no longer settle international payments with other participants individually but would deal directly with the Interstate Bank. The central bank of country A would send all its payment orders for imports from the other participating countries to the Interstate Bank after converting all payments into the unit of account used by the Interstate Bank. The multilateral clearing system foreseen in the Minsk agreement would use the (Russian) ruble as the unit of account.

The bank's role would then be to clear all transactions between country A and the other participating countries. The clearing would result in a single entry in the correspondent account of country A. Each participating country would have a single correspondent account in the Interstate Bank. The clearing was to be done each day, with the Interstate Bank calculating the net deficit or surplus of each country.

These daily balances (flows) could then be used to calculate a cumulative position (a stock) for all participating countries. At the end of the first day the cumulative position would be equal to the deficit or surplus of that day (plus the opening balance). For all following days the cumulative posi-

tion at the end of the day is equal to the previous day's cumulative position plus (or minus) the daily surplus (or deficit) plus (or minus) the interest on the previous day's cumulative position.

An important aspect of the system was to be a limit on the cumulative deficit, or debtor position, any country could build up equal to one month of export receipts (the imports from the country concerned that are declared to the Interstate Bank by the other member countries over a one-month period).

If a country's correspondent account was in deficit on the settlement day (day fifteen of a fifteen-day period) the country could pay the amount of the deficit to the Interstate Bank or obtain a settlement credit up to the credit limit. If the deficit exceeded this limit, the excess sum had to be settled. That means that the deficit country would have to pay the excess in convertible currency or gold by purchasing rubles for them or by borrowing rubles from other countries (but not from the Interstate Bank). In case of a surplus, the surplus would first be used to redeem settlement loans obtained on previous settlement days and then any remaining surplus would be deposited in the account of the creditor country to be used as desired.

The end-users of the system, private banks and enterprises, would not be concerned with this mechanism at all. Importers would pay their national central bank in national currency for the export contract they wanted to pay. Each national central bank would be responsible for setting the exchange rate so that imports approximately covered exports (plus other hard currency sources).

Notes

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1. Except for Tadjikistan, which is in the midst of a civil war and continues to use the Russian ruble.
2. Even Estonian enterprises, which operated in a favorable macroeconomic framework, initially had great difficulty organizing their payments with Russia after the introduction of the kroon.
3. And from one of their western advisors. Most middle-level opponents of the Interstate Bank remained when the 'flagship' reformers abandoned all government duties in early 1994.
4. The commercial banking system is not efficient enough to fully enable trade among CIS countries to recover to a normal market-driven level. This does not mean that intra-CIS trade should recover to its prereform level. Gros and Dautrebande (1992) show that there should be a radical reorientation of trade toward the EU and the West in general.
5. Considering the radical reorientation of trade likely for all CIS countries these estimates are certainly on the high side if one takes a medium-perspective. However, the purpose of the Interstate Bank was to smooth the transition, so the short-run perspective adopted here is appropriate.
6. Politically, the Interstate Bank was not popular in a number of countries since it implied closer ties with Russia.

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Trade Performance and Access to OECD Markets

Bartłomiej Kaminski

- Tendencies in Trade Performance
- OECD Trade Barriers
- Access to OECD Markets Since the Dissolution of the Soviet Union
- Vulnerability to Trade Remedy Measures
- Conclusion

At independence, the countries of the former Soviet Union were ill-prepared to exploit the opportunities offered by international markets. The shock of the disintegration of the common economic space of the Soviet Union was significantly greater for the new states than was the breakdown of the Council for Mutual Economic Assistance (CMEA) to its East European members. Although East European countries had been faithful members of the Soviet bloc, they had had considerable discretion in their foreign economic policy and had maintained some autonomy in their domestic economic policies. They were not part of a single command economic system, because Moscow had not succeeded in imposing integrated supranational planning within the CMEA. Nor were they part of a unified budget system which, in the Soviet Union, had redistributed incomes among the republics. As a result, the countries of Eastern Europe had less misdeveloped economic structures, although their abilities to adjust to international markets had also been impaired by past misallocations of resources.

Lackluster trade performance in the aftermath of the Soviet break up was a combination of unfavorable initial conditions, limited progress in macroeconomic stabilization and liberalization of foreign trade, contraction in import demand in the former CMEA countries, and limited access to Organization for Economic Cooperation and Development (OECD) markets. In

addition, many countries, especially the land-locked former Asian republics, had to deal with inadequate transportation infrastructure.¹

Geography and transportation problems accounted for the fact that the foreign trade of the Soviet Union had been the preserve of European republics. Excluding Russia, Ukraine, and Belarus, the combined contribution of the other republics amounted to less than 7 percent of total Soviet exports in 1990-91. Russia alone accounted for about 78 percent, Ukraine about 13 percent, and Belarus about 3 percent. The two largest Asian republics, Kazakhstan and Uzbekistan together accounted for only less than 4 percent in 1990-91, and the Baltic and Transcaucasian republics' share was 2.5 percent. The central Asian republics had a negligible share, in large measure because their exports of energy were attributed to Russia. By 1993 this picture had changed significantly, with the Baltic and central Asian states having substantially expanded shares in total exports, originating in the former Soviet Union.

While some former CMEA economies were able to cushion the impact of the collapse of import demand in the former Soviet Union by expanding their exports to OECD countries, the new independent states have faced a more daunting challenge. The republics tended to be inward-oriented; their shares in exports to the rest of the world were significantly lower than their shares in interstate trade, reflecting state monopoly on foreign trade at the union level and the centrally controlled internal division of labor.² Not surprisingly, interstate trade accounted for a much larger share of their total trade than was the case among EU economies (Michalopoulos and Tarr 1992). Links with the world economy were tenuous at best: except for Russia and Ukraine, shipments outside the Soviet Union in 1989-90 accounted for less than 15 percent of exports (to other countries of the former Soviet Union and the rest of the world). This situation contrasted sharply with that of European CMEA members, whose shares of non-CMEA exports in this period ranged between 46 percent (Bulgaria) and 76 percent (Romania). (see *Economic Bulletin for Europe*, vol. 43, 1991).

Most countries of the former Soviet Union have a long way to go before they can benefit from efficiency gains usually associated with the move toward integration with the international economy. The Soviet Union, which exported mainly oil and other primary commodities that did not face significant barriers, was not much concerned with conditions of market access. The situation is radically different now that countries have formal economic sovereignty. Foreign trade is of direct relevance to the welfare of the new states—especially the smaller ones that are heavily dependent on external interactions. And as demand in the countries of the former Soviet Union and former CMEA contracted, access to OECD markets has become critically important. In addition to inheriting the legacies of central planning, the countries of the former Soviet Union inherited the Soviet Union's position at the bottom of OECD import preference schemes, facing adverse tariff margins and more restrictive nontariff barriers than other countries. Although market access has improved markedly since independence, the foreign economic relations of the new countries have not yet been fully "normalized."

Tendencies in Trade Performance

Trends in trade that had been discernible since the mid-1980s accelerated in 1992, when interstate trade contracted severely and trade with the rest of the world shrank as well or stagnated. Preliminary estimates indicate that the trade decline with the rest of the world seems to have bottomed out in 1992.³ In 1993 exports to countries outside the former Soviet Union grew by 5.7 percent and imports fell by 6.4 percent. The OECD predicts a further expansion in exports and an increase in imports in 1994.

The Growing Importance of OECD Market

The share of OECD markets in total exports outside the former Soviet Union increased from about 46 percent in 1980 to 53 percent in 1990, 72 percent in 1991, and 73 percent in 1992.⁴ However, the increased shares during 1990-92 were the result not of expanding exports (they remained stagnant at about US\$30 billion), but of contracting exports to other markets.⁵ The Soviet Union was a marginal

Table 12.1 Exports from the Former Soviet Union to the OECD, 1990-93
(millions of U.S. dollars)

	OECD			1993 Percent change		EU			EFTA			Other OECD			Value of 1993 exports to OECD per capita (U.S. dollars)
	1990 ^a	1992	1993	from		1990 ^a	1992	1993	1990 ^a	1992	1993	1990 ^a	1992	1993	
				1990	1992										
Armenia	53	12	9	17	79	23	6	3	4	4	0	26	2	1	3
Azerbaijan	227	57	96	42	168	148	20	45	62	0	2	17	1	1	14
Belarus	1,210	231	378	31	163	900	179	304	180	19	26	130	30	40	37
Georgia	160	108	95	59	87	107	91	45	19	2	2	34	10	23	17
Kazakhstan	519	151	457	88	302	388	84	302	68	20	31	63	37	42	28
Kyrgyz Republic	26	9	16	63	180	24	1	9	3	6	1	-1	1	3	4
Moldova	85	25	64	75	253	69	21	30	11	2	1	5	1	2	15
Russia	22,437	27,390	26,816	120	98	16,668	20,179	17,245	3,345	3,478	3,073	2,424	3,509	2,183	182
Tajikistan	183	34	116	64	343	128	12	65	23	2	13	31	13	20	23
Turkmenistan	55	90	275	495	305	43	40	157	10	25	33	2	4	2	78
Ukraine	3,631	1,144	2,010	55	176	2,813	772	1,105	517	112	110	301	170	217	39
Uzbekistan	464	151	576	124	380	310	113	481	37	8	19	118	10	7	29
Estonia	63	374	471	748	126	26	79	189	28	144	250	9	13	23	300
Latvia	114	547	884	775	162	65	131	682	43	40	154	6	9	27	330
Lithuania	208	641	872	419	136	131	549	721	55	70	78	23	22	22	236
Total!	29,434	30,964	33,133	113	107	21,843	22,276	21,383	4,404	3,929	3,791	3,187	3,831	2,613	116

Note:

a. Republic exports in 1980 were computed on the basis of OECD imports, using Goskomstat's official estimates of exports to various OECD regions as weights.

Source: CIS Information Center for Statistics (1992); UN ECE (1993); 1992 and 1993; OECD imports as reported to the United Nations COMTRADE records.

partner for most OECD countries during 1988-91, with a share in OECD trade of around 1.2 percent. Within the OECD, the European Union (EU) was absorbing a growing proportion of exports from the former Soviet Union: its share increased from 71 percent in 1991 to 74 percent in 1992.

The contraction in exports from the former Soviet Union to non-OECD markets was much larger in primary commodities than in industrial products. Between 1990 and 1992 the value to non-OECD markets of primary commodity exports (SITC 0 to 4 + 68) fell by 65 percent while that of total exports fell by 52 percent.⁶ The value of exports of primary commodities to the OECD fell by just 2 percent. Thus primary commodity exports to OECD economies increased from about 50 percent of total exports in 1990 to 82 percent in 1992.⁷ The share of primary commodities in exports from the former Soviet Union to the OECD remained stable at about 76 to 78 percent, although it fell slightly in 1992, mainly because of falling prices and a

shift to less processed raw materials (for example, from petroleum products to crude oil exports.

Export Performance in OECD Markets

While a country's trade patterns are determined to a large extent by past patterns of production and the ease of adjustment for different industries, the experience of transition economies demonstrates that progress in macroeconomic stabilization and in the establishment of market-supporting institutions contributes to improved export performance and significant changes in the composition of exports (Balcerowicz and Gelb 1994). Redirection of trade is also a measure of progress in dismantling central planning. The transition economies of Central Europe experienced a surge in exports to OECD markets during the first year following radical stabilization and economic transformation programs (Kaminski 1993). How have the countries of the former Soviet Union fared in terms of their exports to OECD markets?

A comparison of exports (by value) before independence in 1990 (based on Goskomstat estimates of trade for the former republics) with exports in 1992 and 1993 gives an indication of the direction of change (table 12.1)⁸

Despite their previous dependence on fiscal transfers from Moscow and substantial industrialization under central planning, the Baltics succeeded in increasing their outside exports.⁹ They substantially redirected their trade flows, mainly to OECD markets. Their share in exports from the former Soviet Union to the OECD increased from 1.3 percent in 1990 to 5.1 percent in 1992 and 8.3 percent in 1993—if Russia is excluded, that share rises from about 6 percent in 1990 to 44 percent in 1992 and 59 percent in 1993. For some Asian republics—notably Turkmenistan and Uzbekistan—an increase in exports can be attributed in large part to more accurate allocation of exports following the dissolution of the Soviet Union. On a per capita basis, their exports to the OECD remain very low, however (see table 12.1).

In 1992 primary commodities accounted for the bulk of exports to the OECD, with fuels, ores, and metals being the major export earners even for countries that had no natural resource endowments (see table 12.2). For some countries, reexports are easy to identify. For instance, the largest item in Latvia's exports to OECD countries was petroleum products. Although Latvia has no known oil deposits and no refineries, crude oil accounted for 9 percent of its OECD exports in 1993 and petroleum products for 40 percent. Similarly, according to the 1990 production statistics, the Baltics did not mine or produce ores and metals, yet ores and metals accounted for 35 percent of the total value of Estonia's exports to the OECD, 13 percent of Latvia's, and 26 percent of Lithuania's—most of them probably reexports from Russia. Russian firms engaged in reexport activities as well, mainly of products originating in the Asian countries as the low share of fuels in Azerbaijan's exports would suggest. Overall, however, because of Russia's enormous natural resources endowment, reexports cannot be as easily estimated as is the case for the Baltic states.¹⁰

Similarities in Net Trade Performance

At the time of independence, the outside foreign trade of the new states displayed remarkable similarities, as demonstrated by their net trade performance in major product groups based on net trade performance indexes (table 12.3).¹¹ (Indexes range in value from -1 for a product that is imported but not exported to +1 for a product that is exported but not imported, so that a positive value denotes net exporter status and a negative value indicates net importer status.) These indexes clearly expose the failure of Soviet planners to develop agriculture and internationally competitive industrial sectors as well as their aversion to consumer products. All the countries of the former Soviet Union are net importers of food products, textiles (except Armenia, Estonia, and Lithuania, see table 12.3), and machinery transport equipment and net exporters of agricultural materials, and fuels (except Estonia and Kyrgyz Republic). The bias of central planners in favor of heavy industries is evident in the net exporter status of the more developed European countries (except Estonia) and of some Asian countries (Georgia, Kazakhstan, Kyrgyz Republic) in iron and steel.

The net exporter status of all new independent states in agricultural materials, ores and metals, and fuels (except Estonia, Kyrgyz Republic, and Tajikistan) cannot be explained by a similarity in the distribution of natural resources. Rather, this similarity in net trade status is due to past patterns of investment location and to transshipments and reexports of surpluses obtained in barter exchange.

OECD Trade Barriers

The new states that emerged from the dissolution of the Soviet Union inherited the adversarial trade relationship between OECD countries and the Soviet Union.¹² Though these countries became members of the IMF and World Bank within a year of independence, they are still not members of the GATT and their foreign trade relations await full normalization.¹³ Because trade between OECD countries and the new countries of the former Soviet Union in their first year of independence was governed by the same conditions of access as had applied to the Soviet Union, those conditions war-

Table 12.2 Commodity Composition of Exports from the Former Soviet Union

	Armenia	Azerbaijan	Belarus	Georgia	Kazakhstan	Kyrgyz Republic	Moldova	Russia	Tajikistan	Turkmenistan	Ukraine	Uzbekistan	Estonia	Latvia	Lithuania
<i>Millions of U.S. dollars</i>															
All goods (0 to 9)	12	57	231	108	151	9	25	27,360	34	90	1,144	151	374	547	641
Primary commodities (0 to 4+68)	4	51	141	102	86	2	15	21,362	33	83	802	144	221	430	496
All foods (0+1+22+4)	0	0	5	2	3	0	2	1,289	0	1	33	0	27	18	42
Agricultural materials (2-22-27-28)	0	8	30	2	9	1	0	1,998	15	52	52	138	37	47	29
Ores and metals (27+28+68)	0	3	38	14	51	1	4	3,308	18	3	154	4	131	69	167
Fuels (3)	3	40	67	84	23	0	8	14,758	0	28	563	2	26	286	259
All manufactures (5 to 8-68)	8	5	87	5	65	1	10	4,465	1	6	319	5	149	113	137
Chemicals (5)	0	2	37	0	17	0	2	1,516	0	0	141	1	24	39	60
Textiles and clothing (65+84)	1	3	9	0	0	0	5	150	0	3	35	1	58	20	30
Iron and steel (67)	0	0	4	4	46	0	0	777	0	0	103	0	2	7	5
Machinery and transport (7)	0	0	36	0	0	0	1	982	0	2	57	0	19	12	11
Not classified (9)	0	1	2	0	0	6	0	1,524	0	0	19	1	1	3	4
<i>Percent</i>															
All goods (0 to 9)	100	99	100	99	100	100	100	100	100	100	100	100	100	100	100
Primary commodities (0 to 4+68)	34	89	61	95	57	24	61	78	98	92	70	96	59	79	77
All foods (0+1+22+4)	2	0	2	2	2	4	10	5	0	1	3	0	7	3	6
Agricultural materials (2-22-27-28)	1	14	13	2	6	10	2	7	45	58	5	92	10	9	4
Ores and metals (27+28+68)	3	6	17	13	34	10	17	12	53	3	13	2	35	13	26
Fuels (3)	28	70	29	78	15	0	32	54	0	31	49	1	7	54	40
All manufactures (5 to 8-68)	68	9	38	5	43	8	39	16	2	7	28	4	40	21	21
Chemicals (5)	2	4	16	0	11	2	7	6	0	0	12	1	6	7	9
Textiles and clothing (65+84)	9	6	4	0	0	0	19	1	0	4	3	1	15	4	5
Iron and steel (67)	0	0	2	4	30	0	0	3	0	0	9	0	0	1	1
Machinery and transport (7)	1	0	16	0	0	3	6	4	0	3	5	0	5	2	2
Not classified (9)	0	1	1	0	0	68	0	6	0	0	2	0	0	1	1

Note: Exports of Estonia, Lithuania, and Latvia have not been corrected for possible reexports.

Items in parentheses represent Standard International Trade Classification (SITC) categories.

Source: Derived from UN COMTRADE records.

Table 12.3 Indexes of Net Trade Performance in Markets Outside the Former Soviet Union in 1992, by Major Product Group

	All foods	Agricultural materials	Ores & metals	Fuels	Chemicals	Textiles & clothing	Iron & steel	Machinery & transport	All manufactures
<i>Total rest of world</i>									
Armenia	-0.99	0.82	0.98	1.00	-0.40	0.01	-0.27	-0.93	-0.05
Azerbaijan	-0.98	0.98	0.72	0.70	-0.54	-0.27	-0.92	-0.97	-0.85
Belarus	-0.75	0.87	0.70	0.83	0.36	-0.07	0.29	-0.49	-0.18
Estonia	-0.61	0.91	0.93	-0.03	0.25	0.12	-0.60	-0.78	-0.31
Georgia	-0.86	0.93	0.99	1.00	-0.33	-0.89	0.99	-0.92	-0.48
Kazakhstan	-0.95	0.90	0.75	0.99	0.36	-0.98	0.55	-0.83	-0.20
Latvia	-0.69	0.93	0.93	0.89	0.39	-0.15	0.92	-0.84	-0.33
Lithuania	-0.49	0.86	0.97	0.94	0.46	0.01	0.89	-0.72	-0.10
Kyrgyz Republic	-0.95	0.75	0.99	-1.00	0.67	-0.94	0.89	-0.11	0.00
Moldova	-0.02	0.60	0.89	0.94	-0.40	-0.50	0.39	-0.21	-0.13
Russia	-0.69	0.90	0.80	0.97	0.20	-0.82	0.39	-0.50	-0.29
Tajikistan	-0.99	0.98	1.00	0.00	-0.58	-0.80	0.12	-0.99	-0.88
Turkmenistan	-0.96	0.99	0.87	0.99	-0.82	-0.35	-1.00	-0.92	-0.86
Ukraine	-0.76	0.63	0.75	0.81	0.27	-0.47	0.45	-0.79	-0.34
Uzbekistan	-1.00	1.00	0.45	0.92	-0.33	-0.87	-0.74	-0.95	-0.81
<i>Trade with OECD countries</i>									
Armenia	-0.99	1.00	0.97	1.00	-0.70	0.51	-1.00	-0.94	-0.01
Azerbaijan	-0.94	0.97	0.55	0.65	-0.84	0.82	-0.99	-1.00	-0.87
Estonia	-0.68	0.91	0.93	-0.06	0.07	0.17	-0.62	-0.80	-0.35
Belarus	-0.85	0.87	0.96	0.91	-0.03	0.01	-0.58	-0.68	-0.47
Georgia	-0.86	0.88	0.99	1.00	-0.88	-0.93	0.99	-0.95	-0.58
Kazakhstan	-0.65	0.84	0.94	0.68	-0.39	-0.76	0.48	-1.00	-0.47
Kyrgyz Republic	-0.11	-0.02	0.98	-1.00	0.53	-0.93	-0.69	-0.88	-0.79
Latvia	-0.77	0.93	0.92	0.89	0.40	-0.15	0.84	-0.86	-0.37
Lithuania	-0.64	0.85	0.99	0.95	0.44	0.12	0.75	-0.83	-0.17
Moldova	-0.77	-0.50	1.00	0.78	-0.35	0.38	-0.52	-0.87	-0.48
Russia	-0.69	0.90	0.90	0.98	-0.07	-0.67	-0.02	-0.78	-0.52
Tajikistan	-0.99	0.95	1.00	n/a	-0.87	-0.53	0.11	-0.99	-0.90
Turkmenistan	-0.94	0.99	0.92	0.99	-0.71	-0.05	-1.00	-0.92	-0.87
Ukraine	-0.82	0.73	0.90	0.97	-0.07	-0.16	0.25	-0.86	-0.54
Uzbekistan	-1.00	0.99	0.84	0.92	-0.82	-0.53	-1.00	-0.99	-0.94

Note: The value of the net trade performance index ranges from -1 for a product that is imported but not exported to +1 for a product that is exported but not imported.

Source: Derived from United Nations COMTRADE records.

rant a brief overview. Moreover, almost all the non-tariff barriers faced by Soviet exporters are still in place, and the new countries are even more vulnerable to escalation of trade barriers than was the Soviet Union, whose major export earners—oil, gas, and gold—were not heavily burdened by non-tariff barriers.

Tariff Barriers

The Soviet Union faced adverse tariff margins in OECD countries and more restrictive nontariff barriers than those faced even by its European CMEA partners. Exports from the Soviet Union were subject to restrictions imposed only on cen-

trally planned economies and faced considerably higher tariffs than similar, competing goods exported by other countries.¹⁴ Tariffs in the United States, Japan, and the EC were some 70 to 90 percent higher than the average tariff on all imports in these three markets. For all manufactured goods combined, the 6.7 percent tariff applied by the EC on Soviet goods was more than twice as high as the average duty all exporters paid on these same products and three times the corresponding rate facing developing countries (see Table 12.4). These adverse tariff margins allowed other suppliers to displace (divert) potential exports from the Soviet Union.

OECD preference schemes accord different tariff treatment to suppliers from various countries. The EU has preferential trading arrangements like the Lomé Convention, the protocol with EFTA for free trade in manufactures, European Association Agreements with Central European countries that envisage a gradual introduction of free trade for manufactures, and regional preferences extended to countries like Morocco, Tunisia, and Turkey. The EU also used more restrictive nontariff barriers against the Soviet Union (quotas, variable levies, discretionary licensing schemes) and with higher frequency than against other trading partners (Olechowski and Yeats 1982). The United States gives preferences to selected developing countries under the Generalized System of Preferences (GSP) and also has important regional preferences under the Caribbean Basin Initiative. The United States also has free trade agreements with Canada, Israel, and Mexico that are aimed at phasing out duties with these countries. In addition, the main device differentiating access to the US market among various sources is most-favored-nation (MFN) status. The Soviet Union was blocked from eligibility by the 1974 Jackson-Vanick amendment linking the granting of MFN status to a country's emigration policies, so Soviet exports were subject to discriminatory tariffs.

Vulnerability to Trade Barrier Escalation

A relatively high share of Soviet exports to the OECD consisted of unprocessed or semifabricated commodities—items whose further processing today could potentially offer important benefits to the new states of the former Soviet Union. Some economists have argued that natural resource-based industrial-

ization strategies can stimulate overall industrialization and growth (Roemer 1979). Among the benefits cited are avoidance of the deteriorating terms of trade for primary commodities, increased employment opportunities associated with the production and export of manufactures, achievement of important linkages with other sectors of the economy, improvement of human capital through learning effects, and the greater stability of prices of processed goods compared to primary commodities. However, trade barrier escalation in major international markets is an important constraint to further processing in commodity exporting countries (see Balassa 1968 for an early statement of this point, or later studies by Helleiner and Welwood 1978 and Yeats 1979). Trade barrier escalation means that tariffs (and nontariff barriers) are low or absent on unprocessed commodities but rise with the degree of further processing, creating a bias against trade in processed commodities.

The higher the escalation the higher the effective rate of protection afforded by tariffs and other trade restraints and the more foreign exporters must reduce returns to domestic labor and capital.¹⁵ Empirical studies have shown that some low nominal tariffs that appear to be unimportant may conceal high rates of effective protection.

Because enterprises and foreign trade organizations in the Soviet Union, which exported mainly energy, industrial inputs, and low value added products for further processing, were indifferent to revenues generated by exports, they had no incentive to respond to higher tariffs by moving to less protected product groups. Effective protection in OECD markets is quite high in several sectors in which new independent states (Armenia, the

Table 12.4 Average Tariffs Facing Soviet Exports of Selected Manufactures in the EC, 1990 (percent)

	<i>Imports from USSR (U.S.\$ million)</i>	<i>Developing Countries</i>	<i>Soviet exporters</i>	<i>All exporters</i>
All manufactured goods	2,171	2.0	6.7	2.8
Chemicals	775	1.6	7.7	3.5
Plywood and veneer	79	0.8	7.1	1.4
Paper manufactures	43	1.5	8.7	7.1

Source: Derived from the World bank-UNCTAD SMART database.

Baltic states, Belarus) should be able to increase processing. In general, effective tariff rates average more than twice the corresponding nominal rate—indicating that OECD trade barriers have a far more restrictive effect on imports than a superficial analysis of nominal rates would suggest (Laird and Yeats 1987).

Nontariff Barriers

As a result of post-war trade negotiations under the GATT, tariffs have declined dramatically in importance as instruments of protectionism in all OECD countries. Average tariffs now range from 0.2 percent to 6 percent, MFN tariffs on industrial products average about 6 percent, and GSP tariffs are about 2 percent. The main instruments of protectionism have become nontariff barriers, including quantitative restrictions (Multifibre Arrangement, agricultural products), voluntary export restraints, restrictive licensing requirements, variable import levies or flexible "import" fees, and import surveillance. For example, EU imports of agricultural products, textiles, footwear, and motor vehicles are subject to such measures. Another very effective group of nontariff measures is related to the so-called trade remedy laws against "unfair" trade. Antidumping investigations and undertakings discourage importers from placing orders for products under investigation as well as for those falling into the same group because of the fear that antidumping duties will increase import cost.

Between 50 and 70 percent of food exports from the former Soviet Union encountered nontariff barriers in OECD markets. More than three-quarters of food exports to Finland and Sweden encountered nontariff barriers, as did almost 70 percent of food exports to Japan. EC nontariff barriers applied to 80 percent of Soviet meat and sugar exports and to slightly less than half of all fresh and preserved fruit products. These nontariff barriers often reflect very high levels of nominal protection against foreign suppliers. For example, the UN Food and Agricultural Organization estimates an average level of protection in the EC and Japan for cereals, dairy, and sugar products of 100 to 300 percent; Laird and Yeats (1990, chap. 5) calculate

that variable import levies in Switzerland and Sweden, which are applied extensively to agricultural imports, often have ad valorem equivalents of over 100 percent.

For manufactures, nontariff barriers were high as well, especially in the EC, Sweden, and Switzerland. Almost 20 percent of Soviet exports to the EC faced nontariff barriers, with leather and leather goods, textile yarn and fabrics, ferrous metals, clothing, and footwear facing especially formidable barriers. A survey by Laird and Yeats (1990) suggests that the level of protection provided by nontariff barriers in the EC lay between 30 and 50 percent for textiles and clothing and between 20 and 30 percent for ferrous metals. Hamilton (1984, 1986) estimates that the protection provided by EFTA's nontariff barriers for textiles and clothing was at least as high as that in the EC, and probably somewhat higher for agriculture. In consequence, nontariff barriers often constituted a major impediment to Soviet exports and, in specific sectors, will almost certainly prevent any significant trade expansion.

A sense of the importance of OECD nontariff barriers to the countries of the former Soviet Union can be obtained by comparing bundles of their exports to the OECD (see table 12.2) with nontariff barrier coverage ratios (table 12.5). In general, the share of a country's exports subject to nontariff trade barriers tends to be larger for countries whose exports include a high share of agricultural products, iron and steel, and textiles and clothing, and smaller for countries specializing in labor-intensive engineering and consumer goods, fuels and ores, and metals. Agricultural product groups suffer the most from nontariff barriers. Although exports of food products account for only a small proportion of total exports to the OECD (and the fifteen countries in the aggregate are net importers of these products), efforts to expand exports (assuming the 1992 export baskets) would encounter formidable barriers. For instance, agricultural products accounted for about one-third of the Baltics' exports to non-OECD markets but for only 3 percent (Latvia) to 7 percent (Estonia and Lithuania) of their OECD exports. Nontariff barriers protecting agriculture in

industrial countries, seem to be behind this discrepancy. Similarly, around one-fourth of exports of agricultural materials—more than 30 percent of exports for some countries—face nontariff barriers in the EU. Iron and steel, important exports for many countries of the former Soviet Union, face enormous barriers in the EU (68 percent of tariff lines) and Sweden (94 percent). In brief, nontariff barriers may prevent any significant expansion of exports in some sectors.

Access to OECD Markets Since the Dissolution of the Soviet Union

Though the countries of the former Soviet Union at first faced most of the discriminatory measures previously accorded to exports from the Soviet Union, the conditions of market access began to improve toward the end of 1992. Many tariff restrictions specifically targeted against the Soviet Union, whether for economic (central planning) or political considerations, have been removed, and exports from most countries now receive either MFN or GSP treatment in OECD markets. Some countries, however, are still subject to the antidumping tariffs and investigations undertaken against the Soviet Union. Since 1987, for example, both the United States and

the EU have levied antidumping tariffs on imports of urea (used for making fertilizers) originating in the former Soviet Union.¹⁶ Also inherited have been antidumping cases filed in the United States concerning titanium sponge and uranium and in the EU against corundum originating in Russia and Ukraine; ferro-silicon from Kazakhstan, Russia, and Ukraine; and potassium chloride from Belarus, Russia, and Ukraine. These restraints are added to the "standard" nontariff measures discussed earlier.

The response of OECD governments to the emergence of fifteen new independent states coping with enormous economic problems was slow and uneven. Except for the Baltic states, imports from other former republics in 1992 were subject to the same restrictions in many OECD markets as those that had been applied against imports from the Soviet Union (table 12.6). The U.S. government granted MFN status to some of the new countries in 1992, and to the remaining in 1993, except for Azerbaijan, which faces 30 percent tariffs compared with the average MFN rate of 5 percent. GSP status, which puts a country on the same tariff footing as designated developing countries, is much more significant than MFN status in reducing adverse tariff margins. For instance, GSP preferential rates

Table 12.5 Share of All Tariff Line Products that Face Nontariff Barriers for Major Product Groups Originating in the Former Soviet Union, 1991 (percent)

Product group (SITC)	EU	Finland	Japan	Sweden	Switzerland	U.S.A.
All food products (0+1+22+4)	39	77	68	76	46	33
Fresh and frozen fish	26	63	100	78	0	0
Agricultural materials (2-22-27-28)	26	0	23	7	20	6
Wood and lumber (24)	21	0	0	0	0	0
Ores, minerals, and metals (27+28+68)	3	0	0	29	9	0
Fuels (3)	1	0	0	1	0	0
All manufactures (5 to 8-68)	18	3	10	26	18	1
Chemical elements (51)	4	0	13	30	16	5
Iron and steel (67)	68	0	0	94	10	0
Transport equipment (73)	0	0	0	13	60	0
Clothing (84)	83	0	71	65	100	0
Miscellaneous manufactures (89)	17	0	2	19	7	0
All nonenergy goods (0 to 9-3)	19	4	18	29	21	5
All goods (0-9)	19	5	19	30	24	6

Note: Nontariff barriers include quantitative ceilings on imports (including all Multifibre Arrangement and other textile quotas), voluntary export restraints, product-specific charges such as antidumping and countervailing duties, restrictive licensing requirements, and variable import levies or flexible import fees.

Source: Derived from tariff records of the World Bank-UNCTAD SMART database.

embrace 63 percent of all combined nomenclature tariff lines in EU imports, with most of them (94 percent of GSP items) subject to zero percent rates.¹⁷ This share is even higher for industrial products (74 percent all at zero percent). The impact on tariff levels is limited. GSP status reduces the average MFN duty on manufactures (excluding chemicals) from 8.1 to 6.4 percent (Laird and Yeats 1987, 95). For 16 percent (1,468 tariff lines) of tariff lines, MFN do not apply (541 tariff lines covering mostly agricultural and fishery products) or are equal zero (927 tariff lines).

The Baltic states have "outperformed" other countries of the former Soviet Union in obtaining better market access. Thanks to their sovereign status before World War II and strong political support from Nordic countries, they had moved very quickly up the pyramid of preferences in many OECD markets (table 12.6). They obtained GSP status in the EU (as of January 1, 1992), a year earlier than the other countries, and have had GSP status in the United States since February 1992. Moreover, the Baltics signed Cooperation Agreements with the EU that replaced the earlier trade and cooperation agreement between the EU and the Soviet Union and in July 1994 signed the free trade agreements covering industrial products. These trade agreements provide for the establishment of a free trade area for industrial goods and for future EU membership for all three countries. They call for the EU to dismantle all restrictions and barriers on industrial products as of January 1, 1995. These agreements pave the way for future full-scale association agreements, similar to those in force between the EU and former European CMEA members.

Bilateral free trade agreements (FTAs) with EFTA countries (except Austria and Iceland) signed in 1992 and early 1993, grant the Baltics "second-best" access (after the EU) to EFTA markets, which have traditionally accounted for a significant proportion of their exports. The Baltic FTAs contain provisions offering duty-free access for almost all industrial products, with no phase-in periods (Sorsa 1994, 28). These agreements clearly contributed to a rapid expansion of trade between the Baltics and Nordic EFTA members despite some trade-restrict-

ing provisions.¹⁸ Estonia, (whose exports increased fivefold), seems to have benefited far more than Latvia and Lithuania from these agreements. By contrast, exporters from all three Baltic states gained from the improved conditions of access under GSP status in EU markets: the value of their exports increased by more than 100 percent—perhaps because of the larger size and greater proximity of Germany, a major market in the EU, than Norway or Switzerland in EFTA.

Trade relations with the EU, the most important trading partner of the countries of the former Soviet Union, have been governed by the 1989 Trade and Cooperation Agreement with the Soviet Union. In October 1992 the EU Council of Ministers adopted a framework for negotiating more extensive agreements with the newly independent countries. After the Baltics, Ukraine was the first to sign a new Partnership and Cooperation Agreement with the EU, in March 1994. The agreement provides for mutual MFN treatment, the removal of quantitative restrictions, and the future establishment of a free trade area. Negotiation of free trade area is conditional on Ukraine's progress in establishing a market economy, to be jointly reviewed in 1998. Market access for sensitive goods was not included in the agreement except for a provision promising negotiation of separate agreements for coal and steel and nuclear materials (trade in textiles and clothes is subject to separate agreements already in force). The EU concluded similar trade liberalizing agreements with Moldova and Russia. The EU Council of Ministers plans to ensure cooperation agreements with Belarus by the end of 1994 and begin negotiations with Armenia, Azerbaijan, and Georgia.

Vulnerability to Trade Remedy Measures

Despite significant improvement in conditions of market access in major OECD countries in 1993, normalization of foreign economic relations for countries of the former Soviet Union remains incomplete. They are not members of the GATT, and their continuing use of state trading makes them vulnerable to trade restricting measures. The Baltics are the only countries that have signed agreements

Table 12.6 Trade Status of Countries of the Former Soviet Union with OECD Countries, as of January 1994

	European Union		Austria		Switzerland		Finland		Norway		Sweden		Canada		United States		Japan	
	MFN	GSP	MFN	GSP	MFN	GSP	MFN	GSP	MFN	GSP	MFN	GSP	MFN	GSP	MFN	GSP	MFN	GSP
Armenia	1/92	1/93 ^a	1/92	3/93	Yes ^b	No	2/93	No	1/92	No	No	No	1/92	4/92	4/92	No	Yes ^d	No
Azerbaijan	1/92	1/93 ^a	1/92	3/93	Yes ^b	No	2/93	No	1/92	No	No	No	1/92	11/92	No	No	Yes ^d	No
Belarus	1/92	1/93 ^a	1/92	3/93	Yes ^b	No	2/93	No	1/92	No	No	No	1/92	11/92	2/93	No ^c	Yes ^d	No
Georgia	1/92	1/93 ^a	1/92	3/93	Yes ^b	No	2/93	No	1/92	No	No	No	1/92	11/92	8/93	No	No	No
Kazakhstan	1/92	1/93 ^a	1/92	3/93	Yes ^b	No	2/93	No	1/92	No	No	No	1/92	11/92	2/93	4/94	Yes ^d	No
Kyrgyz Republic	1/92	1/93 ^a	1/92	3/93	Yes ^b	No	2/93	No	1/92	No	No	No	1/92	11/92	2/92	12/93	Yes ^d	No
Moldova	1/92	1/93 ^a	1/92	3/93	Yes ^b	No	2/93	No	1/92	No	No	No	1/92	11/92	7/92	No	Yes ^d	No
Russia	1/92	1/93 ^a	1/92	3/93	Yes ^b	No	2/93	No	1/92	No	1/92	No	1/92	4/92	6/92	10/93	Yes	No
Tajikistan	1/92	1/93 ^a	1/92	3/93	Yes ^b	No	2/93	No	1/92	No	No	No	1/92	11/92	11/93	No	Yes ^d	No
Turkmenistan	1/92	1/93 ^a	1/92	3/93	Yes ^b	No	2/93	No	1/92	No	No	No	1/92	11/92	10/93	No	Yes ^d	No
Ukraine	1/92	1/93 ^a	1/92	3/93	Yes ^b	No	2/93	No	1/92	No	No	No	1/92	4/92	6/92	3/94	Yes ^d	No
Uzbekistan	1/92	1/93 ^a	1/92	3/93	Yes ^b	No	2/93	No	1/92	No	No	No	1/92	11/92	1/94	No ^c	Yes ^d	No
Estonia	1/92	1/92	1/92	7/92	FTA--04/93		FTA--12/92		FTA--07/92		FTA--07/92		1/92	4/92	12/91	2/92	No	No
Latvia	1/92	1/92	1/92	7/92	FTA--04/93		FTA--05/93		FTA--07/92		FTA--07/92		1/92	4/92	12/91	2/92	No	No
Lithuania	1/92	1/92	1/92	7/92	FTA--04/93		FTA--01/93		FTA--07/92		FTA--07/92		1/92	4/92	12/91	2/92	No	No

Note: Dates are listed by month/year; FTA=free trade agreement.

a. Granted on an exceptional and temporary basis.

b. Continuation of the 1948 agreement with the Soviet Union.

c. Under eligibility review by the U.S. government.

d. De facto applied since January 1992.

Source: Office of the U.S. Trade Representative; EFTA secretariat; United Nations Economic Commission for Europe

that foster an institutional environment conducive to "deep integration" with OECD countries.

Production structures inherited from decades of central planning and the incomplete transition to a market economy make the countries of the former Soviet Union especially vulnerable to protectionism in OECD markets. Remaining government price and trade interventions make exporters an easy target for trade remedy laws against "unfair" trade, including antidumping measures. The status of the countries as "nonmarket economies" (which allows the country initiating an antidumping proceeding to disregard a producer's actual costs and use costs in a comparator market economy to assess the extent of alleged dumping) and their lack of legal expertise in dealing with highly technical and complicated antidumping proceedings intensifies their vulnerability to such actions. Moreover, the surge of exports of some products to OECD countries following the redirection of sales from former CMEA and developing country trading partners have increased the exposure of exporters to various import-restricting actions.

The incomplete liberalization of prices and the foreign trade regime, compounded by the collapse of interstate trade links and shrinking domestic demand, has heavily distorted export incentives. Subsidized transportation costs, bank credits, and energy prices have made some sectors artificially competitive in international markets. Macroeconomic imbalances and inflation have provided an extra incentive to maximize earnings in hard currencies rather than in rapidly depreciating domestic currencies by diverting commodities from domestic markets. With the collapse of domestic demand, consumption of industrial inputs has also declined, leading to cuts in imports and to increased surpluses directed to international markets. In some primary commodities, the region has turned from a net importer to a net exporter.

The proliferation of antidumping actions against exporters from the region is illustrative of problems triggered by the incomplete transition (and of the temptation for countries allegedly "injured" by the flood of cheap imports to resort to protectionist measures). The number of antidump-

ing investigations initiated by the EU against countries of the former Soviet Union increased from one in 1991 to eleven in 1992.¹⁹ The region accounted for 38 percent of all antidumping investigations. During the first three-quarters of 1993, the Commission of the European Union initiated antidumping investigations against imports of unwrought aluminum (originating in all fifteen countries, but targeted primarily against Russian exports), ferro-silico-manganese, and ammonium nitrate. It imposed provisional or definitive antidumping duties on ferro-chrome (Kazakhstan, Russia, and Ukraine); corundum (Russia and Ukraine); ferro-silicon (Kazakhstan, Russia, and Ukraine); isobutanol (Russia); and potassium chloride (Belarus, Russia, and Ukraine (various issues of the Official Journal of the European Communities). The United States initiated fewer antidumping cases (against ferro-silicon originating in Kazakhstan, Russia, and Ukraine; uranium from Ukraine and Tajikistan; and siliconmanganese from Ukraine) after the dissolution of the Soviet Union, perhaps reflecting the fact that exports of primary commodities were directed mainly to the EU (USITC 1993a, b, c).²⁰

Russia and Ukraine, the two largest economies of the former Soviet Union, were the most frequent subjects of EU antidumping investigations and imposition of duties. They were followed by Kazakhstan, Belarus, and Georgia. U.S. antidumping investigations were restricted to Kazakhstan (ferro-silicon), Russia (ferrosilicon), Tajikistan (uranium), and Ukraine (ferrosilicon, uranium, and silico-manganese).

There is some evidence that a lack of legal expertise in dealing with the highly technical and complicated antidumping proceedings contributed to unfavorable rulings. In imposing a provisional antidumping duty on imports of isobutanol originating in Russia, the EU Commission notes that "No Russian exporter replied to the Commission's questionnaire."²¹ Ostry (1993, 13) reports that exporters from the former Soviet Union accused of dumping uranium on U.S. markets decided to fill out "the thousands of pages of necessary paperwork" without seeking legal advice. They failed to return some of the forms and blundered on others. As a result,

the investigation was delayed, and a "voluntary" quota was in effect until its completion (USITC 1993 c). Countries of the former Soviet Union are at a further disadvantage because of their status as nonmarket economies or state trading economies. These designations allowed antidumping authorities substantial discretion in assessing dumping margins (Hindley, 1993). A producer in a market economy is selected as a proxy, and a reference price is constructed based on that producer's costs, without regard for actual production costs. The danger remains that even when prices are fully liberalized in these countries, their status as nonmarket economies will change with a considerable lag. For instance, although Poland has liberalized practically all tradeables, and introduced a liberal and transparent trade regime, it is still classified as a nonmarket economy in relevant GATT statutes.

Just the threat of an antidumping investigation can drive exporters to negotiate "voluntary" restraints. This technique is frequently used by U.S. producers (Destler 1992, 158). The EU frequently imposes quantitative restrictions, instead of waiting for exporters to curtail their own exports. For instance, in response to the French government's request, the EU recently limited imports of aluminum to a global quota of 60,000 tons. But no matter what procedures are employed, the outcome is always the same: a deterioration in market access. For producers in transition economies, facing depressed demand at home and the disappearance of traditional markets, and having little experience in marketing and operating in competitive international markets, the consequences may be severe.

Conclusion

For the countries of the former Soviet Union, trade is in flux, reflecting their adjustment to a new external environment. Trade flows are increasingly determined by economic considerations. Accordingly, their trade with some developing countries and former CMEA partners, which had been artificially sustained by the Soviet Union for political reasons, has contracted. Interstate trade still accounts for the bulk of total trade for these countries, except for Estonia and Russia. Many of the countries are heav-

ily dependent on trade with Russia. For all of them, however, OECD markets, especially the EU, have substantially increased in importance.

Despite enormous differences in economic development and natural resource endowment in the new independent states the composition of exports to the OECD displays striking similarities. The countries are specialized in primary commodities. Agricultural materials, ores and metals, and fuels have been their major foreign currency earners.

The lackluster trade performance in OECD markets was due to initial structural impediments including the breakdown in supply linkages among enterprises of the former Soviet Union, and to slow progress in macroeconomic stabilization and trade liberalization. But the conditions of access to OECD markets have also contributed. Normalization of commercial relations by OECD governments has lagged behind the pace of change in these countries, with the dismantling of central planning and state monopolies over foreign trade eliciting delayed responses except from Canada. For most of their independent existence, these countries faced adverse tariff margins on exports to their major OECD markets. And except for the termination of specific quantitative restrictions in the EU against exporters from formerly planned economies, other nontariff barriers have remained in effect. Antidumping tariffs and investigations initiated against producers in the Soviet Union before January 1, 1992 were not suspended: the dissolution of the Soviet Union went largely unnoticed by those responsible for protecting domestic markets in OECD countries. The use of antidumping measures against them is facilitated by the fact that they have not yet completed the transition to markets, they are not protected by GATT statutes, and the lack of experience in dealing with technical issues of market access.

With the contraction in domestic demand and interstate trade, exports have become critical to the survival of many firms and to the balance of payments position of many countries. Success in transforming a former planned economy into a market economy hinges on sustained exports to the West, for at least two reasons. First, the collapse of intra-regional trade, to the extent that it reflects the elim-

ination of distortions inherent in central planning, is not a short-term shock. With the introduction of convertible currencies, consumers and investors are able to make decisions on the basis of economic considerations. Because of the higher competitiveness of Western suppliers, demand for most investment goods and durables has shifted away from these former partners. Although trade with countries of the former Soviet Union and former CMEA members may increase once the economic slump in the region is over, it will not return to its previous levels. OECD economies will remain a major exporter and importer for transition economies.

Second, the demise of the Soviet common economic space led to a contraction in aggregate economic activity. Expanding export to OECD markets would moderate the decline in aggregate economic activity and make it easier for governments to control their budget and fight inflation. Consequently, a lack of a significant improvement in market access could undermine macroeconomic stability and threaten the transition.

What can be done to improve access to OECD markets? First, OECD governments might consider granting GSP treatment to all countries of the former Soviet Union. That would put their exporters on the same tariff footing in OECD markets as exporters from countries at similar levels of GDP per capita. Second, OECD governments should consider suspending trade remedy actions against "disruptive" imports originating in countries that have in place sustainable stabilization and structural adjustment programs supported by the IMF and the World Bank. Because of inherited distortions, former centrally planned economies cannot be expected to move instantaneously to competitive markets. They should not be penalized for being economies in transition.

Third, accession to the GATT should be expedited to allow these countries to become founding members of the World Trade Organization. Once special admission procedures are in effect, membership could be made conditional on observing GATT rules in their trade relations with each other and with GATT members, GATT discipline—committing to binding tariffs and forswearing the use of

nontariff trade barriers would allow them to benefit more from the efficiency gains associated with trade expansion and with a more predictable framework of interstate trade.

Linking market access with performance under IMF and World Bank supported programs of stabilization and structural adjustment and expediting membership in the emerging World Trade Organization would convey the message that the West has a stake in the successful transition to market-based democracies and so is willing to assume some of the costs of the adjustment. Successful restructuring in the East will thus be accompanied by some readjustment in the West. The quicker the mutual adjustment takes place, the better for all parties involved. And, linking market access with the pace of transition would provide an extra stimulus to move along quickly with economic reforms.

Notes

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1. Infrastructure had been developed to serve the division of labor within the common (autarkic) economic space. Transportation in the Soviet Union, organized mainly around railways, was focused on Moscow. Road transport, used mainly to feed the railways, accounted for a small portion of total freight thus indicating a limited stock of trucks. The quality of roads was very low. One study found that fewer than half of roads were suitable for cars. (see *Independent*, 3 September 1991, as quoted in McAuley 1991,199.

2. The greater involvement of Russia in external transactions was the result of several factors: its natural resources endowment; the centralization of foreign trade operations in foreign trade organizations, located mainly in Moscow; the transportation infrastructure, which prevented other potential net exporters (especially those from Central Asia) of raw materials from gaining access to world markets.

3. The analysis of trade flows is based primarily on partner trade statistics reported to the United Nations COMTRADE records. Other sources (mainly CIS official data as well as estimates of the UN Economic Commission for Europe) are also used. In the case of important trading partners that did not report to the United Nations trade data base or provided incomplete information (for instance, in 1992 India and Hungary reported trade with Russia but not with other former republics, while the former Czechoslovakia, Bulgaria, and Iran did not provide the United Nations with information on their trade). The trade flows of the Baltic states, involving transshipment, are not corrected unless otherwise indicated.

4. For detailed data on directions of Soviet exports, total and by republics, see Kaminski and Yeats (1993). The data for 1992 are derived from the UN COMTRADE database.

5. China was an exception. The value of total exports to China almost doubled from US\$2,051 million in 1991 to US\$4,017 million in 1992, with Russian sales of aircraft accounting for most of the increase. China's imports from Russia amounted to US\$3,526 million (as reported by China in the UN COMTRADE data base).

6. Among developing country partners China is again an exception. Although the share of primary commodities in China's imports from the former Soviet Union declined from 16 percent in 1991 to 14 percent in 1992, the value of these imports increased substantially from US\$334 million to US\$537 million. The bulk of imports of primary commodities was from Russia (US\$337 million) which accounted for 89 percent of primary commodities and 81 percent of total imports from the former Soviet Union into China. Not surprisingly, given its size, endowment in natural resources and geographical proximity, the second most important trading partner of China among former Soviet Union countries was Kazakhstan — its total sales to China were US\$141 million with US\$24 million in primary commodities. (Derived from China's trade statistics in the UN COMTRADE data base.)

7. This expansion was compounded by exports of surpluses in some primary commodities that had previously been imported. For instance, the former Soviet Union shifted from a net importer of zinc and lead to a net exporter. In the case of lead, the former Soviet Union has been a net exporter since 1988, with the 1992 surplus becoming equivalent in terms of volume to its peak net imports in 1986 (Sheales 1992, 559).

8. All the usual caveats concerning the low quality of these data apply to this analysis, which is further hampered by reexport activities which are recorded in OECD trade statistics as imports from a reexporting country. To retain consistency with the OECD trade data for 1992, Goskomstat's estimates of the shares of various markets in total outside shipments republic were used as weights and applied against the value of OECD imports from the Soviet Union in 1990.

9. Interestingly, according to all predictions (with the notable exception of Brown and Belkindas 1993), the Baltics and Belarus stood to lose most from the demise of the Soviet Union. Their demonstrated capacity to redirect their trade goes against these predictions. However, independence turned out to be an excessively expensive proposition for Belarus, which gave up its economic sovereignty by opting for full integration with Russia.

10. Yet, owing to favorable geographic location and commitment to economic reforms, the Baltics in general and Estonia in particular stand out ¾ even if after subtracting the value of reexports of crude oil, ores, nonferrous metals, and minerals from their OECD exports. In 1992 the value of Latvia's and Lithuania's exports to the OECD almost doubled and that of Estonia increased fourfold. Their combined share in total exports from the region was larger than that of Ukraine and accounted for around 40 percent of

total exports from the former Soviet Union excluding Russia.

11. The net trade performance index (NTI) is calculated according to the formula:

$$NTI = \frac{(X_j - M_j)}{(X_j + M_j)} \quad \text{where } j \text{ is a product or a product group, } X \text{ is exports, and } M \text{ is imports.}$$

12. This section draws heavily on Kaminski and Yeats (1993).

13. As of April 1994, Georgia, Tajikistan and Uzbekistan had not applied for membership in the GATT, while Azerbaijan, Belarus, Kazakchstan, Kyrgyz Republic, and Turkmenistan had observer status. The remaining countries accession to the GATT is being processed.

14. For example, Soviet exports of undenatured ethyl alcohol faced an EC tariff of 73.8 percent which was 42 percentage points higher than the average duty that developing countries pay on this product and more than 30 percent higher than the average duty on all exporters combined. Approximately the same adverse tariff margin (41 percentage points) applied to exports of unfermented apple juice, and differentials of 15 percentage points or more occurred on half the tariff line products. (Derived from the World Bank-UNCTAD SMART database.)

15. The concept of effective protection, which measures the influence of protection on value added in a production process, provides useful insights into the effects of escalating trade barriers over commodity processing chains. Specifically, the effective rate shows the percentage reduction in value added foreign exporters of processed commodities must absorb in order to compete in the protected market (see Grubel, 1971, for a nontechnical discussion of the concept of effective rate of protection). Due to the importance attached to the issue, the World Bank identified processing chains for 49 individual commodities that are exported by developing countries in primary and processed forms. See the appendix to Safadi and Yeats (1993) for details. All stages of these chains are defined in terms of the SITC system in order to facilitate analyses of international trade in these items.

16. The main exporters are Belarus, Georgia, Tajikistan, and Uzbekistan. It is interesting to note that despite higher tariff their exports rose from 57,231 tons in 1991 to 94,432 tons in the first eight months of 1992 (International Trade Reporter, April 21, 1993).

17. An important caveat is that many of these imports are subject to GSP preferential rates only within quota amounts and to MFN rates above them. As a result, their significance is overstated.

18. These stem mainly from the bilateral nature of the agreements. By limiting rules of origin to one EFTA country, they favor resource-intensive products by protecting producers of inputs in the two partner countries and thereby discriminating against higher-stage processed products. For an in-depth discussion, see Sorsa (1994).

19. See Eleventh Annual Report from the Commission to the European Parliament on the Community's Anti-Dumping and Anti-Subsidy Activities (1992). Historical levels were consistently lower; just one antidumping investigation initiated in 1989 and two investigations in 1990.

20. The U.S. International Trade Commission (USITC) found that Tajikistan's exports of uranium did not injure or threaten the U.S. industry with "material injury" but that those of Ukraine (excluding highly enriched uranium) did. The USITC recommended antidumping duties on imports of ferrosilicon from Kazakhstan, Russia, and Ukraine.

21. See Commission Regulation (EEC) No.2720/93, item A (7) in Official Journal of the European Communities, No.L 246/12, 2 October 1993.

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Policy Recommendations

*Constantine Michalopoulos
and
David G. Tarr*

- Trade Policy in the Context of Broad Economic Reform
- Trade Policy
- Payments Arrangements
- Access to International Markets
- The Political Economy of Trade Reform

Previous chapters in this volume have shown that the establishment of fifteen independent states in the economic space of the former Soviet Union—each embarking on systemic reforms on a different scale and at a different pace—has created many difficulties for trade among them and with the rest of the world. Although there has been progress in trade reform, its pace and scope have been uneven. In most countries trade incentives are highly distorted, trade and payments institutions are underdeveloped, and the state continues to be heavily involved in trade. Much remains to be done in support of their objective of longer term adjustment and integration into the world economy. This chapter summarizes the main recommendations for trade and payments reform to achieve that objective. These recommendations are placed in the context of the broader complementary reforms required for a successful transition, in particular, macroeconomic stabilization and commercialization and privatization of enterprises.

Trade Policy in the Context of Broad Economic Reform

The first main lesson of the experience with trade reforms in the fifteen countries of the former Soviet Union is the importance of the linkages between macroeconomic stabilization, enterprise reform, and international trade and payments policy. Estonia and, to a lesser extent, Latvia, Lithuania, the Kyrgyz Republic, Moldova, and Russia are the countries in our

study that have made the greatest strides in trade reform. They have also made the greatest progress with macroeconomic stabilization. Ukraine and Uzbekistan, at the other extreme, have large distortions in their trade regimes and heavy state intervention. Not surprisingly, the two countries have also failed (as of mid-1994) to adopt macroeconomic policies for stabilization. Inflation has been rampant in both countries, and most of the adjustment to international prices has yet to come.

There are several complex links between macroeconomic stability and trade reform. Without macroeconomic stability, high inflation will prevent enterprises from receiving better price signals from trade liberalization for reorienting production toward profitable exportables or import substitutes. Macroeconomic stability also helps in establishing currency convertibility, a critical component for addressing the payments problems that have constrained trade, especially among the new independent states (see chapter 5 on Estonia.). Trade reform is part of price and enterprise reforms that are critical to macro-economic stabilization. The chapters on Russia, Ukraine, and Uzbekistan emphasize how the lack of a hard budget constraint, reflected in the presence of large subsidies on imports and directed credits at negative real interest rates, has impeded stabilization. In contrast, the progress Russia has made in stabilization during 1994 owes a great deal to the reduction of subsidies and directed credits to enterprises.

In the long run, the privatization of producing enterprises is also important to export performance and the success of trade reform. Without privatization, enterprises will not respond efficiently to the improved price signals. Even more important, the lack of innovation that characterizes state-owned enterprises will make it difficult for them to compete in sectors where quality improvements are important, such as the machinery sector, and so to improve export performance. In the short run, however, removing the state monopolies on distribution may be the more important area for privatization. The relatively poor export performance of the Kyrgyz Republic has been attributed in large part to problems in the state distribution network. Estonia,

which has expanded exports most effectively among states of the former Soviet Union, has an effective, decentralized distribution network.¹ By May 1994 Estonia had transferred half of its state-owned enterprises to private ownership or control.² Estonia has also attracted private foreign direct investment for joint ventures, as in the textiles and apparel sector. These joint ventures have led the way in exports in these sectors.

One concern with stabilization policies in Eastern Europe has been the worry that combining rapid trade liberalization and the use of a fixed exchange rate as a nominal anchor could result in overvaluation of the exchange rate, creating undue competitive pressure on domestic enterprises from imports and imposing heavy adjustment costs on economies not yet capable of adapting to the new price signals. This problem has not emerged in the former Soviet Union so far. Few stabilization efforts have used the exchange rate as an anchor (the currency board arrangements in Estonia and Lithuania are exceptions), and formal controls on imports have by and large been minimal. The problem so far has been too little competition from imports rather than too much.

The exchange rate has tended to be undervalued rather than overvalued primarily for two reasons. One is that financial demand for foreign exchange has been very strong in almost all countries. Residents, reacting to an economic climate of large fiscal deficits, high rates of inflation, and negative real interest rates, sought a store of value other than domestic currencies. Domestic assets did not meet the need because of unclear property rights, so residents chose to hold foreign exchange, both domestically and abroad, where the latter resulted in capital flight. A second reason for the undervaluation has been the extensive use of export restraints, in the form of licenses, taxes, and foreign exchange surrender requirements at below market rates, by all but the Baltic states. When exports are restrained, the ability to import is restrained by the reduced availability of foreign exchange. By artificially restraining exports to the convertible currency area, countries forgo foreign exchange earnings that, if available, would cause the market price of the for-

foreign exchange to fall (the real exchange rate to appreciate) and make imports less expensive.³

Also, increasing the price of foreign exchange in market-determined environments (or reducing the quantity available for imports in rationed environments) are import subsidy programs such as those in Russia in 1993 and in Uzbekistan today. Allocating foreign exchange at below market rates to preferred importers, as in Ukraine, has a similar effect. Because neither the import subsidies nor the foreign exchange were generally provided for goods that competed with domestic production,⁴ the effect was to reduce the amount of foreign exchange available for competitive imports.

There are four broad conclusions to be drawn from this discussion of stabilization, enterprise reform, and trade policy. First, progress with reform in the three areas tends to be mutually reinforcing, though it is clear that trade reform alone cannot succeed in the absence of progress on the other two. Second, the countries that have reformed the slowest have often maintained that their strategy will reduce the high cost of transition. One of the important findings of the study is that the slow adjustment strategy has typically backfired in the new independent states since the slow reformers, such as Ukraine, Uzbekistan, and Georgia, have not arrested their output decline and still face most of their adjustment costs in the future. On the contrary, the Baltics, which are the countries that have reformed the fastest, have done the most in the way of reorienting production and trade. At the same time, the near term growth forecasts for these states are relatively optimistic: in Estonia output expansion began in 1993, and in Latvia and Lithuania, the decline appears to have bottomed out and some output expansion was expected by late 1994.

Third, privatizing producing units is critical to effective long-run export performance, but privatizing trade and distribution channels and attracting joint ventures in producing units may be more important for expanding trade in the short run. Fourth, the principal imperfections in the trade regimes of the new independent states are in exports not imports, and thus it is in the domain of export restraints that these countries must make the most

progress. At the same time they need to exercise vigilance to ensure that as the real exchange rate starts appreciating in response to effective stabilization, the implicit restraints on imports are not replaced with formal restraints that would tend to impede future adjustment.

Trade Policy

Perhaps the most important recommendation regarding trade policy is that governments should reduce their direct involvement in international trade. While many countries, in particular the Baltics, have made long strides in reducing state trading, in other countries state trade organizations or other public entities continue to dominate international trade—trade in cotton in Uzbekistan and gas in Turkmenistan are two examples. In general, the biggest changes are needed in trade among the countries of the former Soviet Union. Governments need to stop directing what, how much, and at what price commodities should be traded and start doing what governments of market economies do about international trade. Usually, that role is to provide a policy and regulatory environment conducive to trade and to help establish the financial and institutional infrastructure that would facilitate enterprise to enterprise trade (see chapter 11).

The obligatory lists and bilateral clearing that are a continuing part of interstate trade in 1994 are incompatible with a market economy and should be eliminated quickly. Because governments choose which products are on the lists in bilateral negotiation, it is governments rather than market forces and comparative costs that define and control such trade. Experience with obligatory lists in the CMEA has shown that the process leads to losses of dynamic efficiency as well. When enterprises improve the quality of their products, it is extremely difficult to obtain a higher price through the government negotiation process, resulting in little or no product innovation. Obligatory lists are often implemented through state orders or planning (Russia, the Kyrgyz Republic, and Moldova are exceptions), which means that the country is not making the desired transition from central planning to the market. The perpetuation of state orders and obligatory lists hampers the

introduction of a hard budget constraint for the affected enterprises and, more broadly, retards the introduction of market principles in enterprise operations.

Although by 1994 the list of goods traded under state obligation was narrowed to a short list of a few commodities (except between Russia and Ukraine), the distortionary impact of the obligatory trade remains pervasive. Countries such as Uzbekistan use obligatory lists as a means of taxing the agricultural sector on exports to Russia (by offering domestic producers low prices) in order to subsidize the energy-using sectors on imports of Russian energy. The international transactions are likely to occur at world market relative prices since Russian interstate energy sales were no longer subsidized in most cases by 1994 (sales to Belarus are an exception, and there may be others).

Where state obligations to export continue, however, that does not have to imply a need to impose state orders and quantity regulations on producing enterprises. Instead, the state could use procurement agents to purchase goods for interstate trade as Russia does through Roskontrakt. Diversifying state trading contracts would allow other traders to acquire the experience in handling bulk commodities in interstate trade that is required in a market-based trading system and would encourage competition. Private companies should be given equal access to these contracts (including equal access to the financing provided by ministries of finance to facilitate the state trade), and state foreign trade organizations should be encouraged to privatize. Since even small countries typically have thousands of companies (mostly small) that engage in trading services, free entry and nondiscriminatory treatment should demonopolize trading services. Ukraine's experience shows that the private trading companies are much more dynamic and responsive to the needs of their clients than state trading companies, are capable of performing the same functions, and are, in fact, stepping in to perform distribution services where the state trading network has performed inadequately.⁵

Indicative list trading has also outlived its usefulness. It made some sense as a transitional device during a time when the free-rider problem and

export licenses characterized trade between the new countries, but today this trade should be conducted directly between enterprises.⁶ If countries wish to keep domestic prices below world prices—generally, an ill-advised practice—export taxes can be used for this purpose without export licenses (see below).

Export Policies

For some commodities, notably oil in Russia and Kazakhstan and basic raw materials and foodstuffs in several other countries, governments have chosen to maintain export restrictions to keep domestic prices below world prices. The aim has been to keep the consumer prices of food and other necessities low to achieve social objectives and to ease the adjustment of enterprises to the market environment. But export restraints are not the best instruments for achieving these objectives. The social safety net is more appropriately fashioned through targeted transfers in income or in kind, while assistance to enterprises, where appropriate, should be provided through explicit budgetary support.

International Trade. Export restraints (licenses, quotas, taxes, and surrender of convertible currency at below market rates) to convertible currency areas are undesirable because they reduce foreign exchange earnings and distort resource allocation. But if circumstances argue for the use of export restraints (say, because of an inability to raise budgetary resources quickly to provide financing for the social safety net or for enterprise restructuring), then the choice of instrument matters. Though export licensing and export quotas are commonly used, the preferred tool is a variable export tax set to equal the difference between the world price and the domestic price.⁷

First, a tax on exports is transparent. The government and exporters know how much the export tax costs in forgone foreign exchange per unit sold.⁸ Second, an export tax allows exporters to engage in contracts with the certainty of being able to deliver. With export licenses the uncertainty about receiving a license makes it difficult for exporters to enter into contracts. Third, a licensing system wastes resources. Since licenses have substantial value

("rents"), potential exporters will devote considerable resources to obtain the license and capture the rents, wasting resources for society. Fourth, an export tax generates government revenue, helping ease fiscal problems.⁹

The only commodities needing quantitative export controls are those that countries are required by international agreement to limit, such as in the Multifibre Arrangement (MFA). In such circumstances, it is best to auction export licenses, an arrangement that ensures that only the agreed-on quantities are exported, while transferring the rents from the licenses to the state (which reduces wasteful rent-seeking of enterprises). Competition among suppliers at the auction allocates the licenses to the most efficient domestic suppliers, maximizing the rents retained in the exporting country.¹⁰

The principle of converting quantitative export restraints to export taxes and then gradually reducing the taxes had gained acceptance in several countries by 1994. It is strongly recommended that quantitative export controls to hard currency areas be eliminated in countries that still retain them, such as Ukraine and Uzbekistan.

Interstate trade. Countries have been more reluctant to reduce quantitative restraints on exports in interstate trade, although the reasons for the controls were no longer applicable in most cases. The demise of the ruble zone and the introduction of new currencies by most countries eliminated the problems of free-riders and differential progress in price liberalization.¹¹ Countries appear to want to control interstate trade for a different reason. They want to minimize sales to countries with nonconvertible currencies of commodities for which they believe there is a ready market in convertible currency countries. They fear that unwanted balances in nonconvertible currencies or uncollectible arrears will accumulate or that countries will tranship those commodities to the rest of the world. These export restraints take the form of bilateral clearing arrangements with obligatory shipments or of quotas showing maximum permissible volumes to be purchased for particular products.

While these might appear to be legitimate concerns, they derive fundamentally from the failure

of governments to relinquish control of the production and trade of key energy products and raw materials. Had they done so, the risk of accumulating unusable balances or arrears would have been borne by producers or traders rather than governments.

In sum, countries need to focus expeditiously on programs to privatize the distribution and trade of energy products and raw materials, as well as to address the payments problems constraining interstate trade (see below). Export controls are inferior instruments for addressing these problems. There is no reason, except for the free trade area considerations discussed below, to maintain two trade regimes, one for the other countries of the former Soviet Union and one for the rest of the world. Exporters should be left free to sell in whatever country the best (after tax) profits can be made.

Import Policy

Protection. Protection and trade preferences are the two major issues of import policy. Undervalued real exchange rates have provided high levels of implicit protection that have, by and large, permitted countries to get by with little formal protection against imports. However, countries such as Ukraine and Uzbekistan, which have made limited progress in overall liberalization, still control imports through the allocation of foreign exchange. By mid-1994 a significant appreciation of the real exchange rate in several countries (Estonia, Latvia, Lithuania, and Russia) changed the situation. Industrialists started to pressure for protection. Though nontariff barriers have not been instituted, substantial new and differentiated tariffs have been put in place or are under consideration. The main justification for such tariffs has been the protection of domestic industry.¹²

Tariffs are preferable to quantitative restraints on imports for all the reasons elaborated above on the advantages of export taxes over export licenses and quotas. Experience suggests that tariff protection should be moderate (perhaps no more than 10 to 15 percent), transitional, and declining, though each country would need to tailor its tariff structure to its own circumstances.¹³

Temporary and declining protection may be a means of easing the adjustment to a market economy for industries that have never faced competition. With significant unemployment, the optimal path of tariff policy (which trades off the marginal social costs of increased unemployment from tariff reduction against the marginal social benefits of a more rapid adjustment of factors) is to adjust the tariff gradually to its long-run low level.¹⁴

There are several reasons for avoiding high tariff barriers. First, if tariffs are high, industries that benefit from them will resist liberalization, even though tariffs to ease adjustment should be temporary. Once the government slips its liberalization schedule, expectations are altered, and the advantages of transitional protection are significantly reduced.

Second, protection is a second-best means of easing the burden of adjustment. No matter what the justification for protection, the welfare gains are greater with a production subsidy (for enterprises showing promise of adjustment) or a tariff combined with a subsidy on consumption, with the levels declining over time.¹⁵ The problem in this case is that fiscal constraints in the fifteen states make it difficult to recommend the use of subsidies in support of enterprise restructuring—although, notwithstanding these constraints, several countries continue to provide large subsidies, without targeting, through the budget or the banking system with adverse consequences on stabilization and restructuring. But the temptation would be great to keep tariffs high indefinitely or to design made-to-measure tariffs industry by industry to “ease” the transition—a dangerous road because protection supports noncompetitive enterprises and preserves the inefficient industrial structure. Then the economy will not produce according to its comparative advantage, and the efficiency gains and higher growth rates from an outward orientation will not be achieved.

Third, high tariffs, even during a transition, discriminate against exports.¹⁶ Both tariffs and an undervalued exchange rate protect import-competing industries, but use of the exchange rate is preferable to high tariffs because an exchange rate that is not overvalued also encourages exports.¹⁷

Trade preferences. Governments of the fifteen countries have taken an ambivalent stance toward policies that would provide preferential treatment to trade with each other. There have been many public statements of support, and several preferential arrangements have been put in place among certain groups of countries, based essentially on differential tariffs and taxes. Some governments (Ukraine, for example) have also attempted to use the obligatory portion of bilateral clearing arrangements to obtain preferential treatment for their exports in other new independent states. At the same time, several governments have taken steps to inhibit exports of some of the most important tradables to other countries through nontariff barriers and have introduced higher tariffs or taxes on imports from other new countries with which they had not concluded free trade arrangements. For example, before April 1994 Russia levied import duties at double the MFN rate on imports from the Baltic states and Moldova. Latvia applies higher export taxes on goods going to new independent states with nonconvertible currencies.

These arrangements give rise to a number of policy issues:

- Are trade preferences a useful instrument for easing the adjustment costs of enterprises facing international competition?
- Are the current arrangements suitable for addressing that objective and, if not, how do they need to be modified?
- Are trade preferences likely to be important in stabilizing and eventually reversing the decline in interstate trade?

The argument in favor of trade preferences as an instrument of adjustment policy is an extension of the argument for moderate and time-limited support to domestic industry. A first-best solution would be to provide explicit, transparent subsidies through the budget. A second-best solution is to provide modest, time-limited and declining tariffs. The question is whether it might be appropriate to provide such protection on a preferential basis for trade with some or all the other countries of the former Soviet Union.

The basic justification for providing protection on a preferential basis is the strong interlinkages of the production network inherited from the planning regime of the former Soviet Union, which in some industries established a few very large plants that produced for the entire country. If the new countries protected only their own national markets, then they will not have protection in the bulk of their traditional market, the rest of the former Soviet Union. Without a preferential trade area, most states will likely continue to be unable to sell their soft goods, as states search for the least-cost, quality-adjusted supplier. They will then collectively suffer a decline in export demand for their uncompetitive industries before they can adjust and reorient output. But under preferential trade agreements, there would be scope for continuing preferential trade in these less than fully competitive products.¹⁸

Note, however, that the justification is for time-limited preferential protection. As explained in chapter one, in the long run there is a need for a major reorientation of trade. Trade with the rest of the world needs to increase, while the arbitrary and excessive dependence on interstate trade generated by the planning system needs to be reduced. Thus in order not to discourage the long-run integration of these economies into the global trading network, it is important that the preferences be temporary and decline on a preannounced schedule. After a suitable transition the preferential trade area could be terminated by lowering tariffs to the third countries and raising them to members of the preferential area. It is difficult to gauge how long such a temporary arrangement should last. In 1992 we had argued that it should not last longer than five years (Michalopoulos and Tarr 1992). Given the difficulties countries have encountered in adjustment, five years may be too short. It should always be considered, however, that the longer an arrangement lasts, the more entrenched protected interests become and the more difficult the transition may be.

Serious implementation issues arise for both a customs union and a free trade area, the two options for a preferential trade area. A customs union requires agreement by all the countries involved on a common external tariff. Such agreement is likely

to be very difficult to negotiate with many of the fifteen countries. A free trade area does not require agreement on the external tariff, which seems to offer an important advantage. But the benefits are likely to be greater for an arrangement that covers a substantial amount of total trade, a condition that may be difficult to achieve, and some coordination on third-country tariffs is useful even in a free trade area. If tariffs to third countries in a free trade area differ significantly, that is likely to induce smuggling from low-tariff countries to high-tariff countries, allowing the low-tariff countries to capture the tariff revenues.

To counter smuggling, rules of origin are needed.¹⁹ And for a rules-of-origin system to function effectively a well-developed customs service is required. Russia has indicated its intention to implement a certificate-of-origin system, implemented through the relevant industry group of the chambers of commerce in countries with which it has negotiated a free trade agreement. Although the Russian Department of Customs has estimated that the system will not be costly to implement, there is reason to believe that if tariff differences across states are large, the costs of enforcing such a system will become very high.²⁰

These problems suggest that a temporary free trade area with moderate tariffs but extensive product coverage may be the most suitable alternative to pursue.²¹ Even such an arrangement may be difficult to put together, however, and weaknesses in the customs services will result in implementation difficulties. Some people argue that establishing such preferential arrangements would give the wrong signals to industries that sooner or later have to be reoriented to the international market. And even a temporary agreement will protect bad industries as well as good, resulting in considerable trade diversion. Some states—especially small ones, for which an open competitive environment is especially important in the long run—may regard as excessive the trade-diversion costs of participating in a preferential trade area, even temporarily. Finally, the implementation of preferential trade areas in many parts the world has not been successful, leading to further skepticism about the effectiveness of such

an arrangement in the former Soviet Union (see de Melo and Panagariya 1992).

In 1994, only the free trade area negotiated among the Baltics and the recently implemented customs union between Russia and Belarus appear to conform to the institutional arrangements suggested above.²² The arrangements for free trade areas negotiated by Russia with several countries as well as the arrangements in Central Asia are not free trade areas in the sense above. Participating countries continue to apply their export restraints against each other (and continue to use state trading arrangements). These actions are inconsistent with free trade principles. They reduce trade, some of which may be efficient even in the long run. If countries really want to expand trade with each other in an efficient way, they will have to modify these "free trade" arrangements.

Countries need to carefully assess the advantages and disadvantages of free trade arrangements. A free trade area alone would not have a significant impact on interstate trade unless other important constraints are addressed, such as the payments problems. If countries adhere to the recommendation for maximum tariffs of 10 to 15 percent, the preference margins for partners free trade areas are not likely to provide much advantage. Some states may find it preferable to participate in preferential trade arrangements with some other countries of the former Soviet Union, such as the arrangements among Kazakhstan, the Kyrgyz Republic, Russia, and Uzbekistan. This arrangement allows smaller countries to preserve their principal markets without incurring the coordination problems of a larger grouping.

The key issue for the smaller countries is whether to join a meaningful free trade area involving Russia, which is their main market. Countries whose competitors do so would be at a disadvantage on sales in Russia unless they also joined such an arrangement (for example, Moldovan producers face competition in Russia and have lost market share due to the discriminatory tariffs). For some states such as the Baltics, which have already substantially reoriented their trade away from Russia and the former Soviet Union, participation in a pref-

erential trade area with the states of the former Soviet Union is likely to be a step backward. But for all countries, there is little point—other than an expression of political solidarity—in joining a free trade area unless some of the key constraints affecting interstate trade are addressed through the arrangement or in parallel with it.

Payments Arrangements

With the breakup of the Soviet Union, countries had to establish individual links with correspondent commercial banks in financial centers. There appear to be few problems with payments arrangements for trade with the West. In some cases, however, (Ukraine, for example) international trade is still conducted within the framework of bilateral trade agreements because of a scarcity of foreign exchange and continued government involvement. The domestic payments systems of all these countries are still inadequate, hampering trade and contributing to the continued use of barter (see chapter 11).

These problems are small, however, when compared to the payments problems that continue to plague interstate trade. For ruble-denominated transactions long delays in payments and clearing of balances through the banking system, in a context of high inflation, have discouraged trade and encouraged less efficient private barter arrangements. The scarcity of foreign exchange and the need to conserve hard currency for transactions with the rest of the world have also discouraged the denomination and settlement of interstate trade in hard currencies. The introduction of several new national currencies or quasi-currencies that are more or less inconvertible has raised additional questions about the unit of account and the method of settlement to be used for interstate trade transactions.

Currency Convertibility

Currently convertibility should be the goal of all countries, at least for current account transactions. A key requirement is the establishment of a foreign exchange market with unrestricted access.

If convertibility is achieved, then it becomes immaterial whether transactions and settlements are

made in "hard" currencies or in each other's currency because they would be interchangeable. The availability of finance, the stability of the exchange rate, the existence of forward cover, global trading conventions, or similar considerations would then determine the currency used. Traders may wish to avoid denominating transactions in rubles despite convertibility because it is not perceived to be a good store of value and there is no forward cover. Trade between Estonia and Russia, for example, is usually denominated in kroons because of its greater stability. Whichever currency is used, settlements would be made through correspondent commercial bank accounts. A growing network of such accounts has evolved among commercial banks in the former Soviet Union and can be used for this purpose.

Estonia and Latvia have demonstrated that it is possible to establish currency convertibility early on, provided that appropriate macroeconomic policies are pursued. Estonia achieved convertibility using a currency board system backed by substantial gold reserves; Latvia, with fewer reserves, used a floating exchange rate, suggesting that a strong foreign exchange reserve position is not a requirement for convertibility.

Trading with Inconvertible Currencies

Commercial Bank-Based Solutions. Correspondent accounts in commercial banks can be used to conduct interstate trade even when the national currency is not convertible. Trade would be denominated in a currency, such as the dollar or the Russian ruble, with markets maintained in that currency.

Trade can be denominated and settled in hard currency if commercial banks establish reciprocal correspondent accounts in dollars in each other's banks. An alternative would be for commercial banks to maintain hard currency accounts in reputable banks in developed market economies and to arrange for transfers on behalf of their clients through those accounts. Commercial banks in the former Soviet Union are already using this arrangement to facilitate trade with developed market economies. For individual commercial banks this approach reduces the number of correspondent

accounts they need to open and the amount of hard currency they need to keep on deposit.²³

The principal advantage of trade based on dollars or other hard currencies is that they are relatively stable currencies that represent stores of value. The most serious impediment to hard currency-based trade in the present environment is the limited access to hard currency in many countries of the former Soviet Union. Auctions or markets for dollars exist in many countries, but the supply of hard currency is limited because of taxes, exchange surrender requirements, and the general incentive of enterprises that earn foreign exchange to hold on to it as a store of value and hedge against inflation. Moreover, to limit the demand for dollars there are constraints on access to these markets that limit the convertibility of domestic currencies into dollars for the purpose of conducting trade. For example, bids for buying dollars through the interbank markets in Ukraine are subject to screening and approval.

To conduct trade in dollars or other hard currencies through a network of correspondent accounts, banks will need to accumulate a store of dollars to satisfy the transactions demand for dollar-serviced trade. There is an interest cost for maintaining these deposits that is equal to the difference between the interest earned on the accounts and the opportunity cost of these funds. Thus, the interest cost of the transactions demand for dollars is a cost to these countries of trading in dollars rather than their own national currencies. For countries or banks whose cost of borrowing dollars on international markets is quite high, these costs may be substantial.

An additional cost is the transactions fees that must be paid to commercial banks in developed market economies for processing the transactions. It may be, however, that the fees for the transactions do not increase because of the greater perceived reliability of Western banks in the 1994 environment and the relative efficiency with which they process transactions. For some transactions, particularly large ones, banks in the former Soviet Union have been known to hold funds before crediting accounts, to reap the benefits of the float. These banks also have a greater risk of default. Problems

such as these may induce some enterprises to engage in barter and other costly activities to avoid the banking system, which would increase the real transactions costs of trade.

An alternative to hard currency is to denominate trade in Russian rubles and use the existing system of correspondent bank accounts for ruble settlements. (For technical requirements, see Sachs and Lipton 1992.) Commercial banks in countries introducing new currencies have opened correspondent ruble accounts in Russia, and Russian commercial banks maintain correspondent ruble accounts in those countries. These types of arrangements have been used to conduct some of the trade between Russia and Ukraine, Russia and Belarus, and Ukraine and Belarus since late 1992. Correspondent bank accounts have also been used for trade between Russia and other states (Armenia, Kyrgyz Republic, and Moldova), as well as between Ukraine, Belarus, and other countries. A few of the larger banks in Russia and Ukraine maintain multiple correspondent accounts and claim to process transactions in two to three days, an enormous improvement over the months it took in 1992 to use the central bank correspondent accounts. However, there are reports of long delays in Ukraine for obtaining rubles.

While using rubles for the conduct of trade would avoid the need to obtain hard currency on world markets to service the transactions demand for money for trade,²⁴ there are other serious problems in denominating trade in rubles. The most important problem is the high rate of inflation, which discourages exporters from accepting payment in rubles.²⁵ An additional risk, given the instability of the exchange rate, involves ruble-denominated payments for contracts in the future. The absence of futures markets in most of the newly independent states makes it difficult for traders to hedge against an adverse movement in the exchange rate on futures contracts even in dollar-denominated contracts. Contracts denominated in Russian rubles pose similar foreign exchange risks for non-Russian agents, with the additional problem of reaching agreement on a price in the future denominated in a rapidly inflating currency. Ruble-denom-

inated futures contracts would have to be based on an index of inflation. It would be simpler to denominate futures contracts in dollars and then to settle in rubles based on an accepted auction rate between the ruble and the dollar at an agreed time in the future. This arrangement reduces the risk of ruble-settled futures contracts to the foreign exchange risk, which is inherent in dollar settlement as well.

Risks of nonpayment by buyers and nonperformance by sellers are typically handled through insurance services, trade contract enforcement, and appropriate methods of payments (notably letters of credit), mechanisms that are not available in Russia and most of the other states of the former Soviet Union. Letters of credit guaranteed by Western banks for dollar-denominated transactions are available, however, and this mechanism is already used to guarantee payment for imports from Western countries. That means that traders that use the ruble as the basis of interstate payments through commercial bank correspondent accounts in the former Soviet Union take risks that can be avoided if the dollar and Western banks are employed.

Countries with inconvertible currencies face a tradeoff in the choice of ruble or dollar between lower transactions costs with the ruble from avoiding interest costs on dollar deposits to service trade and flight from the ruble because of its high rate of inflation. The higher the rate of inflation of the ruble, the better is the choice of the dollar. On the other hand, if trade finance is available from Russia in rubles, that could be an important inducement for denominating trade in rubles.

The scarcity of foreign exchange and problems with the use of correspondent accounts and with the ruble as a store of value have driven much enterprise-to-enterprise trade between countries with inconvertible currencies to barter terms. Barter, which is intrinsically less efficient, will be abandoned if a well-functioning payments system is established. Countries should strive to strengthen the payments system of commercial bank correspondent accounts while working toward convertibility. At the same time, although state trading barter arrangements should be discouraged, privately arranged barter or payments arrangements during

the interim should not be discouraged. Provided the barter deal is arranged by individual agents acting on the basis of market signals, private barter trade reflects the fact that the individual agents find barter more efficient than the banking system; moreover, private barter should respond to the principles of comparative advantage. Regulations prohibiting private barter do not attack the cause of the problem, which is macroeconomic instability and payments difficulties.

Multilateral Clearing Arrangements. If convertibility is not achieved for a number of the new states, these countries might consider establishing multilateral clearing arrangements through their central banks. The objective of multilateral clearing would be to facilitate trade by providing efficient and secure settlement of payments for enterprise-to-enterprise transactions on a multilateral basis. Secondary objectives could include the elimination of remaining payments restrictions on correspondent banks transactions and savings in the use of scarce hard currency resources.

A simple multilateral clearing mechanism can be operated through participating central banks. Countries would have to agree on a number of technical issues, such as the institutional arrangements (who will act as the clearing agent), the establishment of a clearing unit of account (linked, say to the SDR), eligible transactions, the amount of interim finance provided and the extent and nature of conditions attached to its provision, and the period, terms, and currency of settlement.

Such a scheme was being developed under the Interstate Bank, which was to have been operated through the Central Bank of Russia with participation by most the new independent states other than the Baltics. The Interstate Bank was to have operated with a two-week settlement period in rubles or hard currency and interim finance limited to one month's exports (for details, see Gros's comment to chapter 11). Plans for the bank appeared well advanced in late 1993, but became derailed.

There are several reasons why such a clearing arrangement could still be pursued as a transitional mechanism, as long as it does not distract from the long-term goals of convertibility and trade financ-

ing through correspondent bank accounts. The key advantages of such a scheme are that it saves on scarce foreign exchange by permitting denomination and settlement in rubles; permits multilateral clearing, which is especially important for trade among participants other than Russia; offers some interim credit and some protection of value, unlike correspondent bank arrangements which offer neither; and provides an additional way to arrange for effective enterprise to enterprise payments and reduces the incentive to barter. The arrangement also carries some risks, however. It could distract from efforts to promote convertibility, and it remains to be seen how clearing and settlements through such a mechanism will compare with the speed of correspondent bank arrangements. Also, the persistence of large imbalances in interstate trade may lead many debtors to try to increase the amount of interim finance offered, transforming the arrangement into a payments union. This could lead either to its demise or to the de facto reemergence of Russian financing, through the payments system, both of which would be undesirable.

More grandiose proposals for stimulating interstate trade, such as a payments union, have also been proposed, but are counterproductive. A payments union will discourage development of a network of correspondent accounts among commercial banks since central banks will try to channel payments through the payments union where the country receives credit. And, other things equal, a payments union will allocate credit to the countries adopting the worst macroeconomic policies (see annex).

Whatever the payments alternatives, however it is important that information about them be made widely available to enterprises so that they can avail themselves of the emerging opportunities. At the same time, efforts are needed to strengthen other elements of the system, such as documentary credit and the domestic payments system, that facilitate international payments related to interstate trade.

Access to International Markets

In the short run the key constraints in expanding exports to the rest of the world are supply side

problems, quality control, and export policy rather than market access issues. Yet market access problems exist, and unless actions are taken now, they are likely to become more severe.

The most important step countries can take is to join the GATT. That would give countries some protection from the arbitrary imposition of controls by other countries, including other former republics of the Soviet Union. Too often, the new independent states have used trade as a weapon in their political and economic relations with one another. To join the GATT, countries would have to undertake trade reforms along the lines recommended above. For countries that do undertake such reforms, accession to the GATT should be expedited to the extent possible.

Designation as nonmarket economies by most OECD countries and a concentration of exports—other than raw materials and energy—in sectors where nontariff barriers are prevalent are two of the principal problems of market access for these countries.

The broad solution to these problems is for OECD countries to reduce their nontariff barriers. The Baltics have eased this problem by negotiating special access arrangements with the EU and EFTA. But for most of the new independent states lifting the designation as “non-market” economies is of more immediate relevance since the designation makes it easy for OECD countries to reach positive findings on dumping cases and facilitates the imposition of protective measures. The problem threatens to become even bigger as supply-side constraints ease. Clearly, the countries themselves must make progress in introducing market reforms and eliminating state trading practices. That is already happening, though more slowly in some countries than in others. It is also important that OECD governments move quickly to change the status of these countries as soon as they have introduced the essential elements of market reform, as demonstrated, perhaps, by their having reached agreement with the World Bank and the IMF on programs of structural adjustment and stabilization.

OECD governments also need to consider the specific problems transition economies face when

designing their trade policies. For example, the European Union has alleged that, with transport and energy prices below world market levels, some sectors are artificially competitive. Although moving prices toward world market levels is inherently desirable, commodity subsidies available on a nondiscriminatory basis (such as natural gas, which is used in U.S. chemical exports) are not considered to be countervailable. Moreover, unfair trade actions against these countries have typically been precipitated by the undervalued exchange rates rather than by explicit dumping. Indeed, prices of raw materials are usually priced lower in domestic markets than for export, making it difficult indeed to argue that these countries were “dumping” their raw materials.

In addition to explicit measures to enhance trade access, the international community needs to provide technical assistance and advice in the design and establishment of institutions that support expansion of international trade. Such assistance is needed in various areas, from payments systems to quality standards and export promotion activities. Several countries already have some assistance programs in place. While it is important that they be strengthened, they should not be viewed as alternatives to actions to improve market access.

Finally, OECD countries need to eliminate the vestiges of the cold war from their trade regimes. Implementing their stated intention to terminate the COCOM arrangements controlling exports to the Soviet Union of products embodying technologies with both civilian and military applications would be an important step.

The Political Economy of Trade Reform

The top priority task on the domestic front is to reduce state intervention in international trade, especially interstate trade, where such vestiges of central planning as state trading and state orders still remain. Reforms are likely to be resisted by the entrenched bureaucracies in branch ministries or ministries of foreign economic relations since a key part of these reforms is to remove from ministries functions that can be performed by the private sector while retaining and strengthening functions that improve the environment for trade. Solutions will

differ in individual countries, but at least one country (Moldova) decided to abolish the Ministry of Foreign Economic Relations. Other important tasks include strengthening the payments system and other institutions supporting trade. External assistance may be vital in strengthening these institutions.

A major challenge will be to resist growing pressure to impose import controls. As countries join the GATT, international pressure will contribute to binding tariffs. The same interest groups that succeeded in getting directed credits at negative real interest rates and subsidies through the price system or budget transfers are likely to shift their attention to import controls as a means of delaying restructuring and adaptation to the market environment. These pressures will intensify as countries adopt stabilization measures that eliminate directed credits, reduce other explicit or implicit subsidies, and lead to appreciation of the real exchange rate. Countries need to be vigilant in their opposition to such measures—which are likely to expand to encompass antidumping and countervailing duties²⁶—because they can lead to the same inefficiencies as previous policies.

The political economy issues may be somewhat different with regard to export controls. Although GATT accession agreements do not typically address export restraints, it may be that export controls prove easier to dismantle than has been the case with imports. With import barriers, the benefits of protection are typically concentrated in a few industries that lobby the government. Those who lose from the import protection are a diverse lot, and the costs of the protection to any one individual or industry are typically insufficient to motivate them to lobby against the protection. The logic is opposite for export restraints. The costs of the restraints are concentrated in the industry that is restrained by them. It will lobby the government to remove the restraints. But the benefits of the export restraints are spread to diverse groups throughout the economy, and they will generally have insufficient economic interest in the restraints to lobby the government in their favor. Thus there is reason for cautious optimism that countries such as Russia that

have announced their intention to lower export restraints will succeed in doing so.

More broadly, because of Russia's importance in interstate trade, its policies are likely to set the tone for trade policy in many of the other countries. For example, a decision by Russia to terminate all state trading, including obligatory lists, is likely to have a profound impact on countries that have made little progress in liberalizing their trade regimes. At the same, Russia needs to exercise care in its leadership on interstate trade and payments: many governments zealously guard their new independence, and they are loath to participate in arrangements that reduce—or appear to reduce—their freedom of action.

Annex: Problems with a Payments Union

Clearing or payments unions are sometimes recommended for countries with different inconvertible currencies. Unless institutions are developed to facilitate direct trade among individual agents without government foreign exchange rationing, trade will be hampered. A clearing union allows transactions to be denominated in a common unit of account (say, for convenience, in U.S. dollars), while permitting private agents to pay for imports and to receive payment for exports in their national currencies. Settlements are made in convertible currency, and multilateral balances among participating countries are paid in full after fairly short settlement periods. The proposed Interstate Bank (see Gros's comment to chapter 11) is a clearing union. A payments union differs from a clearing union by allowing for substantial credit in the settlement of the multilateral balance.

Clearing and payments unions are not employed between countries with convertible currencies. Both clearing and payments unions are inferior to convertibility, and care should be taken that establishing such arrangements does not retard progress toward convertibility. These arrangements are also not employed within a country or within a common currency area that has an inconvertible currency, because direct trade among individual agents is possible in all of these cases through the use of domestic currency.

Advantages of a Clearing Union

In addition to facilitating direct trade among individual agents, a clearing union economizes on the use of hard currency reserves since only the multilateral balance needs to be cleared in hard currency; individual transactions are conducted in national currencies. Moreover, since only the multilateral balance is relevant to settlement, a clearing union removes any incentive to discriminate bilaterally among trading partners within the clearing union.²⁷

Disadvantages of a Payments Union

In a payments union, only part of the multilateral balance needs to be paid until a country exhausts its credit limit. Payments unions are sometimes recommended in the hope that they will somehow accomplish one or more of the following objectives: provide balance of payments support, provide an incentive for regional trade, or establish a payments facility among countries with inconvertible currencies. But superior instruments are available to meet each of these objectives: the first objective is best met by bilateral balance of payments support, the second by a preferential trade area, and the third by a clearing union. And it is well established in economic theory that the instrument that most directly attacks the problem at hand should always be used.²⁸ A payments union does not directly attack any of the three objectives mentioned above directly. Moreover, a payments union creates some important problems without conveying advantages that cannot be obtained from a combination of the other instruments.

Balance of Payments Support

First, consider the question of who provides the credit to start a payments union. Countries of the region, including Russia, seem unwilling to provide the substantial credit needed to start the payments union. Should donor nations or multilateral institutions step in to provide the credit? The problem with their doing so is that credit is provided for debtor nations within the payments union. But since the rules of payments unions allow access to credit on the basis of predetermined credit limits, imposing conditions on this balance of payments support is

difficult. Countries that are pursuing the worst macroeconomic policies may run the largest deficits and draw most heavily on the credit. Perversely, balance of payments support would go to the countries whose adjustment programs are least worthy of support.²⁹ In this way, a payments union may prolong inappropriate macroeconomic policies; in particular, it may prolong the period during which the country operates without a convertible currency (see below). Moreover, participating nations may have a greater need for balance of payments support to finance imports from outside the payments union, but the credit provided to the payments union is restricted to balance of payments support within the region. Direct lending to individual countries for balance of payments support rather than credit through a payments arrangement would thus make more sense.

Incentive to Regional Trade

It is sometimes argued that a payments union will encourage intraregional trade, but only preferences for intraregional trade at the level of importing agents can do that. A payments union provides an incentive to a country to trade on an intraregional basis. But how will the governing authorities assure that the incentives to the country are transmitted to the individual agents who make the decisions to import? The country will have to offer financial incentives to its agents to import from within the payments union, most easily executed through its trade regime. Through higher tariffs or other barriers against third countries (such as stricter foreign exchange rationing) the softness of the payments situation can be internalized in the decision-making process of individual agents. For some countries imposing tariffs on third countries would represent a step backward in their trade regime.³⁰ The level of tariff preference for intraregional trade is best determined through the negotiation of a preferential trade area, which directly considers the costs of trade diversion and the benefits of trade creation.

Facilitating Payments among Agents in Countries with Inconvertible Currencies

Though a payments union, like a clearing union, can directly facilitate transactions among

individual agents in countries with inconvertible currencies, it does so while providing credit that is not necessary to accomplish that objective. And that creates problems.

Such arrangements may discourage the development of correspondent accounts in commercial banks and the convertibility so necessary to full integration into the world economy. If a country receives credit through participation in the multilateral payments union, its central bank will have an incentive to force agents to channel their payments for imports through the payments union instead of through commercial bank correspondent accounts.

In conclusion, bilateral balance of payments support, a clearing union and preferential trading arrangements more directly and efficiently attack the problems that a payments union seeks to address. All of these more direct instruments may be usefully employed.

Notes

1. Pinto, Belka and Krajewski (1993) found that the state owned enterprises in Poland were successful in expanding exports after the major Polish reforms in 1990. But Pinto and van Wijnbergen (1994) explained that this success was dependent on the anticipated privatization of these firms. Managers endeavored to create a positive record of performance before privatization. Pinto and van Wijnbergen also note that the absence of subsidies was also an important part of the successful export experience. See also Winters and Wang (1994), who maintain that the highly devalued exchange rate of early 1990 combined with excess capacity in the state-owned enterprises was important in explaining export success.
2. This is as large a greater percentage of private ownership as achieved in any other country of the former Soviet Union with the possible exception of Russia. See Nellis (1994) for an elaboration on Estonia and Lieberman and Nellis (forthcoming) on Russia.
3. More generally, there is an equivalence between a tax on exports and a tax on imports in terms of the impact on imports. The intuition for this theorem is that while import tariffs restrain imports directly, export taxes restrain exports and foreign exchange earnings. Since a country requires foreign exchange to import, a country cannot import if it does not export. Although governments have not imposed significant tariffs on imports, the export restraints limit imports and protect import-competing industries as if there were tariffs on imports.
4. In some cases, such as wheat in Russia, import subsidies were provided for a domestically produced good; but these subsidies were provided only to the extent that domestic demand could not be met by domestic suppliers at a price acceptable to the authorities.
5. In the event that state purchases preserve a monopoly in distribution, deconcentration through antimonopoly action may be considered a second-best solution to terminating state purchases.
6. The countries of Central and Eastern Europe used a system of indicative lists after the demise of the CMEA, but the lists did not prevent a significant collapse of trade with the former Soviet Union. See Tarr (1992) for an analysis of indicative lists and other transition devices employed after the demise of the CMEA.
7. The export tax would therefore decline as the domestic price is liberalized toward the world price.
8. In some cases, substituting the equivalent export tax for a quota may call for an export tax above 100 percent. Such high and uneven incentives in the trade regime cause greater distortions than a more neutral trade tax regime and should be avoided (Thomas, Nash, and others 1991).
9. Auctioning of licenses or quotas can be used as an alternative; under certain conditions it yields the same results as an export tax.
10. Such an auction system was envisaged by the Russian Ministry of Foreign Economic Relations and authorized by Directive 90 of the Russian Federation.
11. The different pace of price decontrol in the ruble zone was also a motivation for export licenses, but with independent currencies export taxes rather than licenses can be used as a second best choice to price decontrol.
12. Tariffs have also been introduced for revenue purposes. A fundamental principle of commodity taxation however, is that neutral taxes (taxes that do not discriminate between imports and domestic sources of production) are the most efficient at generating revenue. Thus, in theory, a tariff (in the pure sense as a tax that discriminates against imports) should not be used for revenue purposes alone. This argument needs to be qualified, however, where a country has a generally inefficient domestic tax system but collects import taxes efficiently. The relative efficiency of tax collection may dominate the neutrality principle, and import taxes could be used for revenue, as in many Sub-Saharan African countries. Value-added taxes have been implemented in many of the states, but it takes time to turn the VAT into an effective nondiscriminatory tax collecting mechanism. Given the short-run difficulties of generating revenue in many of the fifteen states, it may prove useful on occasion to impose taxes on trade, including import tariffs, as a temporary measure until efficient domestic tax collection systems are in place.
13. World Bank experience suggests that developing countries that have been successful in stimulating growth and exports have maintained tariff structures that do not exceed 15 to 30 percent (Thomas, Nash, and others 1991). Recognizing that political pressures for protection are bound to persist, it may be tactically advantageous for governments in the new independent states to aim for some-

what lower tariff ranges, which may enable them to maintain a liberal regime.

14. The most thorough development of this argument is Mussa (1984). Under the assumption that the only instrument of intervention available to the government is the tariff, he shows that in the absence of unemployment or other distortions, the optimal time path of the tariff is immediate free trade, even when there are costs of adjustment of factors of production. He has several qualifications, however. First, myopic expectations by potentially displaced workers are a justification for gradual adjustment toward free trade. Second, concern for the income of workers in shrinking industries will also justify a gradual adjustment such that the industry contracts at roughly the speed of normal attrition of factors in these industries. The most important qualification in our context is based on Mussa's tentative assumption that faster liberalization will increase unemployment. The optimal commercial policy over time should be one that balances the marginal social costs of unemployment with the marginal social benefits of faster adjustment.

Challenging the assumption that trade liberalization has a significant effect on unemployment is a nineteen-country study by Papageorgiou, Choksi, and Michaely (1990). They found that the effect of trade liberalization on unemployment has been small. Often the reallocation of labor was within sectors, causing less disruption than feared. This would argue for a faster transition toward the long-run low tariff were it not for the fact that in the fifteen states unemployment is likely to be high from other shocks, so that the marginal unemployment cost of another displaced worker will be higher.

15. Jagdish Bhagwati, V. Ramaswami, T.N. Srinivasan, and Harry Johnson have developed this proposition in a series of articles. The arguments are summarized in Bhagwati (1971).

16. Exporting industries are taxed by tariffs in a variety of ways. First, the tariff causes the real exchange rate to appreciate and therefore reduces the return to exporting in domestic currency. Second, exporters must pay the import tariff on their imported intermediate inputs. Rebating this tax through duty drawback mechanisms is often attempted, but these mechanisms are often cumbersome and unsuccessful. And the tariff induces import-competing industries to drive up the price of primary factors in competition with exporting industries.

17. Despite these considerations, very high tariff protection has been proposed on an interim basis for socialist economies in transition (see McKinnon 1991) to protect industries with negative value added. This argument could be valid if the negative value-added industries will become efficient competitors on world markets and if this would not occur without government intervention because of externalities. Corden (1992) has noted that this argument is a special case of the infant-industry argument, which would also apply to positive but low value-added industries. The industries of the fifteen states have, however, received protection for decades, and it is hard to visualize these old negative value-added industries being classified as infants, ones in which externalities to investment exist that cannot be captured by the firms. Even if there were such cases,

Baldwin (1969) has argued that protection will generally not address the externalities. Moreover, protection is seldom associated with increasing efficiency, and it frequently has the opposite effect (Thomas and others 1991).

18. Havrylyshyn (1994) argues against a temporary preferential trade area because it will calcify the old trading relationships, but he does not argue for immediate free trade. Rather, he proposes a phased adjustment to free trade along MFN principles for each of the countries. The argument for a phased reduction of protection, rather than a rapid reduction in protection, must be based on a saving of adjustment costs. But if the reduction of protection is along MFN lines, without regional preferences, there will be considerably less saving on adjustment costs because the traditional market for many of the goods of domestic industries is the former Soviet Union, not the present domestic markets.

19. Another reason for moderate third-country tariffs: even within a free trade area, the high-tariff countries bear a disproportionate share of the trade-diversion costs, because the high tariffs induce more trade-diverting imports from the partner countries.

20. A variety of problems may develop as a result of a certificate-of-origin system. First, rent-seeking and rent dissipation may develop, especially for illegal certificates of origin. Second, a system in which certificates of origin are checked for their authenticity to determine the true origin of the goods is likely to add significant delays to border processing and add to corruption at the borders. Both delays and corruption are already reported as a significant problem. Finally, the system may contribute to producer associations exercising cartel-like price control in the issuing country. See World Bank (1993) for details.

21. These problems also highlight the possibility that, if a free trade area is implemented, pressure will be applied to the high-tariff countries to lower their tariffs. The free trade area may thus result in good policies driving out bad ones.

22. Belarus, however, applies its VAT on both exports and imports which is a bias against all imports (or exports), including those from (to) Russia.

23. See Michalopoulos and Tarr (1994) for an explanation of how a typical transaction would be carried out in practice and for an elaboration of the arguments discussed in this section.

24. This will convey an advantage for Russia, as it will not need to obtain dollars on world markets to service trade settled in dollars. Moreover, other countries will maintain deposits in rubles in correspondent accounts, thereby increasing the transactions demand for rubles and allowing Russia to gain seigniorage. In theory, the additional seigniorage gain to Russia attributable to increased transactions demand for rubles from the other FSU states could be distributed by Russia to these countries through Russian compensation payments, which would result in advantages to all participants. In practice, an agreement on distribution of seigniorage may well be unacceptable to Russia. Russia might, however, be willing to provide ruble finance in its place. To the extent that Russia is willing to provide financ-

ing in rubles, this may induce other countries to denominate trade in rubles and use rubles as a means of settlement.

25. The monthly rate of inflation of the Russian ruble was over 20 percent as of November 1993 (almost 800 percent annually), but declined through the spring of 1994 (see chapter 2 in this volume).

26. Pressures for protection through the antidumping and countervailing duty laws have arisen in Estonia and Latvia in 1994.

27. If a network of debit-credit positions exists among the countries without a clearing union there is an incentive to bilaterally discriminate. The home country will favor importing from countries that owe the home country money and discourage importing from countries to whom it is in debt.

28. This has been developed by a number of authors, most notably Jagdish Bhagwati, Harry Johnson, V. Ramaswami, and T. N. Srinivasan. See, for example, Jagdish Bhagwati (1971).

29. Although not supported by significant external aid, this was the case in the payments union of the Central American Common Market, when Nicaragua obtained most of the credit after 1979 and the payments union collapsed as a result. The payments union of the Central American Common Market ceased to operate even as a clearing union after it collapsed.

30. See J. Polak (1991) for an elaboration of this argument.

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