How to Contain Economic Inertia in the Transitional Economies

"No one said it was going to be easy... and no one was right..." (President George Bush, after Yogi Berra)

The restoration of capitalism initiated in Central and Eastern Europe by the 1989 revolutions, and in the former Soviet Union by the coup, countercoup, and then revolution in August 1991, was expected to set the economies in the region onto a path toward greater efficiency, technical progress, and prosperity. A "shock therapy"—price liberalization, monetary and fiscal austerity, opening up of the economy to unrestricted free trade, internal currency convertibility for residents—was understood to require initial sacrifices, but sacrifices that, thanks to stabilization, privatization, and other economic and political reforms, would be short-lived.

These expectations were premature. The first two years of this therapy in Central and Eastern Europe, and the first year for the states of the former Soviet Union, have led to a drastic deterioration in general economic conditions. Between 1989 and 1991 national income in the Central and Eastern European countries dropped on average by about 15 to 20 percent, and industrial output by about 25 to 30 percent. Employment has fallen much more slowly, though fast enough to create unemployment of 8 to 12 percent or more of the economically active population; in Poland unemployment measured 13.8 percent in September 1992. Initial inflation, often hyperinflation, has been brought down but not defeated.

By the end of 1992 the first signs of a turnaround had appeared in Poland. In September industrial output was 9 percent higher than in September 1991, and industrial output in December 1992 was expected to be 13 percent higher than a year before. In October 1992 modest industrial growth resumed in Hungary. The Washington-based PlanEcon observed the first signs of recovery in Poland and Hungary—though recovery still insufficient to reverse the decline in GDP for 1992 as a whole—and forecast a resumption of growth in Bulgaria and the Czech Republic.

The UN Economic Commission for Europe was more pessimistic in its latest forecast (see page 19). It expects Albania, Romania, and states of the former Soviet Union to remain in a deep recession well into 1993. The restructuring of productive capacity has...
hardly begun in the region and is
delayed by drastic investment cuts.
In 1988-91 gross fixed investment fell
on average by about 37 percent. In
1992 it continued to fall, more slowly
in Poland and the CSFR but preci-
tously in the former Soviet Union.
These investment trends engender a
sober view of the medium-run sustain-
ability of incipient recovery. Supply
inertia, not the desired supply
response, has been the standard
predicament of transitional econom-
ies.

This state of affairs is not a necessary
concomitant of transition, nor a con-
sequence of shock therapy that might
be eased by a more gradual approach,
but the unnecessary consequence of
policy failures:

• The failure to accelerate the liqui-
dation and bankruptcy discipline, the
financial restructuring of enterprises
and banks, and the antimonopoly
measures
• The failure in government manage-
ment of the state sector, evidenced by
instances of excessive taxation of state
enterprises, the continued redistribu-
tion of financial resources from prof-
itible to unprofitable state enter-
prises through credit policy, and the
neglect of intersectoral and inter-
regional supply links, including in-
ternational supply links (see box).

Managerial Behavior
Entrepreneurship, defined by
Schumpeter as a combination of or-
ganizational skills and the ability to
anticipate demand, is not absent in
state enterprises, even in centrally
planned economies. It exists there in
a modified form, oriented toward the
security of supply sources rather than
the penetration of market outlets, and
directed toward playing strategic
games with central planners—anti-
pating their demands—rather than
with potential competitors and cli-
ents.

In transitional economies managers
of state enterprises are gradually lib-
erated from central control. Their
dependence on branch ministries is
loosened; direct commands are re-
placed first by government contracts,
then by contracts with suppliers and
clients; and their subsidies are cut
but they can fix their own output
prices. Managers must search for new
supply links and sales outlets; and
market prices for inputs and outputs
create opportunities for profitable
input substitution and product differen-
tiation. Their external financial
resources are also squeezed: inter-
est rates are raised substantially:
interest rates are raised substantially
in nominal and real terms, and bud-
g het allocations become scarce.

In these new conditions state manag-
ers are still not motivated to maxi-
mize profits. There are no capital
markets to assess an enterprise's value
as a going concern. Even if managers
were concerned with bank-
rupency constraints, they would con-
tinue to be motivated to preserve
employment and output and to main-
tain wages at levels far higher than
would maximize the value of the en-
terprise. Indeed, an enterprise could
reach a point at which its net capital
value is zero—beyond which the bank-
rupency constraint might begin to op-
erate. As a result, not much profit, let
alone amortization funds, will be
available for reinvestment.

This situation will change only if
managers are subjected to effective
control by financial markets through
the exercise of shareholders’ voting
rights, and the associated threat of
hostile takeovers. Neither the disper-
sion of shares among a large number
of uninformed private shareholders
nor the concentration of shares in in-
vestment funds is likely to achieve
such effective control; diffused share
ownership will leave managers still
quite comfortable to exercise their
discretionary powers.
Slow Implementation

The adverse effects of an unchanged incentive structure are amplified by the usually slow progress of essential reform steps—the breakup of monopoly power, the implementation of liquidation and bankruptcy procedures, and the financial restructuring of enterprises and banks.

- Centrally planned economies were characterized by extremely high industrial concentration, with single-product producers and producer associations responsible for supplying not only domestic markets but often the entire CMEA and exports to the rest of the world. Once enterprises are given autonomy in determining their pricing and output, the monopoly and oligopoly power built into such industrial concentration and specialization is bound to exacerbate inflationary and recessionary trends.

- Delays in implementing liquidation and bankruptcy procedures are responsible for enterprises being able to pursue with impunity policies of greater disinvestment than those allowed by a solvency constraint, and to maintain higher wages and higher, noneconomic employment than would otherwise be possible. The lack of liquidation and bankruptcy procedures encourages enterprises to accumulate debt. Arrears owed the state budget and banks are equivalent to a monetary expansion. But interenterprise arrears reflect a redistribution of profits from viable enterprises with growth potential to nonviable enterprises sustaining loss-making output—and lead to inflationary disinvestment.

- The enforcement of liquidation and bankruptcy procedures requires the prior financial restructuring of enterprises and banks. Activities might be liquidated which, although unable to make enough profit to service past debts, have a present value as a going concern higher than their liquidation value. Thus, nonviable activities should be closed down, and viable activities should if necessary be recapitalized through new capital injections or debt cancellation. Banks should be recapitalized to compensate for can-celed debt. Recapitalization of state enterprises and banks should be a net claim on the state budget, competing with other claims.

Policy Suggestions

Supply inertia is a distinctive feature of the stabilization and liberalization experience of postcommunist economies. To contain the resulting transition costs, the following measures should be considered:

1. After state enterprises have been turned into joint stock companies, managers could be required to fix their companies’ value (to be considered the selling price if bidders emerge during privatization). Based on this valuation, managers would have to make a normal rate of profit thereafter (including subsequent capital growth), and would receive a predetermined share of profits above that norm. Workers would receive shares worth a year’s wages at that valuation, transferable gradually to “outside” holders over the next five years. This structure would expose managers to a discipline equivalent to that of their capitalist counterparts: they would benefit from profitability, reinvestment, and growth, and would be subject to a takeover of assets if their valuation was too low. Workers would have no incentive to urge distribution of profits and assets. In due course the development of a stock exchange could strengthen this incentive structure and bring it closer to the standards of advanced market economies.

2. Monopolistic behavior could be checked by introducing external competition, even with a moderate degree of tariff protection; by splitting enterprise associations and multination enterprises; and by setting upper price limits with direct reference to world price levels.

3. Until liquidation and bankruptcy procedures are put into effect, disinvestment could be prevented by legal obligations for enterprises to maintain the level of their real capital (assessed as indicated above, and not on the basis of historical capital, even if revalued in line with inflation). The accumulation of interenterprise debts could be prevented by applying punitive interest rates on such arrears (as attempted in Hungary, though at too low a rate to make a significant difference), or by the outright imposition of a cash prepayment constraint.

4. Recapitalization of state enterprises and banks should be an early and urgent undertaking. This merits Western support more than the achievement of formal convertibility at fixed exchange rates.

5. Taxes on state enterprises should relate to their real performance, at rates that allow the firms to plough profits back into restructuring both directly and through external funds. Their access to finance should be based on an evaluation of their general creditworthiness and the estimated present value of investment projects for which funds are sought.

6. The disruption of essential intersectoral and interregional supply flows could be avoided by diffusing more information about enterprises’ input requirements, without reinstating any administrative planning machinery. Internationally, introducing automatic multilateral clearing—the transferability of bilateral trade balances among trade partners within former trade blocs, even short of anything as ambitious as the post–World War II European Payments Union—could help preserve or restore those trade flows that, given the sunk costs of past good and bad investments, still correspond at least temporarily to comparative advantages.

Domenico Mario Nuti
Professor, University of Rome, and Advisor to the Commission of European Communities in Brussels. The article is based on his paper “Economic Inertia in the Transitional Economies,” forthcoming in Impediments to the Transition, EUI Monographs in Economics, edited by E. Espa and others. Florence: European University Institute, 1993.
How are Russian enterprises coping with their turbulent business environment? How do firms and banks interact, and what are the links between them? To find out more about the micro side of the reform program, a recently launched survey aims to cover as many as 100 enterprises in seven cities across Russia. The survey is meant to cover as representative a sample as possible, based on the 1989 industrial census. As part of that survey, World Bank staff recently traveled to Russia and visited some twenty enterprises in Moscow, Novosibirsk, and Sochi. The visit was organized by U.S. researchers in collaboration with the Russian host organization, the Central Economics and Mathematics Institute (CEMI), headed by Valery Makarov. (Data for the survey are still being processed. A follow-up is planned for summer 1993.) Two members of the group, Alan Gelb and I. J. Singh, filed the following report on their findings:

It came as no surprise that the financial situation of the enterprises we visited showed great diversity. Firms that produce consumer goods were typically in a better position than those that produce investment or military goods or technical designs. Historical accidents have also played their part: in some cases, firms were able to purchase large input stocks before the twentyfold price hikes of 1992; in other cases, managers were able to buy out their firm using a combination of accumulated funds and money borrowed at 6 percent nominal interest.

Privatization. Several of the firms had been spontaneously privatized prior to the passage of the Law on Privatization, generally through some "top down" process involving their detachment from ministries and associations. The price for such firms, in retrospect, was astonishingly low. At the time of the visit, firms were busy developing their privatization plans. [See Transition, November 1992, p.6, the Editor.] Although the distribution of shares had not been worked out in all cases, it was clear that employees (including managers) expected to be in a very strong position, particularly in firms with good prospects or with valuable assets, notably real estate. One potentially adverse consequence appeared to be the likelihood that privatization would result in a pattern of quite concentrated ownership and control, at least for existing firms. It was also clear that the firm's rapid action was needed to define and allocate property rights. In the interim, managers faced little accountability. The firms interviewed were generally independent of associations, and although most managers had been elected to their positions by employees, organized labor was surprisingly weak as compared with, say, the situation in Poland.

Production and employment. In common with the rest of the Russian economy, most of the firms had experienced a drop in output, on average by perhaps 20 percent in the past two years. Yet the situation was not so bleak for all firms. Output had actually risen for some products. State orders had essentially vanished, and firms had developed direct contacts with suppliers and purchasers. This did not necessarily mean a higher level of competition. Local monopolies were common—sustained by traditional patterns of doing business rather than overt regulation—and were especially prevalent in construction-related areas, where inter-enterprise links encompass a long vertical chain from sand and other basic materials to the prefabrication construction, and even purchase, of apartments. Firms were beginning to switch product lines to consumer goods in response to changing demand. (The most remarkable case of conversion encountered was the development of a silkworm "zapper" by a high-technology defense company to save the silk that is lost when cocoons are immersed in water prior to unwinding the silk.)

Employment had fallen in most cases, and there seemed to be surprising flexibility in labor allocation within firms and even some signs of movement toward a more flexible labor market. Initial employee reductions were often through early retirement or voluntary resignation (including departures of some of the better employees for the private sector), but there were also dismissals for drunkenness and in some cases for lack of productivity. Social and other services were being cut (usually transferred to local governments), but firms often still bought food and basic goods for their employees. Piece-rate and bonus systems were widespread.

Inflation and price liberalization. In the firms surveyed, almost all trade took place at liberalized prices and in a bargaining framework. Output prices were claimed to have risen less sharply than the costs of key inputs, so that profit margins would have been squeezed severely had the firms not had inventory cushions. Contracts were generally not indexed (there were a couple of rather sophisticated

---

*From the Russian daily Izvestiya*
exceptions to this, however), and most firms quoted prices on the basis of cost plus a large preset margin, although this might be partly due to inadequate coverage of costs. Firms were becoming conscious of the “demand barrier” in setting prices, despite still-limited domestic and foreign competition. Some firms were taking steps to develop more accurate costing and to economize on inputs with sharply rising relative prices.

**Interenterprise payments and debts.** Problems in the payments system have replaced the failed planning system as the major constraint on interenterprise transactions. Despite liberalization, it was not clear whether the proportion of barter has fallen or risen. Within Russia there seemed to have been an easing of the payments crisis since June, with some decline in the average time required to settle transactions, at least between firms close to each other. This seems to have been partly due to policy measures aimed at reducing the overhang of interenterprise debt in the banking system. Payments remained drawn out between the states of the FSU, however, with delays of three to four months and more being cited. Innovative responses to this payments crisis are being developed, including sophisticated systems of barter, transactions to offset one another between states to avoid the need for international settlement, import substitution within Russia, and even occasional payments to “grease the wheels” of commerce when needed. Firms have shifted to a prepayment system, refusing, whenever possible, to ship goods before settlement.

**Toward One-Firm One-Bank?** The number of banks in Russia has exploded, from only a few in 1990 to about 1,500 in 1992. The survey shed light on the reason for this explosion and revealed that it is likely to continue until macroeconomic and regulatory policies change drastically. Almost all firms wanted a bank to call their own, and many were already shareholders in at least one bank. Owning a bank provided many valuable benefits. An equity stake was exempt from the 20 percent reserve requirement on a deposit and was equally liquid since the bank would lend up to five times the capital contribution. Ownership could provide privileged access to loans, as well as services, including the settlement of transactions. There were also few other opportunities for the investment of financial surpluses, particularly as real estate—although desirable—is hampered by weaknesses in the land-ownership laws. Earnings on deposits were very low relative to inflation, but so were loan rates. Yet not all firms indicated an unqualified desire to borrow; friction about payments and the high level of economic and political uncertainty created a certain amount of caution.

**Taxes.** In addition to complaints—characteristic of taxpayers everywhere—about the level of taxes and government waste, a major problem cited was the frequency of changes in the tax code and in tax administration. Furthermore, firms have had to shift to a prepayment system for taxes, with penalties for underpayment and no rebate of overpayment. The volatile inflationary situation has greatly complicated tax administration. Experience in Eastern Europe has shown that the corporate tax base typically falls sharply in the second year of reform—rather than immediately—and that some of this decline is due to improper inflation accounting. It was not clear whether the same pattern would be true for Russia.

As a preliminary conclusion, our visits suggest that reforms in Russia have left firms in an environment of enormous uncertainty and high perceived risks. Many firms are starting to adapt, in the face of sudden inflation and large relative price shocks. Price liberalization has had some salutary effects on behavior. At the same time, local monopolies, vertical integration, and problems in the payments system slow the growth of competition. Improving the payments system is a top priority—although regularizing the settlement process could cause a further real decline in money holdings. There are strong forces urging integration of the enterprise and banking sectors—an understandable response in the short term, but one that in the longer term could make the economy structurally vulnerable in a crisis. Ownership and control are evolving rapidly, and it looks as though the “insiders” will dominate in the foreseeable future.

---

From Siberia to Stalin’s Dacha—Impressions

Traveling around Russia in the wintertime poses some challenges, including being delayed by Aeroflot, with all your luggage, onto an apron far from airport buildings—at night, in the middle of a snowstorm! Our group stayed in Akademgorodok, a specialized scientific town of some 40,000 near Novosibirsk and a center of scientific and technical research. This town evinced some of the paradoxes of today’s Russia. Visitors from the most prestigious research institutes in the West shared its only hotel—and praised its scientific and technical expertise as second to none. Yet the institutes are dying, strangled by loss of funds, except for those that are able to sell equipment, such as particle accelerators, for hard currency. A process of human conversion is under way, as mathematical theoreticians retool into bankers and consultants.

Sochi, on the Black Sea coast, was an entirely different world from Siberia, warm, with luxuriant palm trees and other vegetation. Sochi, being a famous resort area, is also a center of light industry, including food processing. The group stayed in the former Central Committee hostel (the best food experienced in Russia) and visited Stalin’s dacha for dinner.

Stalin’s dacha—a paneled manor house that boasts a private cinema (the feared leader was an avid fan of American movies), large bedrooms with surprisingly small beds, and a conference center—is being partly privatized.

---

Alan Gilb and I. J. Singh, CECTM
The World Bank
Quotation of the Month: "No Reason to Expect Inflation to Stabilize"
Commersant Experts Discuss Russia's Economic Future

According to Russia's state committee for statistics (Goskomstat), in November the cost of living rose by one-third and real income may have dropped by as much as three-quarters over 1992. The new rise in inflation rates was spurred by a number of factors.

There has been an increase in cash issued over the past few months—168 billion rubles in September, 194 billion rubles in October, and 253 billion rubles in November—causing prices to spiral once again. A rapid rise in income played a significant role in this jump. The increase in minimum state pensions and seasonal payments in agriculture dramatically increased demand for cash, and the presses churned out an unprecedented 250 billion rubles. Excessive rubles held by the public accounted for 39 percent of their income, nearly surpassing June's record high.

Wholesale prices skyrocketed almost overnight as banks issued an unprecedented 1 trillion rubles in credits in November, representing a 70 percent increase over October. The burst of credit extensions through November was the result of the Yeltsin government's eleventh-hour attempt to attract public and industry support before the convening of the Congress of People's Deputies. In early November, the government granted a 4 billion ruble credit to Kuzbass to buy grain in Kazakhstan. The Sverdlovsk region was granted 6 billion rubles to organize the Ural Military District. On the eve of the congress, the government expedited the release of 77 billion rubles to defense industries converting to civilian production. On November 25, the central bank released money deposited to account 725, which is used for settlements between debtor enterprises. In all, more than 100 billion rubles in frozen monetary assets was flushed into the economy.

The rise of the average industrial price index in November was largely explained by higher prices for fuel and related products. In October alone, prices for fuel products rose 2.13 times. After prices were raised, the gap between prices of primary and intermediary industrial products disappeared, thereby producing a knock-on effect, especially on consumer goods production. According to Goskomstat, after fuel prices were liberalized, debts between enterprises increased, and some were even forced to stop paying workers because of shortages of funds.

Between August and September, firms owed each other and the state about 1.8-1.9 trillion rubles. By November 1, that sum had increased to 3.3 trillion rubles, more than they had owed each other when the debt crisis peaked on July 1. The effect on the economy was less devastating than in the middle of the year, however, because prices have more than doubled since then. In addition, firms and commercial banks deposited more money in the central bank than previously. In other words, this debt is not high enough to paralyze settlements as was the case in June. But there is still a threat that growing debts will stall...
settlements and lead to delays in cash payments to the public, and result in more centralized credits to inefficient firms.

In contrast to most Western economies, which rely on a variety of equilibrating mechanisms such as rationally balanced credit markets, the absence of Russian market regulators has produced an irrational and inflationary price structure that is undermining Russia's attempts at achieving macroeconomic stabilization.

Although the central bank and the government should get credit for pursuing ingenious tactics in reconciling enterprise debts, many of their solutions have been of the band-aid variety. Too often, these deficits were shifted from one account to another, only to be written off by further credits. And again, although both institutions deserve praise for stabilizing the ruble on the currency exchanges and for lowering the budget deficit, their efforts have had little effect on keeping inflation in check.

The circulation of the money supply also directly affects inflation. Despite a steady increase of cash in circulation, there is still a powerful tendency against savings. Since interest rates for all deposits, when adjusted for inflation, are effectively negative, firms prefer to buy and sell, rather than hold onto money. This is what John Keynes called a "liquidity preference"—the desire of the public to hold money in the form of cash as a means of short-term hoarding. In 1992, the share of liquid assets has increased steadily, from 54.5 percent in January to 70.6 percent in July and to 84.2 percent in October. The share of cash in overall money supply grew from 15.9 percent in January to 24.1 percent in July and 26.8 percent in October.

Industries are becoming increasingly wage-intensive. This dynamic is illustrated by comparing the earnings-to-wages ratio of major industries since the beginning of the year. In January 1992, for each ruble's worth of product sold, industries paid 23 kopeks to workers; in October this figure rose to 36 kopeks. Furthermore, industries are, for the most part, turning centralized credits into cash by increasing social payments to workers.

There is no reason to expect that inflation will stabilize in 1993. As Russia becomes more integrated into the world economy, inflation is certain to rise even farther as prices adjust upward toward world levels. Overall money supply is likely to grow in the first quarter of 1993 to 8 trillion rubles, and the amount of cash in circulation to 3.5 trillion rubles.

[Russian] economists estimate that the average monthly price increase will be 45 to 47 percent in the first quarter of 1993. Higher costs in agriculture, higher procurement prices, and a higher dollar rate could push up the cost of living index by 55 to 60 percent a month or 12 to 12.5 percent a week in the first quarter of 1993. The rapid decline of living standards is bound to heighten social tension, the more so since latent and de facto unemployment is already growing by at least 20 percent a month as a result of mounting closures and the enforced idling of industrial enterprises.

Russia's government has two alternatives for weathering the crisis. The first is the inflationary indexation of wages and social reimbursements, which would require issuing at least 500 billion rubles monthly. The pitfalls of this approach are obvious: once the government embarks on the inflationary road, it will not be able to leave it for many years to come.

The other alternative calls for freezing prices for staples and reintroducing state orders for the production of a minimum volume of goods. Monopolist producers of other commodities will probably see their profit margins controlled. Imported goods would be subject to excise duties equal to those applied to domestic products, and, simultaneously, strict controls on retailers' write-ups would be introduced.

Thought Exchange

A Case for Direct Hard Currency Transfers to Russia's Needy—Comment on George Soros's Recent Proposal

Our readers keep expressing interest in a new forum to discuss the most burning issues of transition in a frank and open way. As topics are abundant, we start our Thought Exchange right away—quoting ideas and comments, rather than prices. (The Editor)

At present, there are two clearly discernible threats facing post—cold war attempts to make economic reforms and to nurture nascent democratic institutions in the former Soviet Union. First, the people face dire shortages of basic and essential goods and services. The shortfall is manifested in the sharp reduction of domestic production of certain goods across all sectors of the economy, whether privately or publicly owned, and the inability to import these goods because of the lack of foreign exchange. Last year, overall production in Russia fell by 20 percent. For the average Russian family, not only are basic necessities in short supply, so are the raw materials, semifinished goods, and spare parts that are needed to maintain production in the aging factories and on farms. Already there are signs of a negative "employment multiplier," which will be characterized by massive layoffs among Russia's roughly 70 million workers.

Second, the lack of resources not only prevents the new investment required to modernize plants and rebuild the infrastructure (transport and communication, housing, health and education); it hinders the day-to-day operation and maintenance of essential production lines. The easy way out has been through government deficit financing. But this has seriously destabilized the currency, resulting in runaway inflation of 2,000 percent a year. The result is bound to be erosion of confidence in the economy with drastic effects on private savings and investment.

Recently, Mr. George Soros, an emigré from Hungary who is a businessman and humanitarian, has come up with an innovative idea for Western assistance to the FSU (see box). Soros pro-

Summary of George Soros's Proposal

...To be effective, [Western] help should take the form of an internationally financed safety net, distributed directly in the form of hard currency—dollar or Deutsche mark bills—to the unemployed and needy...Given the fact that the minimum wage in Russia is $6 a month, the cost of such a scheme would be well within the range of an IMF program. I believe $10 billion a year would be sufficient for the entire former Soviet Union. The benefits would be incomparably greater because the scheme would have several multiplier effects and would set into motion a virtuous circle.

* The most important benefit would be the introduction of a hard currency. The ruble never served as a full-fledged currency, and incipient hyperinflation has only made matters worse. In the absence of a medium of exchange the economy functions largely by barter. And in the absence of a store of value there is large-scale capital flight....

* The social safety net would also provide a powerful incentive to shut down loss-making enterprises. If [workers of enterprises operating with negative value added] were paid by foreign assistance, factories could be idled and the raw materials and energy that go into production could be sold for more than the output.

* The introduction of a hard currency would deprive the government of its ability to finance the deficit by printing money. The government would have to balance its budget. Given the benefits of the assistance scheme, this would no longer be impossible. With a social safety net in place, commodity subsidies could also be reduced—people could be asked to pay more for their bread and oil. At the same time, tax and customs and excise revenues could be protected by levying them in hard currency.

* The introduction of a hard currency could go a long way toward reestablishing trade among the newly independent states....

Many of these advantages could be secured by simply recognizing a hard currency as legal tender, but that would be inconceivable without the scheme proposed here...Of course, if the scheme were implemented the exchange rate might fall. But that is a problem that would arise only after hyperinflation had been brought under control and the domestic currency stabilized. By that time the government ought to have the resources to take care of the needy and unemployed.

Where is the $10 billion to be found? The obvious place is the International Monetary Fund because the IMF has a mandate from the Group of 7. ...A special facility [of the IMF] could be established for countries that have fragmented into many pieces. An intergovernmental arrangement among the G-7 countries might also be feasible. They would jointly guarantee a $10 billion loan to the successor states of the Soviet Union. One country—the United States or Germany—could volunteer to provide the cash that would be distributed, and the other countries would agree to share the burden if and when the banknotes were exported....

poses a massive injection of hard currency—$10 billion a year—to be paid out directly to the needy in Russia and other successor states of the defunct Soviet Union. This externally financed "social safety net" could:

* Generate demand for domestic and foreign goods and services without causing a drain on foreign reserves.
* Check runaway inflation and stabilize the ruble, thus enabling unimpeded domestic financing of investment from private sources through the 1,500 commercial banks already in operation and through other credit institutions.

A smoother transition for the former Soviet economies and a reversal of the downward trend of the economy will be possible only if the population is cushioned against extreme hardship. Apart from the plan's justification on humanitarian grounds, it is good economics and good social policy. The well-being of the citizenry ought to be the central objective of all democracies.

Foreign economic assistance and Western involvement, including multinational organizations, could be targeted to populations bearing a disproportionately heavy burden of their countries' transitions to market economies—a process in which the foreign-aid community also has a big stake. Direct transfers of hard currency to the populace in sufficient amounts, without the usual dithering, might effectively replace the vast and inefficient social welfare subsidy structure, which to date has been maintained through inflationary expenditures, invasive regulations, and conditionalities.

There is another, equally important objective of a massive infusion of hard currency into the economy of the FSU—that is, turning Gresham's law upside down by using good money to drive out bad money. There is an urgent need to restore consumer and investor confidence in the national currency, either by revaluing the ruble or by issuing a new currency.

This should allow Russians to reach under their pillows and convert hoarded "nest eggs" of lifetime savings into development finance.

The alternative will be massive capital flight, and the eventual removal of exchange barriers and controls and introduction of currency convertibility will prove to be too late.

To solve the unprecedented problems of transition in a Soviet-style economy, it is neither necessary nor sufficient to slavishly embrace Adam Smith and the free market. Nor does one have to adhere to Keynesian deficit finance theory, however tempting it might be, if public investment is offered as the only alternative to economic stagnation. There are other alternatives, such as the approach associated with

the views of Joseph Schumpeter (1883-1950), who considered private credit the fuel that can trigger and sustain economic growth and development.

Schumpeter recognized the dynamic role of the capital market and credit institutions in financing innovation and development. At present, however, private credit institutions and banks are sorely lacking in Russia and other successor states of the FSU.

In combination with George Soros's suggestions of creating a social safety net and setting up a hard currency zone within the Commonwealth of Independent States, the establishment of effective private credit institutions could provide the basis for the economic growth of a free economy in the former Soviet Union.

Abdul G. Khan

The author is Adjunct Professor of Economics at the Kogod School of Business, American University, Washington, D.C.

From Croat cartoonist Srecko Puntaric (Felix)
Research Update

Intergovernmental Finance in Transitional Economies—Broadening the Framework for Analysis

A new World Bank research project, "Intergovernmental and Subnational Government Finance in Transition Economies—Broadening the Framework for Analysis," addresses intergovernmental finance issues and explores the need for a broader framework of analysis for decentralization and intergovernmental fiscal issues in the transitional economies.

Not Just a Local Matter

An important and unduly neglected aspect of the transition in Central and Eastern Europe is the extensive decentralization, both political and fiscal, that is taking place in many of the countries newly emerging from behind the socialist veil. Decentralization represents both a reaction from below to the previously tight central political control and an attempt from above to further the privatization of the economy and to relieve the central government's fiscal strain. The aspirations and roles of subnational governments are becoming stronger in most of the transitional economies.

The ongoing reforms in subnational finance in these economies are much more important than generally recognized. In some countries in transition, the subnational governments are quantitatively significant, accounting for a large (up to 50 percent) and often growing share of the budget. Within the fiscal sphere, tax reform, deficit control, and intergovernmental finance form a tripod: unless each leg is properly set up, the entire structure may collapse. Intergovernmental finances will have an important effect on the efficiency with which the transitional economies perform, on their macroeconomic stability, on their safety net, and on the success of their privatization policies.

1. Fiscal balance at the subnational level is critical to macroeconomic stability. Several central governments are attempting to shift the deficit down to ensure that they have adequate revenue flow, either by shifting expenditure responsibilities down or by retaining additional revenues, even if this severely impairs budgets at the subnational level. The results, ironically, could contribute to further instability: the soft budget constraint in these countries may allow subnational governments to respond by accumulating arrears, borrowing (strong-arming their enterprises to finance public expenditures), or developing extrabudgetary sources of revenue. Pushing the deficit down does not necessarily reduce it—it may merely repress it.

2. Some central governments may wish to transfer responsibilities for the social safety net to lower levels of government, but an underfunded subnational government cannot carry out those responsibilities effectively. If the safety net is considered critical to the success of the transition, and therefore a national policy objective, subnational governments should not be expected to finance it. But subnational governments, as they are closer to the people, might administer the safety net more effectively.

3. The ownership of many enterprises has been transferred to the subnational governments, and the responsibility for privatization of the enterprises now rests with those governments. They still rely on these enterprises for profits and tax revenues. If the enterprises are privatized, not only will the governments lose a source of revenue, they will have to assume the costs for nurseries, housing, and other services that the privatized enterprises will spin off. Intergovernmental finances should accommodate these shifts in expenditure responsibilities and provide corresponding revenues.

New Approach

Traditional analysis of subnational finance—focusing on expenditure, revenue assignment, and transfers—cannot be mechanically applied to economies in transition. Therefore, the research will focus on the following major issues:

- Subnational governments, although mainly service providers in market economies, play a pervasive role as producer and owner in post-socialist economies. Thus, they can be either potential impediments to, or supporters of, privatization.
- In most transitional economies, government revenues are declining more rapidly than governments are able to divest themselves of expenditure obligations, contributing to macroeconomic pressures. Subnational governments must take over a wide range of expenditures—including social outlays—that were previously financed by state enterprises. That will complicate attempts to cut subnational expenditures, and could lead to demands for increased transfers from equally hard-pressed national governments. The level, design, and effects of such transfers is thus a critical aspect of the emerging intergovernmental and subnational government finance systems of transitional economies.
- There is a need to coordinate user fee reforms with wage reform on the one hand and general price reforms on the other so as to avoid excessive impact on income and profits, and thus a fall in government revenues. In the past, socialist governments applied fixed prices (including rents and other urban user fees) and wage controls as part of their distributional toolkit. They are now advised to "get the prices right" by using tax policies and targeted subsidies. Changes in public sector prices could imply major distributional shifts unless properly coordinated with other reforms.
Significant changes in the economic structure and in wages and prices imply potentially large shifts in the different tax bases. These shifts must be taken into account when designing an intergovernmental fiscal system. Central governments try to preserve degrees of freedom in dealing with subnational governments and to continue the negotiated tax-sharing systems of the past. Subnational governments seek greater autonomy and demand "fair treatment" and equalization. A particular challenge lies in developing an intergovernmental fiscal framework of grants, shared revenues, and discretionary tax powers that is sufficiently firm, but also compatible with structural changes.

**Methodology and Data**

The project will rely on a methodology that combines empirical analyses and case studies based on earlier research on, among others, Hungary, Romania, and the "federal" states of China and Russia. The project will analyze the importance of ownership for subnational governments, the relation between fiscal decentralization and privatization, the relation between fiscal decentralization and the safety net, and the development of new systems of subnational government finance.

Preliminary investigation suggests undertaking systematic quantitative analysis for selected countries, based on cross-sectional data for subnational governments. Cross-sectional data sets—sometimes for consecutive years—are currently available for subnational governments in China, Hungary, Poland, Romania, and Russia. Additional fieldwork is expected to produce more data sets for Poland and the Czech Republic.

The project is scheduled to be completed in December 1993. It is managed by Christine Wallich, CECPE, the World Bank, and Richard Bird, University of Toronto. (For additional information contact Christine Wallich, CECPE, the World Bank, tel: (202) 473-7686.)

---

**Milestones of Transition**

Slovakia's share of foreign investment in Czechoslovakia was only 7.7 percent in the first nine months of 1992, according to figures released in early December by the Slovak National Agency for Foreign Investment. In 1991, Slovakia attracted 27 percent of the foreign capital. (Slovakia's population has been one-third of the ex-CSFR.)

The Czech Republic passed its first budget as an independent state—a balanced budget of 542 billion crowns for 1993. The government aims for economic growth of 1 to 3 percent in 1993, and, following the introduction of the value-added tax, expects inflation to accelerate to 15 to 17 percent from the current 10.7 percent rate.

Ukrainian consumers have found their cost of living sharply increased as the result of a government decree issued on December 22. For example, in Kiev, the price of bread rose six times, a subway ticket ten times. Ukrainians can expect further price hikes at the start of the new year, including a 50 percent rise in train tickets, a doubling of costs for communications services, and a 60 percent increase in housing rents.

Russia's unemployment rate was only 0.45 percent in October, but 50 to 75 percent of the unemployed are women, according to the Russian State Committee for Statistics (Goskomstat). The number of registered unemployed was 367,500, of whom 219,000 were receiving unemployment benefits. Every third unemployed person was under twenty-nine.

On December 7, Russia's Congress of People's Deputies approved the final version of a constitutional amendment to regulate the private ownership of land. The constitution had contained no provision for private landownership. There is a Russian law that permits private persons to buy and sell land—but only in transactions with the state. The final version of the amendment allows landowners to mortgage their property and to sell to individuals and corporations provided there is no change in the use of the land. None of the other amendments, including one banning the sale of land to foreigners, was passed.

Tatyana Paramonova, Deputy Chairman of the Central Bank of Russia, has stated that the settling of the interenterprise debt accumulated before July 1992 (which amounted to 3.2 trillion rubles) through the issuance of central bank credits is now complete. She claims that the credits required will amount to approximately 181 billion rubles, to be paid out by March 31, 1993, and noted that this was much less than the 1 trillion rubles originally predicted. But the Central Bank's chairman, Viktor Gerashchenko, has spoken of the need for further credits to cover new interenterprise debts, arising since July, which now amount to 3 trillion rubles.

A draft charter of the CIS Interstate Bank was approved at a meeting of CIS financial experts held December 7-9. The main function of the bank is to secure conditions for "the many-sided clearing between banks in interstate and other payments." It was decided that the means of payment for the Interstate Bank will be the Russian ruble. Each state is to have one vote on the bank's managing board, regardless of its economic potential. The initial fund is expected to be "no less than 5 million rubles," and Moscow was considered the most appropriate location for the bank.

Energy problems continue to plague Bulgaria. On December 11 the legislature approved an economic credit package of 1.6 billion leva ($65 million) for thermal power plants and the coal-mining industry. The move will allow the energy industry to pay off outstanding debts, and it appears that a rate hike for consumers has been averted as winter sets in.

(continued on page 14)
World Bank/IMF Agenda

Russia to Join the IFC

Russia's parliament adopted a resolution advocating membership in the International Finance Corporation. IFC membership will grant Russia access to foreign loans and investments, speed privatization, and facilitate creation of a stock market. Russia's share in the capital of the IFC will amount to 3.42 percent, making it one of the largest shareholders. Moscow would have to pay about $28.5 million to become a member and about $17 million more in the first year of membership. The IFC has been helping with Russia's privatization program, which was launched last year as a key element in the country's move toward a market economy.

IDA Funds to be Replenished with $18 Billion

The International Development Association announced on December 15 in Berne, Switzerland, that thirty-four donor countries had agreed to replenish IDA funds with about $18 billion over three years beginning July 1, 1993. Combined with repayments by IDA borrowers, this latest replenishment will finance a total of about $22 billion in commitments for development projects. World Bank Managing Director Ernest Stern, Chairman of the IDA-10 replenishment negotiations, said the willingness of donor nations to contribute this sum—a slight increase in real terms over the $15.5 billion agreed to by donors in the ninth replenishment—was remarkable at this time of sluggish economic growth and fiscal restraint. The IDA would focus more on the poorest countries of Southeast Asia, Africa, and Latin America, with particular emphasis on poverty reduction, family planning, and social services for women in these areas, Stern said.

New World Debt Tables

External resource flows to developing countries—comprising debt, equity, and grants—reached $134 billion in 1992, with foreign direct investment and portfolio investment showing the sharpest rise, according to World Debt Tables 1992-93, published by the World Bank on December 17. In 1992, aggregate net resource flows increased by 17 percent. States of the former Soviet Union are included for the first time in the aggregate statistics of the Tables. The World Bank estimates the external debt of the former Soviet Union to have been $75.4 billion at mid-1992. Repayment arrears at that time amounted to $9.4 billion. Nearly 52 percent of the total debt is due within the next three years. (Russia has assumed responsibility for repayment of the debt of the former Soviet Union, but was able to repay only about $2 billion in 1992 and has warned that it can pay no more than $3 billion in 1993.) The total external debt of all developing countries, including the hard-currency liabilities of the former Soviet Union, rose from $1.5 trillion a year ago to $1.7 trillion at end-1992, an increase of 5.9 percent. For the first time in a decade, flows of foreign private capital to developing countries exceeded aid flows. The World Bank cautioned, however, that recent levels of private capital flows may be unsustainable.

Road Loan to Hungary

Hungary is borrowing $90 million from the World Bank to help fix roads and bridges and replace outdated maintenance equipment with new machinery. The loan will also fund a new national road safety program and technical aid for the country's Ministry of Transport, Communications, and Water Management. The total cost of these efforts is $161 million, with the difference to be covered by the Hungarian government. Funding for road and bridge repair fell by one-third in 1990 and 1991, but traffic has increased 11 percent a year during the past twenty years. In 1970 only 240,000 cars were registered in Hungary; by 1990 their number had jumped to almost 2 million. (The country's population is about 10.7 million.) Roughly one of every four major roads and bridges in Hungary urgently needs repair. Three-quarters of the country's national roads are still "uneven with some distress" and almost half of the vitaly important bridges need "urgent attention," a World Bank study warns. The Board approved the loan on December 22, 1992.

Mozambique to Receive $760 Million

At a Consultative Group meeting in Paris sponsored by the World Bank, Western donor countries and international financial institutions promised $760 million in aid to support Mozambique's postwar economic reconstruction. The aid includes a $500 million emergency program for the period May 1993 to April 1994, covering the cost of resettlement, food aid and distribution, and short-term rehabilitation of agriculture and transport infrastructure. Mozambique's Finance Minister Eneas Comiche expressed hope for total external support of about $1.2 billion in 1993, including a Paris Club debt rescheduling. The war-torn country, now rated by the World Bank as the world's poorest with a per capita GNP of $80, has to demobilize 100,000 soldiers and militia, and repatriate and resettle some 5 million people, about one-third of the country's population. Separately, the IMF has approved a loan of about $42 million, the last loan in a $140 million, three-year enhanced structural adjustment facility. The credit is to support the government's 1993 program, which targets 3 percent growth, 29 percent inflation, and an acceleration of privatization.

IMF: Quota Reassignments of Yugoslavia.......

The IMF Executive Board agreed to reassign Yugoslavia's IMF quota of 918.3 million SDRs to its successor states and adopted measures to admit the states as members. The Board
assigned a 335.4 million SDR share to "small" Yugoslavia, which includes Serbia and Montenegro, 261.6 million to Croatia, 121.2 million to Bosnia-Herzegovina, 150.4 million to Slovenia, and 49.6 million to Macedonia. The successor states have one month to consent to their IMF shares and to the shares of Yugoslavia's $217 million debt to the IMF, which will be split among them in proportion to their proposed quotas.

...and Czechoslovakia

As of January 1, 1993, Czechoslovakia ceased to exist, and the IMF Executive Board has agreed to reallocate the ex-CSFR's assets, liabilities, and quotas. The Czech Republic will be assigned 69.61 percent, and Slovakia 30.39 percent. Accordingly, 589.6 million SDRs will be assigned to the Czech Republic, and 257.4 million SDRs to Slovakia. Czechoslovakia's $1.54 billion debt to the IMF will be split between the two in proportion to their proposed quotas.

New IBRD Representative In China—New Office in Riga

The World Bank has appointed a new resident representative for its office in Beijing, China. Pieter Bottelier, a Dutch national, took up his post on January 1. And the World Bank is opening a regional office in Riga, Latvia, to work with the governments of Estonia, Latvia, and Lithuania. Lars Jeurling, a Swedish national, has been appointed chief of the new Regional Mission in the Baltics. He also took up his post on January 1.

IMF Loan to Tanzania

The IMF has approved an $89 million loan to Tanzania under a $253 million, three-year enhanced structural adjustment facility started in July 1991. (The ESAF program allows concessional lending to low-income members at an interest rate of 0.5 percent; repayable over ten years and with a grace period of five and a half years.) Targets for Tanzania's 1992-93 program include 5 percent growth, 12 percent inflation, foreign reserves equal to four months of imports, liberalization of the import regime, development of new private banks, and initiation of steps to privatization of the parastatal sector.

Shoring up Shanghai Port

On December 22 the World Bank approved a $150 million loan to China to beef up the country's principal port at Shanghai. The Shanghai Port Authority is spending $274 million on the plan. Shanghai boasts the world's tenth largest port, with some 140 berths running along 14 kilometers of the Huangpu River. The port has failed to keep up with China's rapid economic growth, however. As a result, ships docking in Shanghai must wait four to five days on average before they can find a berth. To relieve the transport bottlenecks, China plans to make the Shanghai port more efficient, restructure some existing facilities, and develop new terminals to handle trade well into the twenty-first century. In another development, a new IDA credit of $50 million approved in mid-December will be used by the Chinese government to bolster agencies responsible for designing and carrying out the nation's reform programs.

Russia to Receive $90 Million for Privatization

Russia will move forward with its plans to privatize a number of state-owned enterprises with the help of a $90 million World Bank loan approved on December 17. The loan will help the government set up a "privatization center" responsible for planning and carrying out enterprise reforms. The loan will also finance expert advice on reforming enterprises and an information campaign to educate Russians and potential foreign investors about the privatization plan and the switch to a market economy. Under the plan, up to 25,000 medium- and large-scale enterprises could be privatized. In addition, 200,000 small manufacturing, retail, and other businesses under municipal or regional ownership will be privatized. Russia is contributing about $26 million toward the project, and the European Bank for Reconstruction and Development will provide about $43 million.

Aid Consultations for Central Asian States

Mid-December meetings in Paris of donor nations and international organizations set the stage for pledges of financial assistance to four former Soviet republics. Russell Cheetham, Director of the World Bank's Europe and Central Asia Department, chaired all four Paris meetings, sponsored by the Bank.

Highlights from the meetings:

- Kazakhstan: The country's strong agricultural economy and its petroleum and other natural resources could provide the means to finance a comparatively rapid economic growth. Sufficient financing to support the government's program could be available over the next few months.

- Kyrgyzstan: Output and consumption have dropped considerably since the breakup of the Soviet Union. Kyrgyzstan's financing needs for 1993 could be met, particularly if traditional financing flows within the former Soviet Union were to continue.

- Azerbaijan: Reforms—including a stabilization program, basic structural reforms, and other actions in such sectors as energy, agriculture, industry, and infrastructure—have been accelerated. The country is expected to need about $50 million in technical assistance to move ahead with its reform program.

- Uzbekistan: The government program includes a virtual elimination of the state-order system, price liberalization, reduction and elimination of most subsidies, actions to promote private entrepreneurship, and reform of the financial sector. The government is expected to need about $90 million in technical assistance to carry out reforms.
Hungary's industrial production fell by 22.2 percent in the first nine months of 1992 compared with the same period last year, according to data of the Central Statistical Office. The pace of decline has slackened, however, dropping from 19.5 percent in the first quarter to only 5 percent in the third quarter. Production in the pharmaceutical, gas, silk, and fur industries fell, but growth was registered in heavy industry and the chemical, oil, and paper sectors.

Chinese banks will have made about 400 billion yuan ($68.9 billion) in new loans in 1992's economic boom, unleashing a flood of cash that could cause inflation, according to the Price Information News, an official Beijing newspaper. Vice Premier Zhu Rongji, China's top economic policymaker, warned that the explosion of new credit "reflects poor control and may lead to inflation."

China plans to take over from the cabinet the responsibility for the People's Bank of China (PBOC), strengthening the central bank's role as an economic watchdog, China Daily reported from Beijing. The final goal would be to allow the PBOC to use such tools as discount rates to influence money supply, the paper added, quoting PBOC Vice President Zhou Zhengqing as saying that the bank would control the economy indirectly. A draft national banking law to be introduced in 1993 will eliminate central planning and allow banks to set interest rates and make loan decisions independently.

The unemployment rate in Romania has reached 9.1 percent, according to data supplied by the Labor and Unemployment Department. The unemployed receiving allowances, and those who are no longer entitled to an allowance, together total more than 1 million. A study released by the National Statistics Board on December 14 shows that average monthly consumption in the first half of 1992 was lower than in the same period in 1991.

Romanians eat less meat, fish, sugar, and fruit, and fewer eggs and potatoes. Expenditures on food, nevertheless, grew among wage-earners from 51.6 percent in 1991 to 56.5 percent in 1992, and among retired persons from 61.7 percent to 66.6 percent.

Viet Nam is expected to post a trade surplus in 1992 of $75 million. The trade ministry said that exports in 1992 would hit $2.46 billion (a 19 percent rise over 1991) compared with $2.38 billion in imports. Viet Nam not only survived the cutoff of aid from the former Soviet Union but now enjoys stronger economic growth than it had hoped for, Prime Minister Vo Van Kiet announced. In 1992 GNP grew 5.3 percent, foreign investment 73 percent, industrial production 15 percent, and agriculture 4.4 percent, and state revenues climbed 82 percent due to better tax collection. Kiet warned that Viet Nam would need to inject an estimated $40 billion into the economy over a 10-year period to fulfill its target of doubling 1990 GNP by the year 2000, he added.

From the British daily The Guardian

Kazakh Prime Minister Sergei Tereshchenko outlined a 1993-95 economic stabilization and transition program to parliament. To increase its revenue, the government intends to introduce a general import duty, tax certain monopoly profits, and increase some value-added and other indirect taxes. Beginning in 1993, the hard-currency retention quota will be increased from the present 10 to 30 percent to 50 percent. The program calls for an end to centralized industrial investment and envisages declaring some unprofitable state enterprises bankrupt.

14 December 1992 - January 1993
Bad Loans: A Heavy Burden on Hungary’s Financial System

Although Hungary has pursued a “gradualist” path, avoiding the shock therapy seen in Poland and Czechoslovakia, its GDP fell by 24 percent between 1989 and 1992, and unemployment has risen to 11 percent. The government has been unable to maintain a tight fiscal policy, due to social pressure to maintain wages and benefits and the growing burden of defunct state enterprises. The deficit will be 210 billion forints ($3 billion) for 1992—more than three times the level agreed to with the IMF. The total government debt amounts to 2,140 billion forints ($27 billion), and the planned budget deficit for 1993 is 180 billion forints. This deficit might crowd out private sector borrowing—a troubling development, given that about a third of state firms will have to be closed down and another third radically restructured.

Hungary has attracted more than half the direct foreign investment in Eastern Europe to date—1992 investment, including contributions in plant, equipment, and know-how, reached $2 billion in 1992. But foreign investors have been able to pick and choose, leaving Hungary’s State Property Agency and banks holding onto the less attractive firms. The market value of the 90 percent of industrial assets remaining in state hands is estimated at a mere 400 billion forints ($5 billion).

Different proposals for divesting the remaining firms have been made, including offering consulting firms strong incentives—2 to 5 percent of the sale price—to find domestic or foreign buyers, and leasing the firms to managers on a contract basis. But it is recognized that 30 to 40 percent of assets will remain in state hands for the foreseeable future. In June 1992 a new State Assets Handling Company (SAHC) was created to manage the firms that will remain state property, leaving the State Property Agency to concentrate on privatizing the remaining firms. The SAHC has been allocated 143 firms, including such giants as the Malev airline, the state oil monopoly, and the Ikarus bus factory. SAHC holdings in these firms will range from 25 to 100 percent.

The banks have not been particularly successful at steering the growing domestic savings (which have reached 700 billion forints) into the new private sector, preferring to lend to the government to finance the growing deficit. This is due in part to their risk-averse mentality, and in part to informal government persuasion. Since 1989, companies have faced a mounting liquidity squeeze. In addition to losing paying customers in the former Soviet Union, companies face rapidly increasing costs, and for the first time they have had to build up their own working capital. At the same time the government has attempted to enforce a strict monetary policy, with the result that real operating credit shrank in 1991.

Elements of the new accountancy legislation introduced in December 1991 and January 1992:

- Establishing new, stricter accountancy rules—conforming to Western standards—for companies and banks.
- Requiring any company with debt payments more than ninety days overdue to file for bankruptcy under threat of criminal proceedings against its managers.
- Requiring companies, over the next five years, to follow standard accounting practice for asset depreciation and to make provisions against dubious accounts receivable from pretax profits.

The phased introduction of these requirements could drastically cut company profits for 1992—to only 20 percent of the 1991 level. The resulting erosion of the tax base from enterprises would make it much more difficult for the government to reduce the budget deficit.

For commercial banks, the legislation has required new procedures for making provision against bad loans, and has increased the reserve ratio to 8 percent. Banks are now required to classify their assets as:

- “Substandard” if they involve “large branch risks”
- “Doubtful” if the borrower made losses in the preceding two years or is more than sixty days in arrears
- “Bad” if the borrower is in bankruptcy proceedings.

The legislation further requires that provisions be made against 20 percent, 50 percent, and 100 percent, respectively, of the dubious loans in these three categories. Currently, some 40 to 50 percent of bank portfolios fall into one of these three groups, with some estimates running as high as 70 percent.

To generate reserves to cover these bad loans, banks have been forced to maintain higher interest rate spreads—effectively making new private entrepreneurs pay for the burden of inherited state enterprise debts. The banks have also had to plough their profits back into operations, thus curtailing their tax payments. Government tax revenues from the banking sector are down by more than half compared with 1990 (when they accounted for nearly 8 percent of government receipts). This too might increase the pressure on the private sector if it results in higher taxes.

Based on a recent report by Oxford Analytica, the London Research Group.
For the Record

Small and Medium-Size Private Enterprises and Privatization
June 11-13, 1992, Stirin, CSFR

Organized by the Institute for East-West Studies (IEWS), and attended by government officials, business executives, and academics from Eastern and Western Europe and the United States. The participants analyzed the most important aspects of developing small and medium-size enterprises (SMEs) and pointed out that although SME development has been spectacular recently in Central and Eastern Europe, governments in the region should make further efforts to eliminate historical distortions in the enterprise size structures in their countries. Other policy recommendations include the following:

- Liberal legal regulations and policies for establishing new firms should be maintained.
- Reprivatization (restitution) should not slow other forms of privatization.
- In the privatization of small firms, the sale of assets should be given priority over leasing of assets, and the process should be reasonably decentralized.
- Monopolies in trade and services should be broken up.
- The privatization of medium-size firms requires well-designed, decentralized methods.
- The tax disincentive for expansion of private business should be eliminated (such as excessive social security payments), depending on the budget situation.
- Privatization of the major commercial banks should be given priority.
- Banks should make bureaucratic procedures transparent for small businesses.
- New credit guarantee institutions should be set up to allocate risk among the banks, the SMEs, and the guarantee institution.

Seminar on Natural Monopolies
Joint Vienna Institute
August 31 - September 11, 1992, Vienna

The Economic Development Institute (EDI) of the World Bank and the U.S. Agency for International Development (USAID) sponsored a seminar on "Natural Monopolies: Regulation, Structure, and Pricing Decisions." The seminar was attended by utility executives, government executives, and academics from Czechoslovakia, Hungary, and Poland. Experts—including executives from both private and public utility companies, government officials, academics, technical staff from various organizations, lobbyists, and consultants—discussed theoretical and practical issues of regulating natural monopolies. For example, participants simulated a U.S. congressional rate hearing, with "testimony" from utility executives, consumer groups, environmental groups, and other intervenors.

Forthcoming

Public Finance Reform in the CEE Countries
February 19-21, 1993, Rez, Czech Republic

International conference organized by the Institute for East-West Studies. Topics include the Polish government, budget stabilization, and sustainability; implications of the Polish lessons for Russian macroeconomic policy; the lessons for Eastern Europe of Spanish macroeconomic policy during transition; and comparative analysis and policy recommendations. Participants include Anders Aslund, Kemal Dervis, David Lipton, Jacek Rostowski, and Jan Svejnar.

Information: Jean de Fougerolles, tel: (212) 557-2570, fax: (212) 949-8043.

Black Sea Oil and Gas:
Emerging Opportunities
April 28 and 29, 1993, Istanbul

Oil and Gas Transport and Security: Key to Investment in the Former Soviet Union
May 24 and 25, 1993, London

International conferences organized by the Europe Energy Environment Ltd.


How to Fund Exports and Investments to Eastern Europe and the Newly Independent States
May 13 and 14, 1993, New York

A joint conference of the World Bank and the EBRD. Participants will explore possibilities for tapping into $24 billion in World Bank, IFC, and EBRD contracts in Central and Eastern Europe and the FSU. Speakers from those international finance institutions, from U.S. federal agencies, and from U.S. companies will speak about the procurement procedures and upcoming projects, and provide lessons of experience.

Information: Bill Collins, Conference Coordinator, ITC Consultants Inc., tel: (813) 572-8035, fax: (813) 965-2630.

IMF-World Bank Annual Meetings
October 1994, Madrid

Momentary Hesitation

Milton Friedman comes to Poland and declares: "There are three things you must do: privatize, privatize, and privatize." "Yes, Sir!" says someone in the audience—"But which should we do first?"

(Joke from Poland)
New Books and Working Papers *

Cheryl W. Gray
The Legal Framework for Private Sector Activity in the Czech and Slovak Federal Republic

After its “velvet” revolution in late 1989, the Czech and Slovak Federal Republic (CSFR) moved steadily to create the conditions for developing a private market economy. Not only did the CSFR ease the conditions for the entry of new private firms, but it also took far-reaching steps to return property to former owners and to privatize large parts of its state-owned industry. For this emerging private sector to thrive, there must be a clear legal framework to provide decentralized “rules of the game.”

Gray describes the evolving legal framework in the former CSFR in several key areas: property, contracts, company law, foreign investment, bankruptcy, and antimonopoly law. The legal frameworks in the Czech and Slovak republics are essentially the same, but they could diverge now that the country has split.

The former CSFR differs somewhat from its Central and Eastern European neighbors, especially Poland and Hungary, in that its prewar legal system was more thoroughly abrogated during the socialist period. So, fewer people are familiar with market-oriented legal principles and practices. But in 1989 the CSFR had the advantage of starting with a relatively “clean slate” on which to craft modern laws. In some areas of law—such as company, contract, and antimonopoly law—legal reform is relatively well advanced and could serve as a model for other reforming socialist economies. In others—including constitutional and real property law—legal reform is embroiled in political controversy and lags behind developments in some neighboring countries. The interests of former property owners are clashing with those of current tenants, creating a surge of new cases entering the courts. This surge is likely to be exacerbated as the current moratorium on bankruptcy claims against state enterprises expires in 1993, and as cases under the new intellectual property laws and commercial code come onstream. The judicial system, suffering from recent purges of judges compromised by the former regime as well as from generally low pay and prestige, appears ill prepared to cope with the skyrocketing demands expected in the newly reformed system.

To order: Maxine Berg, the World Bank, Room N11-021, tel: (202) 473-6969.

David H. Scott
Revising Financial Sector Policy in Transitional Socialist Economies—Will Universal Banks Prove Viable?

Focusing on efforts under way in most transitional socialist economies, this paper questions whether the banks emerging in the new policy framework will prove viable or be supervisable. The author offers a model of a financial sector structure designed to foster the development of a sound banking system.

Policymakers must strive to achieve two discrete and potentially conflicting kinds of objectives. These are:

- Fundamental policy objectives (which include establishing and maintaining the integrity of the payments system and the safety of depositors’ savings, and ensuring that money markets function).
- Transitional objectives (which relate primarily to the immediate task of privatizing and restructuring enterprises).

Many transitional socialist economies adopt a policy framework that envisions universal banking. The consequences of the immediate emergence of financial conglomerates, or universal-type banks—in the face of limited managerial and institutional capability, limited capability for supervising financial markets, and extraordinary financial market risks—could be unfortunate if financial conglomerates simultaneously pursue conflicting fundamental and transitional objectives. Therefore the emergence of financial conglomerates should be delayed until skills are developed and market turmoil subsides.

To order: Karin Waelti, the World Bank, Room N9-043, tel: (202) 473-7664.

Other Recent World Bank Working Papers:


To order: Estela Zamora, the World Bank, Room S7-136, tel: (202) 473-3706.


To order: Wilai Pitayatonakarn, the World Bank, Room N9-003, tel: (202) 473-7664.


The world’s population is estimated to be 5.44 billion in mid-1992, and 6.17 billion by the year 2000. Currently Asia has 59 percent of world population; Europe, 15 percent; America, 14 percent; Africa, 12 percent; and Oceania, 1 percent. Over time, Asia’s share is projected to remain fairly stable, but Europe’s share will be almost halved and Africa’s more than doubled.
To Order: Soledad Rothschild, the World Bank, Room N11-051, tel: (202) 473-7460.

To order: Gracia Sorensen, the World Bank, Room H5-253, tel: (202) 473-7088.

Peter Murrell, Karen Turner Dunn, and Georges Korsun
The Culture of Policy Making in the Transition from Socialism: Price Policy in Mongolia

The transformation from socialism gives economists a unique opportunity to observe the effects on policy of culture—defined as a shared vision or model of the way the world should work. The paper, examining price policy in Mongolia, argues that the culture of policymaking that arose and took root under socialism has profound implications for the transition process.

For nearly seventy years, until 1990, Mongolia was the de facto sixteenth republic of the Soviet Union. Its international trade was carried out almost wholly within the CMEA. Mongolia’s industrial base was put in place by the Soviet Union, and its viability depended on continuing interaction with that country. During the 1980s, international trade and government budget deficits were financed in large part by grants and soft loans from the Soviet Union. The economic isolation from the West and the support from Moscow were mirrored on the intellectual side. The Mongolian elite was educated primarily in Moscow, with only a few going as far west as Budapest. Mongolian educational institutions and their economics curricula were based wholly on the standard Soviet model.

Mongolian society, following the country’s first free elections in 1990, was ready to move to a market economy and accepted that price controls were inconsistent with such a move. But when choices were made, when leaders were faced with a disastrous economic environment, price controls reemerged as the preferred policy tool. This occurred despite the government’s avowed commitment to radical reforms and despite external pressure to follow those reforms.

Price reform started in earnest in January 1991, and by March 1992, after successive liberalization measures, only flour products, transport, utilities, fuels, and medicines were supposed to be left under government control. In fact, public and private entities were ordered to comply with rigid procedures in pricing all products and services, whether or not they remained under government control, and local governments gained new authority for controlling prices. In October 1991 the government ordered the confiscation of profits resulting from price increases deemed excessive.

Data show that among the prices that were officially decontrolled, more than half showed no change in the first eight months, despite the severe macroeconomic disequilibrium. Moreover, the data show a divergence between the capital city and rural areas in the extent of price movement. (Prices not subject to official controls, and therefore more subject to divergence in local controls, rose by 19 percent in the rural areas and 32 percent in the urban areas in the same period.) The informal constraints on the movement of prices seem tighter in the rural areas, where local officials have been more isolated from the main currents of reform policy established in the capital.

It was difficult to identify economic agents or political parties opposed to price controls. (Even the new private entrepreneurs advocated price controls.) This similarity of views across the political spectrum represented a deep commonality in the society on the costs and benefits of price control and alternative policies, a commonality hardly explicable independent from the economic history of Mongolia. The experience of Mongolian price reform might be paradigmatic—if somewhat extreme —of what happens generally when a radical reform is introduced in an unreceptive and rapidly deteriorating economic environment.

To order: Center for Institutional Reform and Informal Sector (IRIS), 7100 Baltimore Ave., Suite 510, College Park, MD 20740, tel: (301) 403-8153.

William H. Meyers and others
Agricultural Transformation and Privatization in the Baltics
Center for Agricultural and Rural Development (CARD), Iowa State University, Baltic Reports No. 92-BR-7, Iowa, 1992, 59 p.

The Baltic states of Estonia, Latvia, and Lithuania have been undertaking rapid economic and structural reforms that greatly affect the food and agricultural sectors. Of all the states of the FSU, they are progressing most rapidly in the privatization of land and productive assets. Four papers in this report describe these reforms and the progress made as of Spring 1992 in restructuring agriculture and liberalizing prices and related government regulations.

Although the importance of agriculture in the economies of the Baltic states has declined substantially since their period of independence before World War II, in 1990 agriculture still accounted for 17 percent (Estonia) to 25 percent (Lithuania) of GNP. The food industry adds an additional 11 percent (Lithuania) to 15 percent (Estonia) to GNP, making food and agriculture one-third or more of GNP in all three countries. The share of labor employed in agriculture and food processing ranges from 22 percent
From 1990 to 1992, all three states chose to restore land or equivalent compensation to previous owners, to privatize the productive assets of state and collective farms, and to permit competition among a variety of ownership and management systems. As a result, the number of small family farms has been increasing rapidly, though they still account for a small share of total farmland. Another important change is that the personal plots operated (but not owned) by collective and state farm workers are allowed to be as large as 3 hectares, compared with only one-half hectare during the Soviet period.

In July 1992, Estonia virtually eliminated the state pricing system for food and agricultural products, replacing it with a system of producer support prices and retail markup restrictions that allows the market to function with relatively little government intervention. Latvia and Lithuania introduced similar pricing later in 1991. Producer prices in all three states are set through regional consultations between producers and processors, but the governments have various mechanisms designed to influence prices. Since inputs were heavily subsidized during the Soviet period, input prices have risen far more rapidly than producer prices. Although the largest price shocks occurred between 1990 and 1992, input prices continue to rise more rapidly than producer prices. Both are still below—but moving toward—world market prices.

Other recent papers from the Baltic Research Paper Series:

92-BR-8, An Analysis of Consumption and Expenditures for Lithuanian Households Using Budget Survey Data, Forthcoming.


The recession in the CEE countries has continued in 1992. The rate of decline in output is now slowing in those countries that started earlier and progressed more rapidly in the transformation process. In Poland industrial production has begun to grow again in recent months, but in Czechoslovakia and Hungary the decline is still likely to be more than 10 percent for the year. In Bulgaria and Romania industrial output fell by more than 20 percent in the first half of 1992.

A sluggish and uneven economic recovery may now be in sight for some CEE countries in 1993, according to ECE reports. Uncertainty about the course of privatization may hamper investment, and the weakness of the world economy could reduce export growth, which is expected to be the main engine of recovery. In Albania, Bulgaria, and Romania further decline in GDP is likely. The Czech government predicts GDP growth of 1 to 3 percent in 1993; in Hungary predictions vary between 1 and 3 percent growth, and positive growth is expected in Poland. Actual trends have tended to be worse than government expectations, and a pessimistic scenario, in which the recession continues into 1993 is still possible. In any case, it will take many years to regain pre-1989 levels of output, says the report.


Istvan P. Szekely and David M.G. Newbery, eds.

**Hungary—An Economy in Transition**


**Ewa Dzvonik-Wrobel and Zofia Szpringer**

**Optimal Inflation Cost and Benefits of Disinflation [in Poland]**

Warsaw Institute of Finance WPS No. 25, 1992, 19 p. To order: IF, Information and Publication Section, Warsaw, Swietokrzyska 12, Poland.

Dariusz K. Rosati

**The Politics of Economic reform in Central and Eastern Europe**

Bibliography of Selected Articles

Staff may contact the Joint Bank Fund Library, (202) 623-7054.

Postsocialist Economies


CIS and the Baltics


Central and Eastern Europe


TRANSITION is a regular publication of the World Bank's Transition and Macro-Adjustment Division, Country Economics Department. The findings, views, and interpretations published in the articles are those of the authors and should not be attributed to the World Bank or its affiliated organizations. Nor do any of the interpretations or conclusions necessarily represent official policy of the World Bank or of its Executive Directors or the countries they represent. Richard Hirschler is the editor and production manager. To be on the distribution list, send name and address to Richard Hirschler, Room N-6027, The World Bank, 1818 H Street NW, Washington, D.C. 20433 or call (202) 473-6952, or fax (202) 876-0439. Information on upcoming conferences on socialist economies, indication of subjects of special interest to our readers, letters to the editor, and any other reader contributions are appreciated.