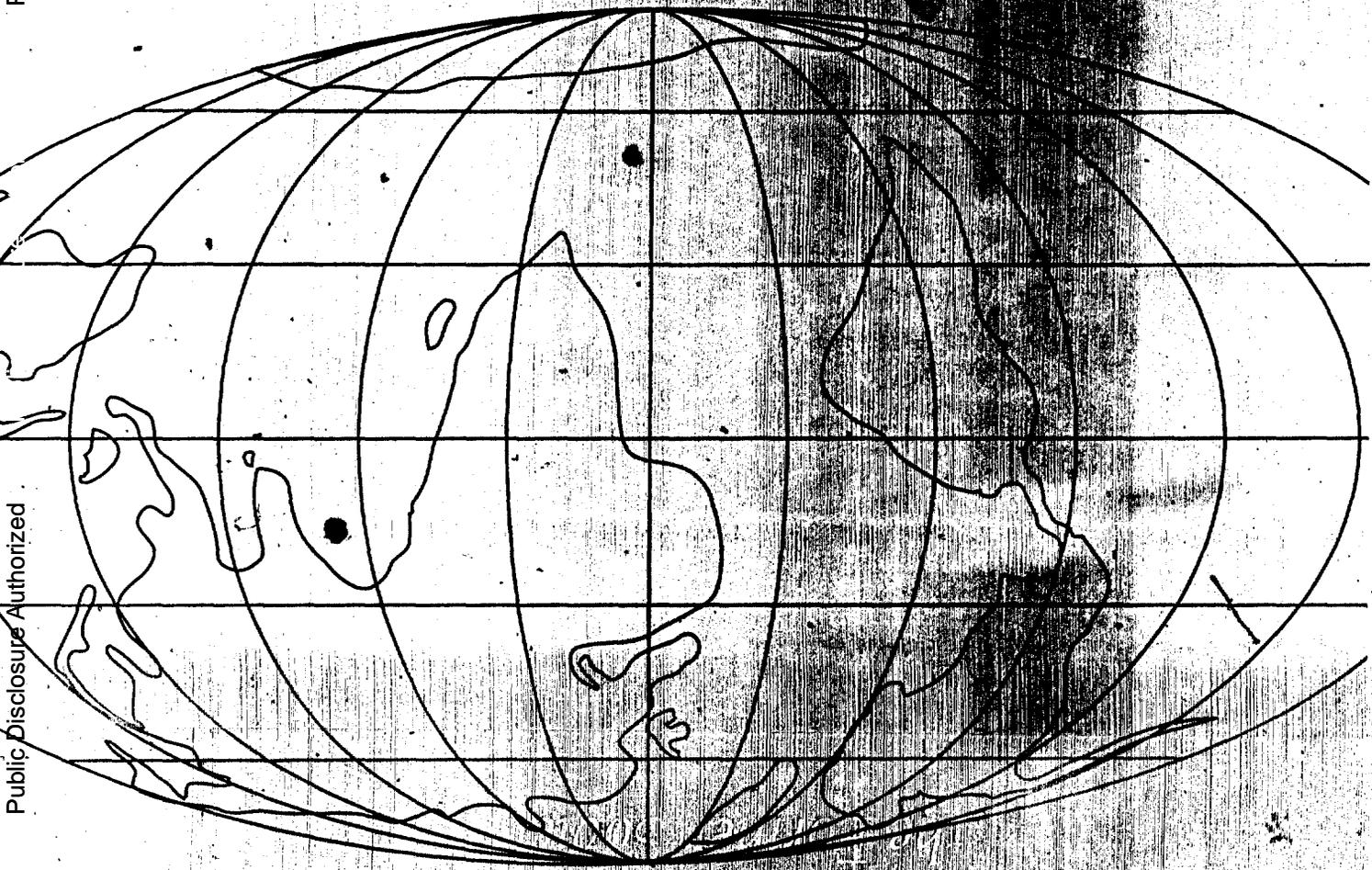


Public Disclosure Authorized

Investment in Central and
Eastern Europe and
the Former Soviet Union

Public Disclosure Authorized



THE EVOLVING ROLE OF THE WORLD BANK

13519
1994



The Evolving Role of the World Bank

The Transition in Central and Eastern Europe and the Former Soviet Union

**Kemal Dervis, Marcelo Selowsky,
and Christine Wallich**

**The World Bank
Washington, DC**

The World Bank Group

The World Bank Group is a family of multilateral development institutions owned by and accountable to member governments. These governments exercise their ownership function through Boards of Governors on which each member country is represented individually. All the powers vested in the Board of Governors, with a few exceptions, have been delegated to Boards of Executive Directors, who are appointed or elected by member governments. The President of the Bank Group is appointed by the Executive Directors.

The World Bank Group today includes five international organizations:

The International Bank for Reconstruction and Development (IBRD), the original institution in the group, opened its doors for business in 1946. Today, it is the largest source of market-based loans to developing countries and is a major catalyst of similar financing from other sources. It lends to governments or to public or private entities with government guarantees. It is funded mainly through borrowings on the international capital markets.

The International Finance Corporation (IFC) was established in 1956 to support private enterprise in the developing world through the provision and mobilization of loan and equity financing and through its advisory activities relating to, among other things, capital market development and privatization. IFC is also a major catalyst of both local and foreign private investment. Its lending and equity investment activities are based on the principle of taking market risk along with private investors. Under the terms of its Articles of Agreement, it cannot accept government guarantees.

The International Development Association (IDA) was created in 1960 to provide finance on concessional terms to low-income countries that lack creditworthiness for IBRD borrowing. IDA is primarily funded from grants it receives from donors in periodic replenishments.

The International Centre for Settlement of Investment Disputes (ICSID) was added to the World Bank family in 1966 to provide conciliation and arbitration services for disputes between foreign investors and host governments that arise directly out of an investment.

The Multilateral Investment Guarantee Agency (MIGA) was created in 1988 to provide noncommercial investment risk insurance and technical services that help promote investment flows. It also disseminates information on investment opportunities.

As is now common practice, the "World Bank" or simply the "Bank" are used interchangeably to mean both IBRD and IDA. The "World Bank Group" refers to IBRD, IDA, IFC, ICSID, and MIGA.

Contents

Foreword	v
Introduction	1
Stabilization and Transition	2
Institution-Building and the New Role of Government	4
Labor Markets, Social Sectors, and Safety Nets	8
Infrastructure	13
Private Sector Development	21
Building the New Financial Sector	26
Aid Coordination	32
The Bank's Research and Training Support	33
Conclusion	35
Box 1. World Bank Group Assistance to Privatization in Russia and Kazakhstan	22
Box 2. Enterprise and Financial Sector Adjustment Loan (EFSAL) in Poland	30

Marcelo Selowsky is Chief Economist in the Europe and Central Asia Regional Office of the World Bank. Kemal Dervis is Director and Christine Wallich is Lead Economist in the Central Europe Department of that office. The authors are grateful to their colleagues in the World Bank who provided contributions for the paper. The findings, interpretations, and conclusions expressed in this paper are entirely those of the authors and should not be attributed in any manner to the World Bank, to its affiliated organizations, or to members of its Board of Executive Directors or the countries they represent.

Foreword

The world has changed dramatically over the last five decades and so has the World Bank. The Fiftieth Anniversary of the World Bank has provided us with an opportunity to reflect on and learn from the Bank's experience and to apply the lessons to the Bank's future agenda.

This series of essays is devoted to improving understanding of the evolving role of the World Bank. Each essay analyzes the Bank's approach to the major development challenges its borrowing countries have faced, starting with the reconstruction and development needs of Europe and Japan in the 1940s and 1950s and ending with the transition of Central and Eastern Europe and the former Soviet Union. One essay examines the evolution of the Bank's relations with the world's capital markets as it mobilizes private savings for development. An overview paper provides a picture of the fifty-year period as a whole.

The story that emerges is one of an evolving and learning institution that has built on its successes and its mistakes. The Bank has responded with vigor and energy to the challenges confronting its borrowers. In this process, it has made a significant contribution to the impressive developmental gains recorded in these past fifty years. In responding to those challenges, the Bank itself has changed, learning from its experiences, deepening its understanding of the development process, and recasting its analytical and financial support to help its borrowers better.

The Bank will continue to nurture its tradition of self-evaluation and learning. These essays will, I hope, contribute to a better-informed debate on the Bank's future role. They complement the recently issued paper, *The World Bank Group—Learning from the Past, Embracing the Future*, which sets out the future directions for the Bank Group.

Armeane M. Choksi
Vice President, Human Resources Development and Operations Policy, and
Chairman of the Bank Group Committee on the 50th Anniversary

The Transition in Central and Eastern Europe and the Former Soviet Union

Kemal Dervis, Marcelo Selowsky, and Christine Wallich

From Eastern Europe to Central Asia, countries have embarked on a path of systemic transformation, the extent of which has few parallels in history. The Bank, too, is now engaged in one of the greatest efforts in its history. In fiscal years 1990–94, twenty-two states in this region became new members, while the Bank committed US\$11.5 billion and opened seven new resident missions. These countries face the task of creating wealth and improving living standards. Both the opportunities and the challenges are immense. Many countries are rich in technology, agriculture, and natural resources. Huge resources, historically devoted to military output and unnecessarily high levels of investment, can now be used to improve the quality of life.

In some countries, much progress has taken place on both the institutional and policy front, especially as regards privatization. In many, however, there is still a need to reduce the dominance of state monopolies and to limit heavy political and administrative interference. All countries share the need to restructure and privatize heavy industry. All also need continued fiscal retrenchment.

Both the opportunities and the challenges are immense. . . . Huge resources, historically devoted to military output and unnecessarily high levels of investment, can now be used to improve the quality of life

Successful transformation will require macroeconomic stability, free prices, the building of modern institutions, including a modern state, and the development of financial markets with a legal framework that supports the operation of markets. Infrastructure needs to be revamped to avoid hindering restructuring and recovery. Finally, in most countries, a readaptation of skills and an improved social safety net will be particularly important.

Stabilization and Transition

In all transition economies, systemic transformation has been made more difficult by the serious macroeconomic imbalances in place when the old order collapsed. Price controls, along with underlying budgetary imbalances, had repressed inflation and created a large monetary overhang. The severing of supply links among enterprises within countries, as well as the disruption of COMECON trade, led to economic contraction and large output losses. Movement to a market economy required freeing

prices and exchange rate adjustments. Thus, transition economies were faced with a hard choice. Much-needed stabilization programs had to be adopted at the same time as these structural causes were leading to output decline. But, failure to pursue stabilization would risk hyperinflation, since monetary financing of the deficit would take place at a time when the demand for money was collapsing.

When they joined the Bretton Woods institutions, these countries engaged in discussions with the IMF on stabilization efforts, and many negotiated formal IMF approval for financial programs. The Bank played a supportive role with a series of fast disbursing operations, financing either general imports (structural adjustment and economic recovery loans) or agreed on lists of priority imports (critical import and rehabilitation loans). These operations provide non-inflationary finance to the budget, since Bank-financed imports generate counterpart fund revenues (Table 1). Bank loans were, of course, only part of larger financial packages,

In all transition economies, systemic transformation has been made more difficult by the serious macroeconomic imbalances

The Transition in Central and Eastern Europe and the Former Soviet Union

including IMF, G-24, and other contributions.

While committed loans were substantial, the actual flow of disbursements in the first twelve months after approval was only a fraction of total

funds committed. This is due partly to the fact that many of these loans were "tranchéd," with tranche release dependent on agreed policy actions, and partly to the Bank's procurement rules. IBRD shareholders insist that Bank funds be spent

Table 1. IBRD and IDA Import Financing Loans and Credits

Country	Loan type	Amount (\$ million)	Month of approval	Dollars per capita	Percentage of GDP	Percentage of funds disbursed 1 year after approval
Albania	Critical imports	43	June 1992	12	6.2	22.0
Bulgaria	SAL	250	August 1991	28	3.4	56.8
Czechoslovakia	SAL	450	June 1991	29	1.4	44.4
Hungary	SAL	200	June 1990	19	0.6	100.0
	SAL II	250	June 1991	24	0.8	70.0
Poland	SAL	300	July 1990	8	0.5	33.3
Romania	Critical imports	150	June 1991	6	0.5	8.1
	SAL	400	June 1992	17	2.1	57.7
Russia	Rehabilitation	600	August 1992	4	0.7	51.1
Belarus	Rehabilitation	120	November 1993	12	1.9	14.7 ^a
Moldova	Rehabilitation	60	October 1993	14	2.6	40.4 ^a
Estonia	Rehabilitation	30	October 1992	19	1.5	60.9
Latvia	Rehabilitation	45	October 1992	17	3.2	35.6
Lithuania	Rehabilitation	60	October 1992	16	1.9	47.3
Kazakhstan	Rehabilitation	180	September 1993	11	1.8	41.5 ^b
Kyrgyzstan	Rehabilitation	60	May 1993	14	3.3	60.3
Slovakia	Recovery	80	November 1993	16	0.1	20.0
FYR Macedonia	Recovery	80	February 1994	36	3.7 ^c	100.0

Note: Underlying data on GDP and population correspond to the calendar year of loan approval.

a. 7 months.

b. 9 months.

c. Percentage of GNP.

to finance imports procured in ways that allow competition among suppliers. Specific rules must be followed and documentation must be available. Both requirements are difficult for new member countries for whom these procedures are new. Although disbursements often speed up with experience, slow disbursement of import-financing loans has often been criticized. Until now, there has been little scope for greater flexibility in the procurement rules.

Debate continues about the role of balance-of-payments loans from the Bretton Woods institutions to support stabilization efforts. Substantial up-front external finance can make a huge difference by helping to stabilize the exchange rate, finance the budget deficit in a non-inflationary way, and create positive expectations. But to have such a decisive impact, the external assistance package must be of a substantial magnitude and disbursed rapidly.

On the other hand, if there is insufficient domestic policy effort, such financing flows do

more harm than good, increasing indebtedness without paving the way to the sustained growth needed to avoid a debt trap. Moreover, if the Bretton Woods institutions provided large amounts of nonconcessional financing to unsuccessful adjustment programs, they would not only undermine their credibility but would build a portfolio of problem loans that could lead to serious financial problems for them in the medium-term future. Clearly, both flexibility and caution are needed to prevent a waste of resources where the real economic returns on external financing are likely to be nil.

Institution-Building and the New Role of Government

Lack of appropriate institutions has been an impediment to implementing stabilization policies and a major bottleneck to modernization and restructuring. To meet the needs of a market economy, the state apparatus for civil service, the organization of public finances, and the regulatory frameworks all need reform. There are limits,

If there is insufficient domestic policy effort, such financing flows do more harm than good, increasing indebtedness without paving the way to the sustained growth needed to avoid a debt trap

however, in trying to accelerate institution building, especially in some countries of the former Soviet Union that lack the prewar institutions and memory of markets shared by most countries in Eastern Europe.

To move a public administration from a system based on direct control of the economy toward one based on incentives involves a reorientation of the state's role—indeed, a reinvention of public institutions. The Central Bank, for example, needs to be strengthened in new functions of indirect monetary control, domestic debt and interest rate management, and bank supervision. Many countries inherited centralized state structures that no longer serve them well and are now strengthening local governments that can mobilize resources and deliver public services more efficiently. The introduction of a market economy also brings with it a need to strengthen tax administration to ensure that the budget will be able to tap newly emerging tax bases—consumption and private-sector incomes. Better tax

administration and a broader tax base would permit, in turn, lower tax rates that are less of a disincentive to private sector development.

Also required are predictable incentives and the rule of law—reforms in the financial and payments systems, accounting systems, the introduction of new legal frameworks, and courts able to enforce contracts. To provide headroom for the private sector also requires a reorientation of the state's fiscal role, including a reallocation of public expenditures and better public investment programming so that the infrastructure needed to support private sector activity develops. Without such changes, the supply response expected from economic liberalization will be dampened, making macroeconomic stabilization more difficult to sustain.

Retooling the state involves sensitive issues that are difficult to resolve. Initial Bank intervention in some member countries was through assistance in strengthening the

To move a public administration from a system based on direct control of the economy toward one based on incentives involves a reorientation of the state's role—indeed, a reinvention of public institutions

While it is important to reduce deficits, reducing the share of public expenditures is also key to creating the economic headroom needed for the private sector to flourish

institutional capacity to implement reforms in areas key to transition. Such Bank support, however, is recent and experience is still being gained. The strengthening of core state functions has been supported through free-standing technical assistance loans, investment lending, and quick-disbursing operations—each focusing on different aspects of institution building. Throughout the former Soviet Union, institution-building loans were designed to strengthen economic management capacity, including aid coordination, and to establish modern treasuries to improve public expenditure and debt management. Targeted technical assistance projects for tax administration (in Albania and Hungary, for example) have sought to bolster resource mobilization—as well as tax policy and its implementation—by strengthening tax and customs offices, training tax officials, and computerizing tax records.

Streamlining the state budget, rechannelling its focus, and making its impact more trans-

parent are perhaps the most important aspects of retooling the state. While it is important to reduce deficits, reducing the share of public expenditures is also key to creating the economic headroom needed for the private sector to flourish. Economic studies undertaken early in the dialogue with each country identified the sustainability and rationale of many government transfers and subsidies. These were typically provided in nontransparent forms though subsidized credits, uncollected debts, tax and social security arrears, and controlled prices. Moreover, the proliferation of extra-budgetary accounts and parallel budgets make controlling both the level and composition of public expenditures difficult. The Bank has tried to encourage making such subsidies explicit and to analyze their justification—both in terms of equity and efficiency.

Important studies of this type were undertaken for Russia, Ukraine, and Uzbekistan, where credit and energy subsidies had major macroeconomic implications. In Hungary, work has focused on the consolidation of

budgetary, extra-budgetary, and other institutional funds, whose continued proliferation puts fiscal stabilization at risk. Work on the sustainability and reform of fiscally costly pension systems is also continuing. Projects in this area have helped to improve administration and computerization of social benefit systems in Hungary and Albania, for example.

Finally, development of the financial and economic infrastructure needed by a market economy—including payment systems, banking legislation, accounting and securities regulatory systems—is also being supported:

- A financial institutions development project of \$200 million was recently approved for Russia—one of the larger technical assistance projects approved by the Bank. It supports the modernization of both commercial banks and Russia's payments and clearing system, the strengthening of the supervisory capabilities of the Central Bank, and an overhaul of accounting and auditing standards.

- Bank loans under way in Poland, Albania, and Slovakia provide technical assistance to improve central banking skills, bank supervision, financial and capital market regulation, and auditing and accounting.

- In Armenia, Belarus, Kazakhstan, and Ukraine, institution-building loans focused on strengthening banking and financial-sector accounting as well as developing a modern payments system. Even so, major challenges remain. These institutional reforms must be followed by concrete restructuring of financial institutions still burdened by bad loans and old habits.

Today neither the level nor composition of public investment is compatible with the growing needs of the private economy. Current public investment levels—sometimes as low as 2 percent of GDP—mortgage the future. To ensure that scarce budgetary resources go where returns are highest, reform of public investment programming is crucial. The Bank has supported the design of public investment programs

Current public investment levels—sometimes as low as 2 percent of GDP—mortgage the future. To ensure that scarce budgetary resources go where returns are highest, reform of public investment programming is crucial

The redesign of social sector spending is also key to fiscal adjustment. Social sector spending now absorbs as much as 30 percent of GDP in some countries and without policy reform, could grow, compromising stabilization

in Albania and Poland and has undertaken in-depth public expenditure reviews in the Baltic countries.

Legal reforms are also key to the transition but are long-term in nature, involving fundamental changes in institutions, processes, and procedures. In the former Eastern Bloc, major gaps exist in the legislation needed to support economic reforms, including the definition of property rights, commercial and financial laws, banking legislation, and regulatory systems. For example:

- In initial rehabilitation loans to Russia, Kazakhstan, the Baltic states, and the Kyrgyz Republic, loan conditionality encompassed the legal and institutional framework for private-sector development, including pro-competition and anti-monopoly policies and an environment conducive to foreign direct investment.
- In Slovakia and Poland, adjustment operations have supported the introduction of bank and securities market regulation and anti-monopoly policies.

- In some former Soviet republics, the Bank has also provided direct support for legal reforms in the areas of privatization, energy legislation, and banking through grants and loans for legal advisers, legal information systems, training, and judicial reform.

Labor Markets, Social Sectors, and Safety Nets

Strengthening social policies (employment, education, health, and the social safety net) is another cornerstone of economic transformation in Eastern Europe. Restoration of this region's growth and international competitiveness depends on the restructuring of industry, or physical capital, and also on the restructuring of human capital to meet the needs of a market economy. The redesign of social sector spending is also key to fiscal adjustment. Social sector spending now absorbs as much as 30 percent of GDP in some countries and without policy reform could grow, compromising stabilization. At the same time, the government must ensure that core social services (such as education, health, and

social welfare) do not deteriorate over the transition.

Toward Flexible Labor Markets

Output and employment declines associated with transition were greatly underestimated. Across Eastern Europe and the former Soviet Union, output has declined by as much as 60 percent, and unemployment in some countries has reached 15 percent or more. In Eastern Europe, unemployment closely tracks output decline. In the former Soviet Union, despite large cumulative output declines, open unemployment remains lower—perhaps because of labor hoarding, often unpaid, which enables workers to continue to avail themselves of enterprise social benefits. But the direction is clear: as budget constraints tighten, the state sector has been shedding employees. Employment growth relies on the development of new activities, and especially of small-scale, private businesses. Policies to reduce labor market rigidities and facilitate mobility, including housing reform, also need to be developed.

Bank Support for Labor and Employment Policies

STRENGTHENING LABOR POLICIES. The primary goal is to support programs that will enhance labor mobility by making it easier to hire and dismiss workers, by improving wage determination policies, and by introducing market-driven training programs for the unemployed. For example:

- The Second Russia Rehabilitation loan now in preparation proposes that unemployment fund resources be used for unemployment only and not for job-creation schemes in state-owned enterprises.
- In Poland, the structural adjustment loan (SAL) and employment services projects are designed to minimize the effects of mass layoffs, with proactive labor market policies focused on strengthening governmental labor offices, retraining, micro-enterprise credit, and other supports.
- Projects designed to strengthen labor offices and services to the unemployed

The primary goal is to support programs that will enhance labor mobility by making it easier to hire and dismiss workers, by improving wage determination policies, and by introducing market-driven training programs for the unemployed

have been approved for Russia and Armenia and are in preparation for the Kyrgyz Republic and Kazakhstan.

TARGETED PROJECTS FOR MASS LAYOFFS. Whether these employment services projects can meet their objectives will only be seen with time. There is concern, for example, that some of these policies are better suited for “frictional” unemployment situations than for countries with high (and likely long-term) structural unemployment. Thus the Bank is exploring a more proactive targeted approach, tying labor and employment support to enterprise restructuring or financial sector operations that entail mass layoffs, severe restructuring, or downsizing. A study of Russia’s coal sector recommends twinning a targeted labor component with any projects that restructure or downsize enterprises.

Redesigning Social Sector Programs

Many countries of the region have recognized the need to redesign and reorient their social sector programs in health, education, and training.

Health care under the command system was generally free, and such health indicators as morbidity and mortality in Eastern Europe and (until recently) in the former Soviet Union were generally quite good. But the command system emphasized more expensive, curative interventions over cheaper, preventive measures. Virtually all transition economies need to move away from the public sector’s monopoly over healthcare, to restructure health expenditure to strengthen primary care, and to improve and reorganize the pharmaceutical industry. Even with these measures, however, improved health outcomes may be elusive, since environment and diet factors also play a role.

In education, many countries see the need to move from an emphasis on narrowly focused vocational education and over-specialized training programs toward more general secondary and technical education and better designed, market-driven training that meets labor market needs. Curriculum redesign—especially for courses in finance, accounting, and management-related

Many countries see the need to move . . . toward more general secondary and technical education and better designed, market-driven training that meets labor market needs

subjects—is high on the agenda. While inflation is rapidly eroding budgets, higher education receives a disproportionately large share of spending in many parts of Eastern Europe and the former Soviet Union.

World Bank Support to the Social Sectors

The World Bank has used a range of vehicles to finance social sector policy reforms and associated investments. In some cases—such as adjustment, recovery, or rehabilitation operations in the former Czechoslovakia, Slovakia, the former Yugoslav Republic (FYR) of Macedonia, and Russia—implementation of selected social policies has been an integral part of a Bank-supported structural adjustment program. In other cases (as in Armenia and Belarus), World Bank assistance for social sectors has been provided through institution-building loans or traditional investment loans.

While projects in the social sectors usually have high economic returns, they may

have low financial returns, and countries in the region are often loath to borrow for this purpose. Their concern is that such projects do not directly generate income and need to be repaid from general government revenues and scarce foreign exchange. Because of this, Bank support to the social sectors has been limited. Even so:

- In Poland, a health project is in place to help move the focus toward primary care and prevention, improve sector management, contain costs, and decentralize and demonopolize delivery.
- In Hungary and Romania, Bank-supported projects have introduced targeted, cost-effective public health interventions such as the rehabilitation of medical facilities, the introduction of management information systems to hospitals, and technical assistance for health services management.
- In Albania, a project to rehabilitate schools, ensure textbook provision, and restructure outmoded curricula is under implementation.

In Hungary and Romania, Bank-supported projects have introduced targeted, cost-effective public health interventions such as the rehabilitation of medical facilities, the introduction of management information systems to hospitals, and technical assistance for health services management

Social expenditures, especially pensions, are the most explosive element in state budgets and are almost certainly unsustainable. Despite their expense and generosity, however, some are so poorly targeted that they fail to protect those most at risk

- In Russia, a management and finance training project will set up a public-private foundation to strengthen the skills needed in a market economy, such as management, finance, and professional services.

Strengthening Safety Nets

To maintain consensus and support, governments must maintain the safety net that protects those hurt most by transition. Social expenditures, especially pensions, are the most explosive element in state budgets and are almost certainly unsustainable. Despite their expense and generosity, however, some are so poorly targeted that they fail to protect those most at risk.

Across the region, countries are focusing on how to reform their pension and unemployment programs and their social welfare systems—which in some countries now consume as much as 20 percent of GDP. Financed by payroll taxes that sometimes account for over 60 percent of wages (including those for health), the system is distortional and thought to

affect competitiveness and the demand for labor. The reallocation of expenditures within this sector is made somewhat easier by its large budget share; and for fiscal, labor-market, efficiency, and international competitiveness reasons, cutbacks are inevitable.

The World Bank has supported reforms in this area through its lending, sector work, poverty assessments, and technical assistance. Social sector reviews, typically a prelude to project identification, have been prepared recently for Kyrgyz Republic, Russia, Ukraine, Hungary, and Poland. Poverty assessments are based on Bank-sponsored statistical surveys of household income and expenditure.

On the lending front, a rural poverty alleviation project in Albania was designed to test different approaches to rural public works and small-scale credit and to create employment and improve the cash incomes of rural households. The remarkable success of this pilot project speaks for its replication on a larger scale in urban areas.

Infrastructure

Public infrastructure investments and private-sector growth are strongly complementary, and the contribution of public investment to private productivity is rarely disputed. Efficient investments in transport and other infrastructure can make a significant difference in supply response. In central Asian countries, for instance, greater integration with nearby (but still largely inaccessible) South Asian markets and access to a wider range of trade partners will depend critically on the improvement of the region's transport and communications infrastructure and its oil and gas pipelines. To create a more efficient infrastructure, however, major policy reforms are needed. And across the region, there needs to be a shift from new capacity-expanding investments to rehabilitation and maintenance.

Large sums will be required. Countries will have to avoid "white elephant" projects and realize that even substantial public resources and donor

involvement can contribute only a small fraction of the investment needed. Internal cash generation and private investment are essential. The Bank's role will lie as much in coordinating assistance, easing constraints to foreign direct investment, helping countries frame "market friendly" regulatory systems, and supporting institutional development to raise and allocate resources for infrastructure as in directly financing investments.

The World Bank has financed some \$840 million in infrastructure and housing investments in FY93 alone. Catching up on the public investment and maintenance backlog is key to attracting foreign direct investment and facilitating trade flows and the supply response. There are, for example, severe capacity constraints in telecommunications—a sector neglected in the past that today suffers from outdated technology. In both the Czech Republic and Slovakia, telecommunications projects have sought to expand capacity, establish a regulatory framework, and support commercialization that readies enterprises

(In infrastructure) the Bank's role will lie as much in coordinating assistance, easing constraints to foreign direct investment, helping countries frame "market friendly" regulatory systems . . . as in directly financing investments

for privatization. In Hungary, a Bank telecommunications loan supported one of the largest ever privatizations in an infrastructure sector.

In many countries, transport needs to be reoriented toward new markets and different modes, for example, away from rail toward more flexible (and more easily privatized) road traffic. In Russia, for example, a highway rehabilitation and maintenance loan is designed to help shift from rail to road for short-haul freight traffic by improving the reliability of roads.

Housing reforms will help create labor mobility and efficient labor markets. They will free state enterprises from burdensome social assets and state and local governments from the fiscal burden of social and communal housing, allowing them to turn their energies from ownership to public service provision:

- Bank activities planned for Russia include promoting land market reform, housing privatization, and demonopolization of the construction industry.

- In Poland, emphasis is on housing finance. The housing sector is a challenge. It is often highly subsidized, and the macroeconomic environment is not conducive to developing housing finance.

- In Albania, a project focuses on completion of unfinished housing units, and the privatization of communal housing by municipalities.

The Role of Guarantees

Keeping the emphasis on indirect support of infrastructure development, the Bank has also engaged in dialogue with countries in the region on the use of guarantees, which permit large-scale investments without directly adding to public sector debt. Contractual compliance guarantees are designed to separate commercial risk from contractual risk. They guarantee loans made by a private lender to a private project against the risk that the government will not meet undertakings critical to the project's viability. Several operations have been discussed concerning motorway projects

Keeping the emphasis on indirect support of infrastructure development, the Bank has also engaged in dialogue with countries in the region on the use of guarantees, which permit large-scale investments without directly adding to public sector debt

in the Czech Republic and Poland and a pipeline project in Poland. In the first of these, private lenders to a private toll road concession are beneficiaries of the guarantee. The contractual risk is that the government will not stick to a pre-agreed schedule of toll rate increases critical to financial viability of the concession. Private financing allows a government to focus its limited spending and borrowing capacity on other high priority and socially desirable projects. But structuring these guarantees and pricing them is not easy.

Cleaner Environments

Incentives under the command regime had much to do with the poor ecological state of Eastern Europe. Across Eastern Europe and the former Soviet Union, water and air pollution continue to undermine both livelihood and health. The socialist system's underpricing of energy, its drive to promote heavy industry, and the prevalence of industrial subsidies encouraged energy-intensive, environmentally harmful industries and

technologies. The main sources of air pollution are power generation, industry, motor vehicles, and road transport, while industrial effluents cause a great deal of water pollution. With energy prices sometimes still at one-third of world prices, overconsumption is rife.

To stop (and reverse) environmental damage requires both know-how and financing. Lack of funds and weak implementation capacity have impeded environmental improvements. But everything cannot be done at once, and difficult choices must be made and priorities set. The World Bank has supported measures to raise public awareness and strengthen institutions. It has also helped governments establish incentives to reduce energy consumption and adopt more environment-friendly technologies.

Some countries (notably Kazakhstan, Turkmenistan, and the Russian Federation) are major energy producers—Russia alone accounts for 20 percent of the world's oil and gas output. Others (the Baltics, Ukraine, and much of Eastern

To stop (and reverse) environmental damage requires both know-how and financing. Lack of funds and weak implementation capacity have impeded environmental improvements



BORROWING MEMBER COUNTRIES OF THE FORMER SOVIET UNION

The Transition in Central and Eastern Europe and the Former Soviet Union

IBRD 26192



AUGUST 1994

BORROWING MEMBER COUNTRIES OF EASTERN AND CENTRAL EUROPE

It is necessary to find ways to move ahead with energy price reform while compensating the most vulnerable groups

Europe, for instance) are heavy importers and, for the time being, reliant on a sole supplier. In producing regions, the aim is to increase the efficiency of production and exploitation, attract foreign investment, and improve incentives for energy conservation through pricing and other policies. In consuming countries, the aim is to diversify supply, develop regional networks for major energy carriers, promote energy saving investments, reduce waste, and address the safety aspects of nuclear power generation.

Adjusting energy prices both in relative terms (between households and industry) and absolute terms is key in all countries. Change, however, will be neither quick nor easy. Private households—which benefitted for years from subsidized energy—are likely to resist. So, too, will industrial users, where demand elasticities in the short run are low. Organized labor has also resisted, fearing what industrial power price increases may do to enterprise profitability and employment. If such objections

successfully slow price adjustments, reductions in pollution will also be slower, since lower energy prices mean continued high energy consumption, lower energy sector profitability, and fewer funds available for reinvestment in pollution-abating technologies. It is necessary to find ways to move ahead with energy price reform while compensating the most vulnerable groups.

While some environmental problems will be helped by price changes, others will need targeted investments. Bank-supported environmental investment projects are currently under way in some countries:

- In Slovenia, an environmental project seeks to help households and industry shift from polluting fuels (such as coal) to gas or district heating by financing gas-connection works and purchases of gas-fired appliances.
- In the Czech Republic, another project is working to improve power system efficiency and reduce air pollution in northern Bohemia.

The same project also aims to reduce lignite consumption by making power plants more efficient, to curtail power plant sulphur dioxide emissions with flue-gas desulfurization, and to increase the reliability and efficiency of power transmission systems.

- In Russia, the Bank helped to establish an environmental framework program under which some \$200 million in pledged funds will strengthen Russia's environmental management and finance resource recovery and pollution projects—"win-win" projects meant to generate foreign exchange to pay off investment costs.

The Bank's involvement in this area has also included environment strategy studies, now completed for most countries. These studies rank environmental priorities on the basis of health impact and cost effectiveness and can help clarify a country's policy regime. The key issues are: How strict should environmental standards be? How quickly should they be enforced? How serious will the

impact of closing polluting enterprises be on workers and nearby towns?

Foreign investors and those interested in privatization are particularly concerned with liability for cleaning up past pollution. Ensuring that environmental policies are "market friendly" is also key. Generally, the Bank has emphasized the importance of reducing ongoing pollution before addressing the clean-up of already polluted areas, which must be done over time and when resources become available. Past environmental damage is generally deemed the responsibility of the government, while stricter pollution standards typically apply to future operations of a private enterprise or joint venture.

Research on environmental taxes and other instruments continues. Vehicle taxes, fuel taxes, and improved traffic management, for instance, can contribute substantially to environmental improvement. Such economic policies can often make a difference, but at lower cost than direct

The Bank has emphasized the importance of reducing ongoing pollution before addressing the clean-up of already polluted areas, which must be done over time and when resources become available

For some early reformers in Central Europe (for example, Hungary and the Czech Republic) most forms of energy to industrial consumers are now close to or at economic costs, and the financial positions of energy enterprises have also improved

investments. These measures can go a long way toward reducing the demands on the environment that, over time, economic growth would otherwise bring.

Energy Projects

With varying degrees of success, the Bank's energy projects have sought to support policy reform, institution building, improved investment efficiency, environmental benefits, and regional integration. In addressing the severe underpricing of all energy, the Bank has had some influence in most countries.

This has been achieved through its economic and sector work, through conditionality in some adjustment and investment lending operations, and through ongoing dialogue. For some early reformers in Central Europe (for example, Hungary and the Czech Republic) most forms of energy to industrial consumers are now close to or at economic costs, and the financial positions of energy enterprises have also improved. Further east, progress is slower, although even in Russia, petroleum and gas prices have

substantially increased in real terms.

Other key aspects of energy policy reform—particularly in sector restructuring, commercialization, and privatization—have made less progress. Major energy enterprises have yet to be privatized, and private investment, particularly in the oil and gas sector, has not been substantial relative to needs. This reflects political and economic instability, as well as inadequate and uncertain regulatory, legislative, and fiscal frameworks.

One project that highlights the importance of policy reform is a \$610 million loan (for a \$1 billion project) supporting the first major effort to rehabilitate Russia's oil sector. The project supports major pricing, taxation, legislative, and institutional reforms to encourage new investment, both foreign and domestic. The benefits and economic returns are high and will begin to be realized when the first round of equipment arrives at Russian oil fields. A second project will build on the first.

Achieving greater efficiency and conservation in energy use is crucial. For the Baltics, a district heating rehabilitation project in Estonia and a power rehabilitation project for Lithuania have just been approved. Greater efficiency is also an objective of the Bank's planned power-transmission projects in Slovakia and Poland, which will link these countries with the rest of the European grid.

Investment projects have dominated the Bank's energy lending, but among adjustment loans, an energy sector adjustment loan to Poland is noteworthy. This loan supports government efforts to develop an energy sector regulatory and pricing framework and to restructure and commercialize public utilities. Such steps are needed to attract the approximately \$3 billion in energy investment required by the gas and power sectors over the next years.

In the nuclear energy sector, the Bank has participated in a G-7 study of environmental clean-up possibilities for phasing out unsafe plants and

replacing them with internationally certified plants or with power plants based on alternative fuels. For some countries in the region, this transformation is not easy. The Baltics, for example, which now rely on a sole supplier of gas, might become more vulnerable with conversion to gas. The Bank has not to date been involved in financing nuclear projects; that financing is generally led by the private sector or other international financial institutions.

Private Sector Development

The challenge of moving an economy where 90 to 95 percent of productive assets are owned by the state or workers' collectives to one where private ownership is dominant (60 percent or more) has no historic precedent. The Bank has used three means to directly support ownership change and private sector development:

- Adjustment loans that support specific policies to speed up privatization.
- Technical assistance loans to finance expertise.

The challenge of moving an economy where 90 to 95 percent of productive assets are owned by the state or workers' collectives to one where private ownership is dominant (60 percent or more) has no historic precedent

Box 1. World Bank Group Assistance for Privatization in Kazakhstan and Russia

Kazakhstan. Following independence in late 1991, Kazakhstan initiated a privatization program. Enterprises were transferred through a slow, case-by-case process and went primarily to worker collectives at highly favorable prices and with restrictions on business practices. By mid-1992, the drawbacks were obvious and the government invited the World Bank to assist in the development of a new strategy.

In the fall of 1992, the Bank, together with EBRD and USAID, worked with the Kazakh State Property Committee (SPC) and other agencies to define a comprehensive, action-oriented privatization strategy with policy recommendations on competition policy, capital market development, and private sector development. By March 1993, it was signed by the President. Parliament passed relevant legislation shortly thereafter.

The program's four components provide for (a) local auctions of almost all small-scale enterprises by the end of 1994; (b) mass privatization of the roughly 3,500 medium and large, nonagricultural firms between 1994-96 (with most shares sold to investment funds using coupons invested in them by individuals); (c) case-by-case privatization of some very large or special enterprises, mainly through international tender; and (d) privatization in the agricultural sector, with the allocation to individual farmers of long-term use rights for state farmland.

This sound program enjoys broad consensus. Execution began by mid-1993 and has proceeded quickly. Pilot programs for small-scale privatization in six large cities and for truck and warehouse auctions have begun. The first international tender for a very large enterprise was also launched, and SPC has started share auctions for mass privatization.

Implementation support has been provided by the World Bank, the European Union, and USAID. The World Bank will provide additional technical assistance under two sequential loans, and further Bank projects may help restructure enterprises after their privatization and seek to improve the economic environment in which they operate.

Russia. A major turning point in Russia's transition to the market occurred in late November 1991 with the implementation of the Law on Privatization. In March 1992, a Bank team of technical advisors—management consultants, lawyers, public relations specialists, economists, and accountants—helped to construct the detailed mechanics of the program. This detailed exercise provided crucial assistance to the conceptually sound but poorly implemented program. Since that time, the Russian Privatization Fund (GKI) has:

- Elaborated an economically defensible and politically palatable privatization program.
- Begun the sale of vouchers permitting 146 million Russian citizens to participate directly in the privatization process.
- Changed firms to joint stock company status, distributed shares to insider workers and managers, and sold, by March of 1994, much of the remaining stock for vouchers in more than 9,000 medium and large-sized firms—an outcome remarkable in its scope and scale.

Between late 1991 and early 1992, before Russia joined the World Bank Group, when GKI was formulating its key privatization policies, IFC maintained a permanent advisor in Moscow who participated in GKI's policy meetings and helped elaborate a conceptual framework of the program—that has stood up remarkably well over the ensuing three years.

In conjunction with the EBRD, the Bank prepared a \$130 million privatization loan which was approved by the Executive Directors in December 1993. The Bank and IFC continue to work closely with the Russian privatization program and have assisted firms after they have been privatized.

- Credit lines to augment the resources of banks and to encourage them to lend to the new private sector.

Through the IFC, the Bank Group has also taken an equity position in private enterprises, and MIGA provides insurance services to foreign investors. As discussed earlier in relation to infrastructure financing, the use of various forms of guarantees (including liquidity-enhancing guarantees for capital markets) could become an important instrument to support private sector development.

Bank Support for Private Sector Development

The Bank has not used policy-based lending to promote a particular model of privatization. Rather, adjustment loans were generally used to speed up privatization following whatever method or mix of methods (privatization tracks) the particular country wanted to pursue. Hungary and Bulgaria, for example, did not want to use voucher schemes for mass privatization. Bank adjustment loans set targets in

terms of “share of value-added privatized by a certain date,” using public offerings or direct sales. In the Czech Republic, Slovakia, and Poland, very different methods of mass privatization were supported by Bank adjustment loans. Countries of the former Soviet Union, too, are pursuing a variety of approaches accepted by the Bank and incorporated into Bank-supported operations. The Bank also supports privatization of agricultural land and state farms—just as important as privatization in the industrial and service sectors.

In addition to its early support for Central Europe (particularly Poland), the Bank has been active in the Russian Federation, Kazakhstan (see Box 1) and the Kyrgyz Republic—with both economic work and technical assistance. Early support to Russia included technical assistance for the mass privatization program, a public information campaign, and policy advice on such issues as corporate governance, interenterprise liabilities, competition policy, environmental issues

The Bank has not used policy-based lending to promote a particular model of privatization. Rather, adjustment loans were generally used to speed up privatization following whatever method or mix of methods (privatization tracks) the particular country wanted to pursue

The Bank's message has been that it is more important to move toward private ownership than to try to perfect any particular privatization method. Experience is teaching both the Bank and member countries what works and what doesn't

associated with privatization, and divestiture of enterprises' social assets.

Drawing on early experiences in Poland, the Czech Republic, and Slovakia, the Bank has been active in disseminating lessons, making transparent the costs and benefits of different types of mass privatization, as well as comparing mass privatization (via vouchers) to case-by-case methods based on auctions and special management or labor buy-outs. The Bank's message has been that it is more important to move toward private ownership than to try to perfect any particular privatization method. Experience is teaching both the Bank and member countries what works and what doesn't. But much depends on the circumstances of individual countries, including the political rapport between insiders and outsiders in the enterprise sector.

From the beginning, there was concern about the availability of credit both to newly privatized enterprises and to enterprises attempting to restructure

before privatization. Lines of credit were prepared for Hungary and Poland in the late 1980s and early 1990s to provide long-term resources to new commercial banks and to encourage them to lend in support of the transformation. A recent loan for restructuring private enterprise in Russia will test the demand for credit by the emerging private sector. The project is innovative. It is accompanied by equity funds and technical assistance centers (financed by the EBRD, IFC, and bilateral donors). The credit will be intermediated by a selected group of commercial banks required to comply with internationally accepted banking standards and practices.

Strong demand for investment credit, however, is unlikely to emerge before an economic upturn, as evidenced by the poor initial disbursement of the Polish and Hungarian credit lines. And wholesale credit that is supposed to reach new entrepreneurs through the intermediation of a banking system itself in crisis may be putting the cart before the horse. A stronger banking sector may be a prerequisite for

rapid private sector development in transition economies.

THE ROLE OF IFC. IFC has supported the private sector by investment in private enterprises and technical assistance with privatization, capital markets, and promotion of foreign investment. The number of approved IFC investments in the region rose from two in FY90 to twenty-nine in FY94. Beneficiaries include Bulgaria, the Czech Republic, Estonia, Hungary, Kazakhstan, Poland, Romania, Russia, Slovakia, Slovenia, Ukraine, and Uzbekistan. IFC's investments have concentrated on manufacturing and capital market projects. Examples of the former include a cement plant in Estonia, float-glass and special steel plants in Poland, and glass container, wheel manufacturing, carbon black, and newspaper investments in the Czech Republic. In addition, IFC has made telecommunications investments in Hungary (including a joint venture to operate Hungary's national telecommunications system) and has two oil projects in Russia. Other ventures have

included agribusiness projects in Hungary and Poland, a hotel and an office building in Warsaw, coal-bed methane gas recovery in Poland, and gold mining in Uzbekistan.

Capital market projects have included the privatization of banks, the creation of new banks in Hungary and Kazakhstan, credit lines—including one to the Moscow International Bank, the creation of leasing and factoring companies, and the participation in venture capital and investment funds both at the national level—the Ukraine Fund, for instance—and on a multi-country level. Technical assistance in capital market development is also available and consists of advice on securities legislation, the creation of stock, bond and, commodity markets, the framework needed for banking and leasing, and the registration and custody of shares in newly privatized companies.

Technical assistance to small-scale privatization is now under way in Ukraine and Belarus. Meanwhile, IFC has provided advisory services and

The number of approved IFC investments in the region rose from two in FY90 to twenty-nine in FY94

assistance to the privatization of major enterprises, often finding them suitable foreign joint-venture partners. FIAS has provided advice on how to improve the foreign investment legislation and climate.

Building the New Financial Sector

Systemic transformation from centrally planned economies to market economies requires not only a new banking system but also the regulatory and payments systems, and other economic infrastructure within which true financial intermediaries can function responsibly.

The problem is time. Ideally, the first step should be to build the supervisory and regulatory environment and create or import financial intermediaries with the appropriate staff. Only then, should these new actors make the credit allocation decisions that influence the path of the economy. In reality, governments have not had this luxury and have had little choice but to use the shell of the old system. Monobanks were hastily split, and a two-tier banking system

established. The new regionally or functionally specialized (but still publicly owned) banks continued to take deposits and make loans. And while much was expected of them in improved credit allocation, directed credit continued and little in the incentive framework changed. Too rapidly, some thought, the door opened to many small private banks, even though the regulatory and supervisory framework was far from adequate. All this took place simultaneously with restructuring, downsizing, and privatization in the enterprise sector, leading to the continued accumulation of nonperforming loans and deterioration of the balance sheets at new banks, public and private.

While there are important differences among countries in their financial sectors, there are enough similarities to suggest common issues that need to be addressed strategically. These include: improvements in legal and regulatory systems, especially in the areas of banking regulation and supervision; modernization of payments systems; restructuring and

Systemic transformation from centrally planned economies to market economies requires not only a new banking system but also the regulatory and payments systems, and other economic infrastructure within which true financial intermediaries can function responsibly

privatizing the former state banks, support for moving commercial banks more rapidly toward international standards; provision of extensive training in banking services, credit operations, accounting and auditing and the like; and moving to market-based credit allocation by phasing out directed credit and non-budgeted interest rate subsidies.

Technical Assistance and Institution Building

World Bank support for financial sector development has tended to have two distinct phases. In phase one, there is intense focus on technical assistance both to the future regulators and supervisors and to bank staff. This involves developing banking infrastructure through basic legislation, introducing improved accounting and auditing, encouraging prudential regulation, modernizing the payments system, and training staff and managers in project evaluation, corporate finance, and risk assessment techniques. In Hungary, for example, an early modernization loan attempted to strengthen the

payments system and to update banking technology. The Poland financial institutions development loan has aimed at twinning arrangements between Polish and international banks to strengthen credit policies and internal management practices.

In Russia, one of the Bank's larger technical assistance loans (a \$200 million financial institutions development project) aims to build the capacity of a core thirty to forty private commercial banks, which will operate to higher banking standards. It also provides the basis for a private (federal) clearing system. The project consists of three components: commercial banking, consisting of institutional strengthening and a systems modernization program; bank supervision, consisting of the development of on-site supervisory capabilities and legal assistance for the Central Bank of Russia; and bank accounting, which will focus on the modernization of accounting and auditing standards and practices. A similar operation is under way in Kazakhstan.

The Poland financial institutions development loan has aimed at twinning arrangements between Polish and international banks to strengthen credit policies and internal management practices

Only when there has been some technical assistance, training, and institutional development can more ambitious adjustment operations be launched

In Albania, Lithuania, and Moldova, the strategic focus is more fundamental. The World Bank is emphasizing the need to establish a proper legal framework for commercial banking, to restructure state-owned banks, and to overhaul the payments system. In Ukraine, where credit policy has made financial sector reform especially difficult, the institution-building loan is financing a twinning arrangement for the state savings banks, and an institutional development fund (IDF) grant is financing technical assistance in accounting for commercial banks. Similarly, in Belarus, where reform is just beginning, an institution-building loan is providing financing for twinning arrangements for the savings banks and the largest private bank, and an IDF grant is financing accounting reforms.

In the less developed Kyrgyz Republic and in Uzbekistan, the strategy is different again. World Bank technical assistance is provided for auditing two key banks with problem portfolios and for training bankers and bank accountants. Under a project now being prepared, an agency would be

created to handle insolvency, including the bad debt of state-owned banks. Basic issues such as supervision, auditing and accounting standards, and payments system modernization are also being addressed. In addition, diagnostic studies of the four state banks are being financed.

In Estonia, where reforms are more advanced and the macro-economy has stabilized, it is possible to be more ambitious. Parallel support from the World Bank and the Swedish government aims at expanding both commercial bank capital and improving banking skills. In Latvia, the World Bank supports efforts to restructure and privatize state-owned savings and commercial banks and to modernize the payments system.

Financial Sector Adjustment

Only when there has been technical assistance, training, and institutional development can more ambitious adjustment operations be launched. In some countries, shell state banks are being allowed to shrink while newly-licensed private banks expand. In

others, the need to address problems in both the banking system and enterprises jointly is paramount. Dealing with the banks alone would risk that future lending would again be channeled to their traditional client base—including weak and debt-burdened or loss-making enterprises. Solving the enterprise problem is a sine qua non for lasting viability of the banking system (as distinct from a one-time overhaul).

Bank assistance recognizes the need to address nonperforming loans of commercial banks—a legacy that has undermined the dual objectives of restructuring enterprises and providing adequate credit to emerging enterprises. In some cases, the limited capacity of the banks has necessitated more centralized approaches in the short-term, with the most problematic enterprises isolated from the rest of the banking system. Increasingly, as banks have the technical capacity to participate in enterprise restructuring, a lasting solution can focus on the active involvement of banks that had lent to problem enterprises in the first place. In Poland, banks were thought to be the only

agent of change for all but a certain subset of troubled, indebted enterprises (Box 2).

Phase two of the World Bank's financial sector support focuses on strategies for the recapitalization of banks and financial restructuring of enterprises that should allow the newly reformed, retrained banks to function as competitive entities with positive net worth. Key questions relate to the most desirable form and timing of the inevitable recapitalization, the degree of its linkage to bank privatization and to enterprise restructuring, liquidation, and privatization.

For some of the more advanced countries in Eastern and Central Europe, the enterprise and financial sector adjustment loan (EFSAL) has become the vehicle of choice to restore banking viability and strengthen financial intermediation. These loans support government policy reforms designed to resolve the debt overhang of state-owned enterprises and the portfolio problems of state-owned banks. Both are needed to unfreeze bank lending (much of which is now tied up in rolling over

For some of the more advanced countries in Eastern and Central Europe, the enterprise and financial sector adjustment loan (EFSAL) has become the vehicle of choice to restore banking viability and strengthen financial intermediation. These loans support government policy reforms designed to resolve the debt overhang of state-owned enterprises and the portfolio problems of state-owned banks

Box 2. Enterprise and Financial Sector Adjustment Loan (EFSAL) in Poland

In 1993, Poland embarked on a far-reaching enterprise and bank restructuring program (EBRP) supported by a \$450 million adjustment loan from the World Bank. The program assumed that banking and enterprise problems must be jointly resolved, and that banks—not the government, a centralized agency, or a “hospital” for sick enterprises—were the only effective agent of change for troubled, indebted enterprises. Banks know their clients best and can distinguish better than a government agency or an outsider between borrowing enterprises that are loss-makers under any scenario (and should therefore be pushed into bankruptcy or liquidation) and those that could be restored to profitability if properly down-sized or restructured and their debt overhang reduced. For this scheme to work:

- Banks must face a hard-budget constraint. Practically speaking, this means that they must be privatized, and that they must believe that no further resources are forthcoming to support them. (In Poland, bank privatization is part of the loan conditionality, and the agent-of-change role is already being played by nonprivatized banks governed by a steadfast and determined Ministry of Finance).
- The accounting and bank regulatory and supervisory framework must be right, with market valuation of loans in bank portfolios and provisioning required for nonperforming loans. In Poland, a comprehensive program to strengthen bank supervision was supported by the EFSAL.
- Banks must be recapitalized to give them a sufficient capital cushion to provision and write off loans to problem or nonviable debtors following restructuring or liquidation.
- The privatization program and governance framework for enterprises must ensure prudent management and a hard-budget constraint. The Poland EFSAL supports the mass privatization program and sets specific targets for more traditional privatization tracks.
- Bankruptcy procedures must function smoothly. Given the expected workload and inexperience of courts, the Polish EFSAL supports a temporary out-of-court conciliation procedure led by banks that would facilitate creditor-led workouts. Banks were given a one-year window to conclude conciliation proceedings. Creditor banks accounting for 50 percent of loans were also permitted to impose a solution on minority creditors.
- For enterprises unable to agree on conciliation or bankruptcy in one year, a government-managed intervention fund was set up with a limited budgetary envelope. Banks will have to write off a large portion of loans handled by this fund.

With these incentives, a profit-minded bank will do its utmost to recover value from its nonperforming loans, either by pushing the borrower into bankruptcy or liquidation to recover whatever value remains, or by restructuring the borrower's debt (jointly with other creditors) such that the enterprise once again becomes profit-generating.

So far, two banks have been privatized and another is in the process. The mass privatization program and privatization through other routes are generally on track. By the end of the one-year window, banks had dealt with 80 percent of their bad loans in value terms and were expected to complete the job in a matter of weeks. Bank-led conciliations were used to work out 60 percent of bad loans in value terms. The balance was handled through triggering bankruptcy or by auctioning off assets. Some of the remaining loans are being “sold” to the intervention fund. It remains to be seen whether these sales will be at prices that reflect the intended punitive nature of state intervention.

One might not choose this creditor-led approach, however, where banks are not yet truly banks—as in Albania or Moldova, where banking and credit skills are still rudimentary. This approach is also not indicated where bank privatization is not on the agenda and where government policies for governing public sector banks are not credible.

nonperforming loans) so that credit can be redirected toward performing state-owned enterprises and the private sector. EFSALs support government policies aimed at strengthening bank management and governance and reforming bank supervision, accounting, licensing, and regulation. Increasingly, EFSALs incorporate incentives for bank-led conciliation and the restructuring of enterprise debt reduction. Such loans have already been made in Albania, Poland, and Slovenia and are now under consideration in FYR Macedonia, Bulgaria, Romania, and Slovakia.

Within these loans supporting financial sector development and deepening financial intermediation, the Bank has also provided technical assistance for capital market development and the strengthening of bank regulation and supervision. One such project in Poland supported an action program to strengthen financial institutions, the regulatory and supervisory capacity of the central bank, and the policy and institutional environment. It included

technical assistance and institution building. Using twinning arrangements between Polish and European commercial banks, it has produced positive results.

Of the eleven financial sector operations in fiscal 1990–94 (totaling \$2.1 billion in commitments), one quarter were adjustment loans to help cover the budgetary costs of bank recapitalization or enterprise restructuring (Table 2). Other operations have aimed to strengthen the banking system in two complementary ways—directly, through the finance of equipment needs or technical assistance to the bank themselves, and indirectly, by providing long-term resources that banks intermediate.

Aid Coordination

Additional support for country programs can be leveraged by the Bank's economic work and cofinancing. Other donors (the European Union, bilateral sources, and other multilateral banks) often find the World Bank's analyses useful as a framework for aid coordination and as a compass for the policy

Of the eleven financial sector operations in fiscal 1990–94 (totaling \$2.1 billion in commitments), one quarter were adjustment loans to help cover the budgetary costs of bank recapitalization or enterprise restructuring

Aid coordination is time-consuming but key to ensuring concerted policy advice, technical assistance, and investment financing

measures that donor-supported programs finance. A Bank-assisted public investment review of Albania, for example, led to greater donor and government agreement on a public investment program, and many donors have now chosen to provide financial support. Such aid coordination is time-consuming but key to ensuring concerted policy advice, technical assistance, and investment

financing. Given constraints on the absorptive capacity of many countries, aid coordination is also needed to ensure that donor support will fit government priorities. The centerpiece of aid coordination is the consultative group process. In Eastern Europe and the former Soviet Union, the Bank has either organized or participated in many EU-led coordination efforts designed to help reduce

Table 2. Financial Sector Operations (July 1989 to June 1994)

<i>Country</i>	<i>Name of loan</i>	<i>Month of approval</i>	<i>Amount (US\$ millions)</i>
Hungary	Financial systems modernization	Sept. 1989	66
Poland	Agroindustrial exports development ^a	Feb. 1990	100
Poland	Industrial export development ^b	Feb. 1990	260
Poland	Financial institutions development	June 1991	200
Poland	Enterprise restructuring and privatization	June 1991	280
Bulgaria	Private investment and exports ^b	June 1993	55
Romania	Industrial development ^b	May 1994	175
Russia	Financial institutions development	May 1994	200
Russia	Enterprise restructuring	June 1994	200
Poland	Enterprise and Financial Sector Adjustment	May 1993	450
Slovenia	Enterprise and Financial Sector Adjustment	July 1993	80
Total			2,066

a. With a component for developing the cooperative banking system.

b. Includes funds for technical assistance to strengthen the banking system.

constraints on external financing and to coordinate the overall provision of foreign resources. Sector-specific meetings have also been held, as, for example, conferences on the agriculture sector in Poland and Albania.

The Bank's Research and Training Support

As a knowledge-based institution, the Bank offers more than just a financial product, and its research has addressed issues ranging from macroeconomic stabilization to enterprise behavior. Bank macroeconomic studies have sought to understand the reasons for the output collapse in Eastern Europe and the former Soviet Union and have drawn lessons from the experience of early reformers. For example, how have the successes and failures of macroeconomic stabilization programs in Latin America compared with those in Eastern Europe? Another focus has been fiscal federalism, where a study compared the Russian experience to that of, among others, China, Brazil, Canada, and India. From these comparisons, the study was

able to provide guidelines and general lessons for all transition economies faced with fundamental changes in their structures of taxation and assignment of revenue (including the thorny issue of natural resource rents) and expenditures among different levels of government.

Other Bank-sponsored studies have examined how state enterprises in Poland and elsewhere have responded to various reforms:

- Comparative studies of private manufacturing in Poland, Hungary, the Czech Republic, Slovakia, and Russia and a survey of the private sector in St. Petersburg have identified factors encouraging and constraining private sector growth.
- Comparative analyses of the emerging legal framework for private sector development in Eastern Europe have provided a baseline to assess the progress of reform.
- Extensive research has been done on agriculture's transition, including the collection

Bank macroeconomic studies have sought to understand the reasons for the output collapse in Eastern Europe and the former Soviet Union and have drawn lessons from the experience of early reformers

One of the greatest challenges of transition has been the widespread need for the retraining of mid-level civil servants steeped in the ways of a planned economy

and analysis of data on farm-level restructuring.

Since transition implies major changes for households, an important focus of Bank research has been labor markets and poverty. Labor market studies have identified a growing pool of potentially long-term unemployed and a widening of skill premia in earnings distributions, and have assessed the implications of these findings for poverty. Transition countries inherited a comprehensive if inefficient and fiscally unsustainable social welfare system. Estimating the distributional impact of social spending was therefore a necessary prelude to effective targeting of social support and to the poverty assessments now beginning in the region.

Research activities have also embodied institution building and extensive collaboration with leading analytical institutes and statistical offices. Scholars from the region have been brought to the Bank, and many joint conferences have been organized with institutions in Eastern Europe and the former Soviet Union.

To deal with the problematic area of data and national accounting, the Bank has produced two editions of its *Guide to Historically Planned Economies*. A Bank newsletter, *Transition*, represents a specific effort to communicate the results of Bank analyses and studies to a wider audience. Circulation is now more than 6,000, and demand in the transition economies is strong.

One of the greatest challenges of transition has been the widespread need for the retraining of mid-level civil servants steeped in the ways of a planned economy. They have had little exposure to market-based systems, and this mismatch in skills has constrained economic policy-making. The task is to raise skill levels while seeking greater consensus on economic policy among policymakers and throughout the population.

Since 1990, the World Bank's Economic Development Institute's (EDI) efforts have included direct training, the sharing of experience both within and across regions,

and—increasingly—the training of local teachers to train mid-level officials in local institutions and agencies. In Russia, where demand for retraining is enormous, EDI retrained a group of teachers recruited mostly from Russian universities and research institutions. In late 1992, a training center at Moscow State University was established that organizes a wide range of courses, targeted primarily at officials and taught primarily by local staff. This model is being replicated in the Ukraine and in Uzbekistan, with plans for Kazakhstan, Belarus, and Moldova. Similar programs have begun at the Center for Economic Research and Graduate Education in Prague, and at Warsaw University. Teachers are being trained in the former Soviet Union, at EDI in Washington, DC, and at a recently established (1993) program with the Joint Vienna Institute. Most recently, EDI has begun to reach out to journalists, parliamentarians, and the general public to disseminate more widely and effectively information on the objectives and likely results from reforms, both macroeconomic and structural.

Conclusion

The Bank's key challenge in dealing with transitional economies has been to calibrate the volume and composition of assistance so that it complements domestic reform, making it less socially and economically costly and more sustainable. Assistance that is too little or too late makes reform unnecessarily costly and may endanger its progress. Financial assistance that is premature may delay reform and lead to capital flight, adding to debt rather than to economic growth and public welfare. When a country's need is exceptionally large, it may threaten the portfolio of the Bank and increase the cost of borrowing for other members.

In identifying the future direction of Bank lending, it is important to recognize that restructuring and growth in transition countries will depend on addressing two major constraints: demand-side constraints that impair the business environment and the desire to invest (such as lack of macroeconomic stability,

Assistance that is too little or too late makes reform unnecessarily costly and may endanger its progress. Financial assistance that is premature may delay reform and lead to capital flight, adding to debt rather than to economic growth and public welfare

The key challenge is to ensure that adequate progress has been achieved toward an environment conducive to restructuring and private sector growth before transferring significant resources through infrastructure and credit

insufficient liberalization, and a weak legal framework) and supply-side constraints in the availability of resources such as credit to enterprises and key public infrastructure needed to complement the growth of the private sector. The key is to achieve a balance between interventions addressing both types of constraints.

Historically, lending operations have been well-g geared for investment operations and credit lines. But lack of progress today in improving the environment for restructuring and investment may result in:

- Undisbursed credit lines, as occurred in countries where Bank loans were approved before investment demand and privatization progress required them.
- Balance of payments financing that ends in capital flight in response to an unstable macro-economic situation.
- Investments that end in under-used infrastructure because the productive sectors have not yet been restructured.

The key challenge is to ensure that adequate progress has been achieved toward an environment conducive to restructuring and private sector growth before transferring significant resources through infrastructure and credit:

- Much legislation and price policy is in the hands of sub-national governments and the division of responsibilities between these governments and the center is still unclear, particularly in Russia and Ukraine. In some countries, it is necessary to await the redefinition of political and economic authority between local governments and central authorities.
- Privatization alone does not assure improvement in governance and depolitization of firms, given the significant role played by insiders. Thus privatization loans and credit lines to newly privatized firms still involve significant risks.
- In some countries, law and order has deteriorated as governments have not refocused their roles in these areas. This may have a major

effect on the climate for new investment and private-sector growth.

The Bank will also have to recognize that legal and institutional development crucial for economic reforms will take time to yield results. These reforms cannot be accelerated with large amounts of financial support. Technical assistance faces absorptive-capacity limits that must be recognized.

The first four years of the transformation from communism toward markets and democracy have included massive output declines, a surge in unemployment, and in some areas, ethnic and religious conflict. After an initially cautious attitude by its major shareholders—at least regarding the Soviet Union—the World Bank Group has taken on the new challenge of supporting and financing the systemic transition in more than two dozen countries, including

Russia. In terms of both the political difficulties in generating consensus and social support, and the technical difficulties in trying to implement the most appropriate policy measures, the task is daunting.

In 1994, however, encouraging signs are appearing: Central Europe has started to grow, with Poland leading the new expansion. Albania, having experienced a disastrous collapse in 1990–92, has seen GDP grow at close to 10 percent for almost two years. The Baltics seem ready for a rebound. And in Russia, the first six months of 1994 show better results than anyone expected a year ago. Throughout the region, momentous changes have already taken place, and perhaps the hope is justified that through the systemic transformation of Central and Eastern Europe and the former Soviet Union, a stronger and more integrated world economy is emerging.

Throughout the region, momentous changes have already taken place, and perhaps the hope is justified that through the systemic transformation of Central and Eastern Europe and the former Soviet Union, a stronger and more integrated world economy is emerging

Distributors of World Bank Publications

ARGENTINA

Carlos Hirsch, SRL
Galeria Guemes
Florida 165, 4th Floor-Ofc. 453/465
1333 Buenos Aires

Oficina del Libro Internacional
Alberti 40
1082 Buenos Aires

AUSTRALIA, PAPUA NEW GUINEA,
FIJI, SOLOMON ISLANDS,
VANUATU, AND WESTERN SAMOA
D.A. Information Services
648 Whitehorse Road
Mitcham 3132
Victoria

AUSTRIA

Gerold and Co.
Graben 31
A-1011 Wien

BANGLADESH

Micro Industries Development
Assistance Society (MIDAS)
House 5, Road 16
Dhanmondi R/Area
Dhaka 1209

BELGIUM

Jean De Lannoy
Av. du Roi 202
1060 Brussels

BRAZIL

Publicacoes Tecnicas Internacionais Ltda.
Rua Peixoto Gomide, 209
01409 Sao Paulo, SP

CANADA

Le Diffuseur
151A Boul. de Montagne
Boucherville, Québec
H8 5E6

Renouf Publishing Co.
1294 Algoma Road
Ottawa, Ontario
K1B 3W8

CHINA

China Financial & Economic
Publishing House
8, Da Fo Si Dong Jie
Beijing

COLOMBIA

Infoenlace Ltda.
Apartado Aereo 34270
Bogota D.E.

COTE D'IVOIRE

Centre d'Édition et de Diffusion
Africaines (CEDA)
04 B.P. 541
Abidjan 04 Plateau

CYPRUS

Center of Applied Research
Cyprus College
6, Diogenes Street, Engomi
P.O. Box 2006
Nicosia

DENMARK

Samfundslitteratur
Rosenværns Allé 11
DK-1970 Frederiksberg C

DOMINICAN REPUBLIC

Editora Taller, C. por A.
Restauración e Isabel la Católica 309
Apartado de Correos 2190 Z-1
Santo Domingo

EGYPT, ARAB REPUBLIC OF

Al Ahram
Al Galaa Street
Cairo

The Middle East Observer
41, Sherif Street
Cairo

FINLAND

Akateeminen Kirjakauppa
P.O. Box 128
SF-00101 Helsinki 10

FRANCE

World Bank Publications
66, avenue d'Iéna
75116 Paris

GERMANY

UNO-Verlag
Poppelsdorfer Allee 55
53115 Bonn

GREECE

Papasotiriou S.A.
35, Stourara Str.
106 82 Athens

HONG KONG, MACAO

Asia 2000 Ltd.
46-48 Wyndham Street
Winging Centre
7th Floor
Central Hong Kong

HUNGARY

Foundation for Market Economy
Dombóvári Ut 17-19
H-1117 Budapest

INDIA

Allied Publishers Private Ltd.
751 Mount Road
Madras - 600 002

INDONESIA

Pt. Indira Limited
Jalan Borobudur 20
P.O. Box 181
Jakarta 10320

IRAN

Kowkab Publishers
P.O. Box 19575-511
Tehran

IRELAND

Government Supplies Agency
4-5 Harcourt Road
Dublin 2

ISRAEL

Yozmot Literature Ltd.
P.O. Box 56055
Tel Aviv 61560

ITALY

Licosa Commissionaria Sansoni SPA
Via Duca Di Calabria, 1/1
Casella Postale 552
50125 Firenze

JAMAICA

Ian Randle Publishers Ltd.
206 Old Hope Road
Kingston 6

JAPAN

Eastern Book Service
Hongo 3-Chome, Bunkyo-ku 113
Tokyo

KENYA

Africa Book Service (E.A.) Ltd.
Quran House, Mfangano Street
P.O. Box 45245
Nairobi

KOREA, REPUBLIC OF

Pan Korea Book Corporation
P.O. Box 101, Kwangwhamun
Seoul

Korean Stock Book Centre

P.O. Box 34
Yeocido
Seoul

MALAYSIA

University of Malaya Cooperative
Bookshop, Limited
P.O. Box 1127, Jalan Pantai Baru
59700 Kuala Lumpur

MEXICO

INFOTEC

Apartado Postal 22-860
14060 Tlalpan, Mexico D.F.

NETHERLANDS

De Lindeboom/In/Oc-Publicaties
P.O. Box 202
7480 AE Haaisbergen

NEW ZEALAND

ERSCO NZ Ltd.
Private Mail Bag 99914
New Market
Auckland

NIGERIA

University Press Limited
Three Crowns Building Jericho
Private Mail Bag 5095
Ibadan

NORWAY

Narvesen Information Center
Book Department
P.O. Box 6125 Etterstad
N-0602 Oslo 6

PAKISTAN

Mirza Book Agency
65, Shahrah-e-Quaid-e-Azam
P.O. Box No. 729
Lahore 54000

PERU

Editorial Desarrollo SA
Apartado 3824
Lima 1

PHILIPPINES

International Book Center
Suite 1703, Cityland 10
Condominium Tower 1
Ayala Avenue, H.V. dela
Costa Extension
Makati, Metro Manila

POLAND

International Publishing Service
Ul. Fielona 31/37
00-677 Warszawa

For subscription orders:

IPS Journals
Ul. Okrzeja 3
02-916 Warszawa

PORTUGAL

Livraria Portugal
Rua Do Carmo 70-74
1200 Lisbon

SAUDI ARABIA, QATAR

Jarir Book Store
P.O. Box 3196
Riyadh 11471

SINGAPORE, TAIWAN,

MYANMAR, BRUNEI
Gower Asia Pacific Pte Ltd.
Golden Wheel Building
41, Kallang Pudding, #04-03
Singapore 1334

SOUTH AFRICA, BOTSWANA

For single titles:
Oxford University Press
Southern Africa
P.O. Box 1141
Cape Town 8000

For subscription orders:

International Subscription Service
P.O. Box 41095
Craighall
Johannesburg 2024

SPAIN

Mundi-Premsa Libros, S.A.
Castello 37
28001 Madrid

Libreria Internacional AEDOS

Consell de Cent, 391
08009 Barcelona

SRI LANKA AND THE MALDIVES

Lake House Bookshop
P.O. Box 244
100, St. Chittampalam A.
Gardiner Mawatha
Colombo 2

SWEDEN

For single titles:
Fritzes Fackboksföretaget
Regeringsgatan 12, Box 16356
S-103 27 Stockholm

For subscription orders:

Wennergren-Williams AB
P.O. Box 1305
S-171 25 Solna

SWITZERLAND

For single titles:
Librairie Payot
Case postale 3212
CH 1002 Lausanne

For subscription orders:

Librairie Payot
Service des Abonnements
Case postale 3312
CH 1002 Lausanne

THAILAND

Central Department Store
306 Silom Road
Bangkok

TRINIDAD & TOBAGO

Systematics Studies Unit
#9 Watts Street
Curepe
Trinidad, West Indies

UNITED KINGDOM

Microinfo Ltd.
P.O. Box 3
Alton, Hampshire GU34 2PG
England

ZIMBABWE

Longman Zimbabwe (Pvt.) Ltd.
Turtle Road, Ardennia
P.O. Box 5T 125
Southerton
Harare

