TRANSITION
THE NEWSLETTER ABOUT REFORMING ECONOMIES
Volume 5, Number 7 September 1994
Transition Economics Division • Policy Research Department • The World Bank

Market Liberalization in Ukraine
To Regain a Lost Pillar of Economic Reform

By Daniel Kaufmann

In Ukraine the three key pillars of a successful economic reform program—macroeconomic stabilization, privatization, and market liberalization—had been largely ignored. During 1993 the inflation rate was the highest of any country not at war. Less than 10 percent of total assets have been officially privatized. Yet, liberalization has been ignored and opposed the most—it has become the lost pillar of transition. The reasons for this neglect include the following:

•Public misunderstanding of economic issues. Recent polls indicate that almost three-quarters of the population favor privatization; but at the same time three-quarters also oppose price liberalization—in the belief that it is largely responsible for the inflationary spiral.

•Persistence of controls over economic activities (including the issuance of licenses and permits) where vested interests and rent seeking opportunity are at stake.

•Inconsistency between lax fiscal policy and (since late 1993) restrictive monetary policy.

Stop-Go Cycles: Keeps Going and Going...

Ukraine, like the rest of the former Soviet Union (FSU), had not experienced serious inflation for many decades. The high inflation rate, rampant since 1992 until recently, caught the public unprepared. With their interventionist recipes, advocates for administrative controls gained strength. Equally, the supporters of monetary restraint, which was conducted by the national bank, also became more influential as abhorrence of hyperinflation became widespread, and the importance of credit restraint became better understood.

By contrast, the need for budgetary (fiscal) restructuring and restraint was not equally emphasized and had no strong constituency. Since Ukraine regained

What's Inside...

Public Disclosure Authorized

Measuring Administrative Controls in Ukraine

In order to "technocratize" the politicized reintroduction of administrative controls in Ukraine, a simple, quantifiable index of administrative controls was constructed by measuring the degree of administrative intervention and market distortion in the foreign exchange, trade, and pricing regimes. Each regime, in turn, includes two indexes:

•Foreign exchange regime indexes

Exchange rate distortion index (figure 1) is the percentage deviation of the market exchange rate from the "effective" official exchange rate (where "effective" averages the two different official rates, weighted by the surrender requirement share). An exchange rate distortion index of 0 means that the official exchange rate is the same as the market rate. An index of 66 means that the effective rate an exporter gets for one dollar of exports is only one-third the market rate (a 66 percent effective "tax" on foreign exchange earnings).

Foreign exchange allocation distortion index (figure 2) measures the share of foreign exchange allocated according to nonmarket administrative mechanisms, and not sold on the official foreign exchange auction (the closest thing to "market-based" official allocation of foreign exchange in Ukraine). A foreign exchange allocation distortion index of 90 means that only 10 percent of official foreign exchange revenues go through the auction mechanism, while the rest is allocated according to administrative discretion (at a rate significantly below a market-determined rate).

•Trade regime indexes

Export restriction index (figure 3) is the share of overall exports administered by quotas and licenses. An index of 80 means that only 20 percent of exports are free from quotas or licenses.

Domestic trade administrative index (figure 4) is the share of state orders and contracts in total output. These are orders that enterprises are supposed to fill by providing specific production volumes to the state or to other predetermined enterprises. An index of 55 means that only 45 percent of output is not subject to state administrative decisions regarding procurement and internal distribution.

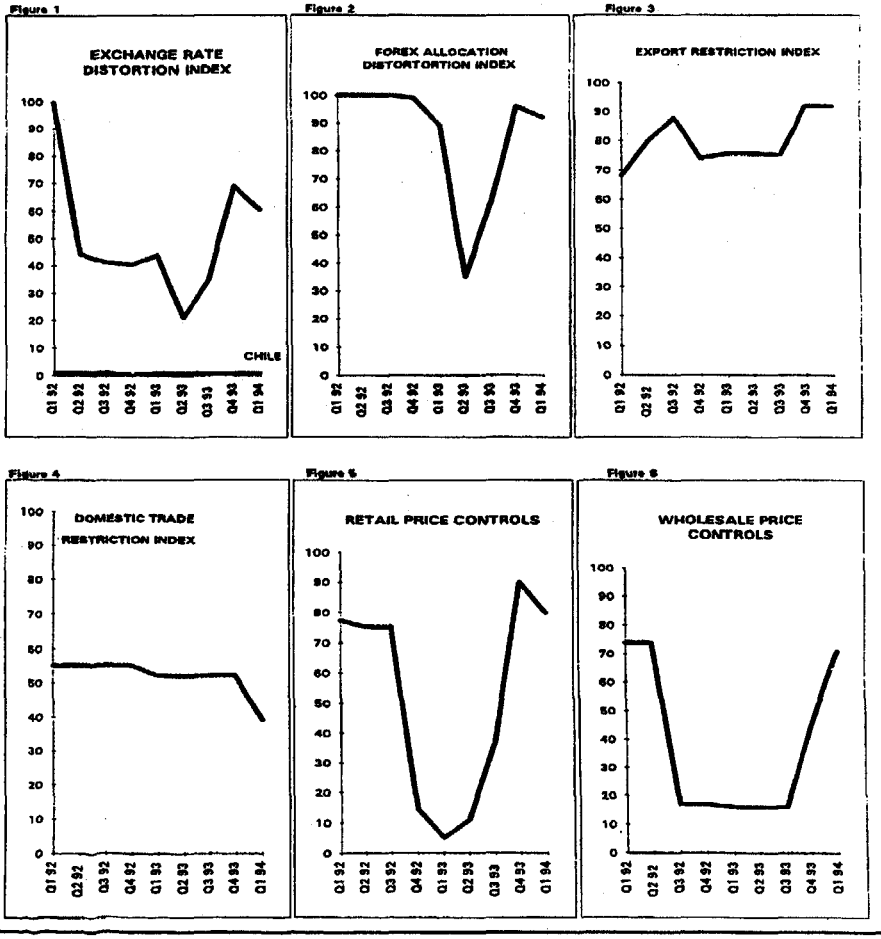
•Pricing regime index

Retail price control index (figure 5) is the share of retail prices subject to administrative controls. An index of 70 means that only 30 percent of total output is in goods not subject to administrative price controls. *Wholesale price control index* (figure 6) is the share of wholesale prices subject to administrative controls.

An overall administrative control index (figure 7, see next page) is a simple average of the six indexes. (Some variables have not been considered, such as trade tariffs and income and profit taxes, which are essential policy tools in market economies, similarly to antimonopoly, public utility, and banking regulations.) The index would be zero in an economy free of direct administrative controls, while the index would be 100 in a centrally planned economy, as the Soviet economy was in the 1970s. In Ukraine the index of administrative controls reached almost 80 in early 1992. The advent of a new government in October 1992 brought about some liberalization in the economy: partial liberalization of prices, a limited relaxation of export restrictions, introduction of a foreign exchange auction. The administrative control index in mid-1992 dropped to 35, a substantial improvement, but still very high by any market economy standards, and even by standards of economies in transition.

In the summer of 1993 Ukraine's new government began to reintroduce administrative controls: the currency exchange auction was abolished, and the exchange rate was fixed at an artificially low level. Controlling the exchange rate forces controls on the allocation of foreign exchange and imports. Price controls have become pervasive, which in turn has pressured policymakers to control exports; as a result, many export licenses have been reinstated. By mid-1994 the degree of administrative control over the economy was virtually the same as it had been immediately following Independence. The overall index surged to almost 75, meaning that the official economy was only minimally "liberalized."

Six Indices of Administrative Controls



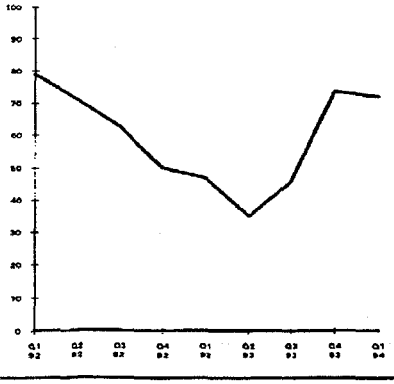
Ukraine: Reformers at a Crossroads

Foreign assistance

Ukraine will need nearly US$1 billion in foreign assistance this year to implement radical economic reforms, according to senior Ukrainian officials. Ukrainian officials reached a preliminary agreement with the IMF on an economic reform program that they say is the first step in a comprehensive package of reforms to be announced soon. The preliminary loan agreement, if approved by the Ukrainian Cabinet and the IMF Board, would mean that a $360 million Systemic Transformation Facility (STF) loan would be available before the end of the year, and could be followed by a second tranche of about the same size in 1995. Furthermore, a $400 million World Bank rehabilitation loan is under preparation. Disbursements could start before year-end if privatization and agricultural reforms move forward.

The reform program commits Ukraine to a series of measures to stabilize prices, liberalize the economy, speed up privatization, enact structural reforms, and tighten fiscal and credit policies. Ukraine's government has also pledged to strengthen its social safety net so as to protect its most vulnerable citizens. IMF Managing Director Michael Camdessus has cautioned that the success of the program will depend both on its vigilant implementation and on substantial financial assistance from the international community. (International financial institutions are working on a plan to secure Ukraine credits of up to $5 billion over two years to support the country's reform.)

Figure 7
Overall Administrative Control Index



President Kuchma and Chairman Moroz

Oleksandr Moroz, chairman of Ukraine's Supreme Council (Parliament) and leader of the Socialist Party, said on September 17 that Ukraine had accepted "on the whole" the IMF conditions attached to an initial $720 million loan. Moroz's support for any reform package agreed with the IMF will be critical to President Leonid Kuchma's ability to implement it. In late July the Ukrainian Parliament voted to halt all privatization until it reconvenes to decide which state property to privatize and how to privatize it. The government has to provide a list of "nationally important" enterprises excluded from privatization, including those in the "fuels-energy complex," transport, and communications.

Moroz earlier argued that the state must assume control of several key aspects of the economy, including the amount of hard currency in circulation, the operations of enterprises vital to the state and, above all, external trade. Moroz anticipates a three-stage program of recovery, each of which would require close government supervision and state control of the "commanding heights" of the economy, well into the next century. The plan envisages a halt in industrial output decline by 1995–96, an improvement in living standards in 1997–98 and, from 1998 onward, a living standard comparable to that in industrially developed countries.

The Economy

Meanwhile, economic decline continues. Sectors such as oil processing, chemicals, and construction materials have suffered the most dramatic declines. The defense complex (including machine building), which accounts for a quarter of Ukraine's industrial output and "40 percent of the total scientific and technical potential" (Prime Minister Vitalii Masol), experienced a 52 percent year-on-year fall in production. Fuel and energy production continues to decline.

Ukraine imports more than 60 percent of its gas requirement from Russia, and the bulk of Ukraine's expenditure outflow is debt repayment to Russia for oil and gas. Supply agreements between the two countries have repeatedly broken down as Ukraine has been unable to pay Russian prices that have risen steadily toward international norms.

Ukraine is $5 billion in debt to Russia; 20 percent of this is for Russian deliveries of gas to Ukraine for 1994. Ukraine's failure to meet this obligation has led to supply cuts from Russia. Ukraine is also in debt to Turkmenistan for energy imports.

Radiant Future with Nuclear Energy?

The nuclear power sector produced 38 percent of Ukraine's total electricity output in the first half of 1994, despite the fact that it faced severe problems. Thermal power stations have significantly reduced electricity output because of a shortage of fuel. Given this growing dependence on nuclear power, Kiev insists that the closure of Chernobyl—demanded by the West—would lead to a severe energy crisis this winter. Ukrainian authorities and the international community remain far apart on the issue.

Mikhail Umanets, the former director of the Chernobyl plant and current chairman of the State Committee for Atomic Energy, calls the G-7 offer of $200 million in immediate assistance to help shut the Chernobyl power plant insufficient. He estimates the costs involved as $1.4 billion to close the plant and an additional $1 billion to complete the three reactors now under construction.

Without economic recovery, there is little prospect that Ukraine's longer-term energy program—which envisages 50 percent self-sufficiency by 2010—will be fulfilled. Current energy output covers little more than 10 percent of the domestic requirement. Ninety percent of the planned increased output would be in coal and nuclear-generated power, although output in both is currently falling—coal by 13.4 percent in 1993 over 1992, and electricity by 9 percent. Still, given a projected decline in energy consumption of 40 to 50 percent by 1995 and Ukraine's position as one of the largest per capita producers of energy in the world, officials in Ukraine are bullish about future nuclear energy exports.

(Based on reports from the Oxford Analytica research group, Oxford, U.K., and various articles from the Financial Times *and* New York Times*)*

its independence in 1991, the budget has continued to serve as the state's principal instrument for influencing economic activity. Budgeted expenditures have amounted on average to 70 percent of GDP. Thus, inflationary pressures arose largely from financing the budget (and quasi-budget) deficit. Public sector deficit financing accounted for about 70 percent of all credit emissions in late 1992, and its share increased to about 85 to 95 percent in late 1993 and early 1994. (By contrast, in Russia the central bank's straight credit emissions have made up 40 to 60 percent of all emissions, and the share of deficit financing in credit emissions came to just 50 percent on average.)

As monetary restraint has taken place without accompanying fiscal restructuring, liberalization lost out. Years after independence, the budget is still a mechanistic planning document driven by accounting and by legal principles that date from the Soviet era. Conservatives understand that fiscal restructuring and restraint necessitates liberalization of trade and prices which they oppose. In fact, further administrative controls between mid-1993 and early 1994, emerged, for several reasons:

•*Monetary stringency without the full support of an appropriate budgetary framework is not sustainable beyond a few months.* Wage, pension, and enterprise arrears get out of hand. Subsidy pressures for key sectors such as coal and agriculture build up, and at least some of the sectors are eventually paid. Thus, following a pure monetary "stop," which may be extended by a few months through the tightening of government controls, there is an inevitable "go." (The late summer of 1994 saw such an inescapable monetary "go," which is bound to translate into renewed inflationary pressures in October and November of 1994.

•*Every time a monetary "stop" starts to bite, supporters of administrative controls argue for a softer monetary policy, and thus for a monetary "go."* The dissatisfaction of the public and enterprise sector, hurt by the payment arrears (resulting from the inconsistent fiscal and monetary policy), encourages the advocates of administrative controls to reimpose "stable" administrative controls over the economy with the claim that they will be able to deal administratively with inflation and output decline. For many, this seems a lesser evil than the "stop-and-go" monetary approach. The administrative control power base is strengthened, the pure monetarists are weakened—and the "fiscal-first" constituency remains as absent as ever. (The evolution of administrative controls in Ukraine is traced through a specially constructed index, that is described in detail on page 2.)

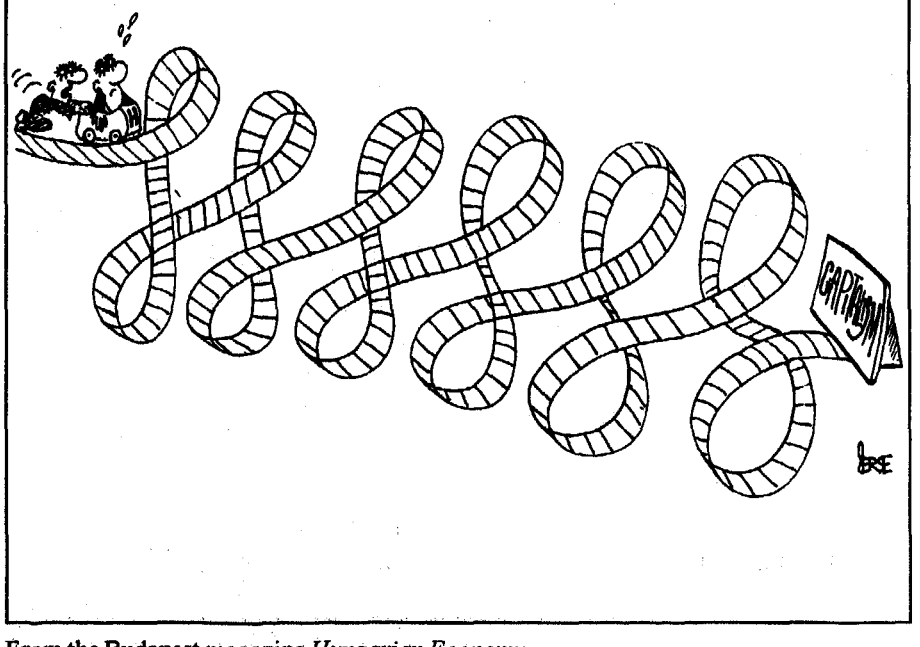
Bleak Surface . . .

The prevalence of administrative controls has had major effects on the official and unofficial economies in Ukraine.

•*The official economy has declined dramatically since late 1991.* Annual GNP dropped by about 15 to 17 percent in both 1992 and 1993, and the free-fall has continued, with GNP plummeting by 26 percent in the first half of 1994 compared with the same period last year. Real wages for the first quarter of 1994 shrunk by half compared with January 1992. Ukrainians on average earn less than $15 a month.

•*Hard cash currency exports, as registered by official data, declined from about $4.2 billion in 1992 to $2.8 billion in 1993.* At the same time, import requirements have increased as a result of the sharply higher energy prices charged by Russia and Turkmenistan. By mid-1993 Ukraine concluded an agreement with Russia whereby $2.2 billion in arrears were converted into long-term debt. During 1993 and 1994 substantial further arrears, exceeding $2 billion, have accumulated. At present, Ukraine consumes imported energy at a

Legal Rollercoaster



From the Budapest magazine *Hungarian Economy*

cost of about $13 million a day, yet it pays for less than one-half of it. Official export receipts cover only a fraction of the present energy import bill. (Domestic industry and agriculture are charged only a fraction of world prices—ranging between 25 percent for electricity and gas to 33 percent for coal—and households are charged only a fraction of what the industries pay.)

•*About 45 million tons of grain were produced during the 1993 season.* Fourteen million tons of the grain have been procured through state orders and about 4 million tons have been sold on the market. The remaining 25 million tons (about 60 percent) have been retained at the farms for seeds and animal feed. With low yields and high waste, virtually no grain,exports were registered. Individuals last year held only 11 percent of all agricultural land, yet they produced 43 percent of all livestock and 37 percent of crops—in other words, they were almost four times more productive than state agriculture. Animal husbandry and meat production declined by 23 percent in the first half of 1994. The total grain harvest in 1994 is likely to be about 34 million tons, the smallest in twenty years and a sharp drop from last year.

Bright Underground?

To estimate the size of Ukraine's shadow economy, it is telling to compare Ukraine's officially reported hard currency export figures (estimated at about $2.8 billion in 1993) with trade partner data on Ukraine's imports gathered at the point of destination (about $6.2 billion in 1993). Even allowing for the possibility of methodological underestimation of official export statistics, the remaining gap could well imply that over half of all exports ($200 million monthly) are diverted to the unofficial economy.

Fluctuation of the foreign exchange supply to the official foreign exchange auctions is also telling: when the official exchange rate of the karbovanec for exporters was virtually the same as in the open market, a monthly average of about $100 million came to auction, in sharp contrast with the administrative control period of dual exchange rates, when the monthly foreign exchange supply to the heavily taxed auctions was less than $15 million. Much of the difference was absorbed by the underground economy.

A January 1993 survey of more than 200 officially registered private sector firms also suggests that about half of their activities were in the unofficial economy. Furthermore, a separate and nonrandom survey of about 20 businesses indicated that in 1992 private businesses were conducting 25 percent of their business outside of the official economy. By March 1994 that share had grown to 75 percent. For state-owned businesses the estimated share of unofficial activities in 1992 was less than 10 percent, yet by March 1994 it had increased to more than one-third.

Clearly, many state and private businesses have adapted to the evolving circumstances by leaving the official economy altogether or at least for a significant portion of their activities. Businesses by now have a clear notion of the " private payments" required to get permits; to bypass regulations, official payments, and foreign exchange surrender requirements; to gain advantages in acquiring subsidized foreign exchange; and to push through every bottleneck in the way of unofficial exporting. The "services" rendered to avoid the official economy do not come cheaply, often exceeding 25 percent of turnover.

Central, state-administered controls, even if intended for all agents in the economy, actually apply only to those agents operating in the official economy. And as administrative controls proliferate the official economy shrinks—often with increasing speed. This means that beyond a certain point, tightening central administrative controls and interventions over the official economy will result in reduced administrative control of the overall economy.

(Since so many enterprises leave the official economy as administrative control tightens, the relationship between administrative control over the official economy and management control over the overall economy becomes a variant of the inverted U-shape Laffer curve.)

Significant market liberalization has thus taken place, in practice, as entrepreneurs have left the official economy, the sphere of government authority. The unofficial economy has become a large, and liberalized segment of the economy today. The emergence and growth of this unofficial economy has both positive and negative aspects. On the positive side, it has largely kept the economy afloat, as incentives to efficient production in the official economy have declined. It has also debunked the myth that Ukrainians lack entrepreneurship. On the contrary, in their entrepreneurial activities they have demonstrated resilience, creativity, and the ability to adjust to changing economic and financial circumstances and policies. This bodes well for the future of Ukraine, if the proper economic policies are put in place.

On the negative side, the shadow economy undermines the state's management of the economy. The legitimacy of the overall legal and regulatory system is being challenged or ignored, and the tax and foreign exchange base, crucial for economic management, is rapidly dwindling. Also, the informal economy, despite its rapid growth, is a survival economy where trading, services, and short-term concerns dominate longer-term activities. Large-scale investments and sophisticated produc-

tion—crucial for Ukraine—are virtually absent. Many of the assets being used in the unofficial sector are in effect derived from the spontaneous decapitalization of the state sector. It is far less efficient for a large segment of the economy to operate unofficially than it would be for that segment to operate within the first economy in a liberalized market environment. And society pays the price in wasted effort and nonproductive payments.

Finding the Lost Pillar

Market liberalization could become a major pillar of structural reform in Ukraine, providing impetus for a turnaround in the economy and for future growth. And contrary to prevailing myths, liberalization could improve the social conditions of the population—if done appropriately. Market liberalization would also facilitate:

•***Macroeconomic stabilization.*** Narrow attempts to impose macroeconomic discipline without accompanying liberalization measures would amount to trying to stabilize a quickly disappearing (official) economy. The tax base has already been eroded significantly. Large subsidies to the enterprise sector, particularly on account of low domestic prices for energy, are being barely financed by the rapidly shrinking official exporter base (the result of the artificially low official exchange rate). Liberalization of prices would alleviate the pressure on direct subsidies still provided from the budget, such as those to services, while liberalization of state contracts would bring about budgetary savings.

•***Exports and production.*** Large export gains could be expected from a unified, market-based exchange rate. A rapid increase in exports would provide foreign exchange for imports, as well as an impetus to troubled domestic industry. Production increases would spur aggregate demand and boost domestic consumption. Liberalization of prices and trade would also translate into dynamic growth by the private sector as well as by entrepreneurial segments of the state sector.

•***Privatization.*** Market liberalization (including price, trade, and foreign exchange liberalization) is important for privatization to succeed. A supportive framework of market incentives creates demand for privatized enterprises—and for the normal operation of these businesses.

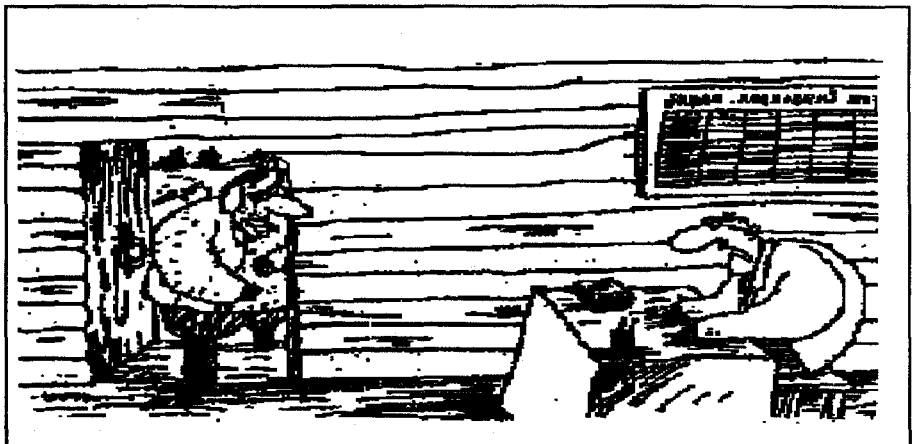
•***Investment.*** Ukraine has seen little foreign investment so far. Its attractions (location, a skilled, educated labor force, high-technology niches, and so on) will continue to be ignored unless macroeconomic stability and liberalized markets (including for foreign exchange) are in place. A credible program of stabilization and market liberalization would bring back much of the foreign currency that left the country as a result of capital flight.

The Ukrainian experience demonstrates that attempts to control the unofficial economy through administrative and legal measures will not work. Instead, agents operating in the shadow economy should be induced to surface "voluntarily" in the official economy. Their confidence and trust have to be restored. Establishing an appropriate market-friendly environment for the official economy is thus the first priority. Herein lies the Ukrainian paradox: To regain control of overall economic management, administrative controls on the official economy must be loosened.

Such paradox appears to have been grasped by the new administration that has come to power during the summer of 1994. The economic reform program being drafted includes macroeconomic stabilization (through appropriate budgetary and monitary policies), exchange rate unification, significant liberalization of prices and trade, and rapid privatization.

The author is Head of the World Bank's resident office in Kiev, Ukraine.

This article is an updated version of the author's paper presented at the Economic Policy Journal–sponsored conference "Societies in Transition: Market Reform Experience for Ukraine," held in Kiev in May 1994.



"Chief, give me 5 more vouchers. They taste great when used as rolling papers for my cigarettes..."

From the Russian daily *Izvestia*

How To Encourage Government Decentralization

Interesting Ideas for Redirecting Lending

The Bretton Woods Commission, a private U.S.-based multinational group of prominent businesspeople, academics, and former government officials, recently advised the World Bank Group to shift funds to the Industrial Finance Corporation (IFC), its affiliate for private finance, and to "expand [its] activities that deal directly with the private sector..."(see *Transition*, July–August 1994, p. 3). The conventional focus on public versus private sector lending may be too narrow to address many of the obstacles to reform and development in the borrowing countries. In many of these countries, central government agencies still dominate the formal economy and society. A more open institutional framework therefore would allow more people and more non–central government institutions to take more initiative. Bypassing central government agencies, and shifting authority to markets and to subnational governments, would link decisionmakers more closely with incentives and could speed up change and economic growth. The Bank Group could accelerate this process by channeling more funds through non–central government institutions, including not only private companies but also multiple levels of subnational governments.

Bypass Operations

Articles of Agreement for two of the three Bank Group lending institutions already allow loans to non–central government institutions: IFC's Articles of Agreement allow loans directly to "productive private enterprises" in member countries without central government guarantees; IDA's Articles of Agreement allow loans "to a member, the government of a territory included within the Association's membership, a political subdivision of any of the foregoing, a public or private entity in the territories of a member or members, or to a public international or regional organization," with or without central government guarantees; only the World Bank is constrained to lend solely through central governments. (The World Bank Group includes the World Bank and three affiliated organizations, the International Development Association [IDA], the Industrial Finance Corporation [IFC], and the Multilateral Investment Guarantee Agency.)

The Bank and IDA have increasingly refrained from lending to governments for activities appropriate for the private sector, such as manufacturing, banking, and importing and distributing agricultural inputs. Over the past decade, IFC financial assistance has multiplied, while Bank and IDA lending has stopped growing. Clearly, scope remains in many countries to reassign more tasks to free markets and to cut bureaucratic obstacles to private economic initiative. But there are many examples of bureaucratic centralism coexisting with private ownership. Mounting economic crime in Russia and other transition economies in Central and Eastern Europe inhabits the interface between public and private sectors: favored businesses make money as government officials give special assistance or look the other way. Such crimes of the new "kleptocracy" metamorphosed from the old nomenklatura and reflect a lack of government accountability to citizens. Institutions preserve too great a "distance" between citizens and officials, so that levers for accountability such as law, public opinion, and elections are too weak to restrain government antisocial behavior.

Going Local

In developed countries, local governments characteristically dominate or have a large share in the delivery of many public goods and services such as local roads, primary and secondary education, police protection, law enforcement through courts, water and sanitation services, surface irrigation, and many others. In less-developed countries, central governments (or state-level governments in larger countries) often claim responsibility for providing these goods and services, but perform poorly.

Reforms that split off from central governments the responsibility to produce or to provide public goods and services appropriate for other levels of government, and that assign those tasks to other levels of government, create new channels for people to participate and to exercise judgment and initiative to buy the public goods and services they want. Fiscal autonomy for subnational governments is a concept that is not exclusive to rich developed countries; China's reformers promote "eating out of separate kitchens" and Russian decentralizers advocate "each pot sitting on its own bottom" as down-to-earth descriptions of fiscal autonomy for local governments. Giving subnational governments autonomy to tax and spend may be considered a form of trade liberalization, with central government agencies abandoning their monopolies in the provision of public goods and services, allowing markets for public goods to emerge.

Some Suggestions

If the World Bank Group intends to encourage government decentralization

in borrowing countries, some modest reforms may be accomplished within the current Articles of Agreement:

•*IDA could establish a fund or quota to assist subnational governments in member countries in selling bonds on national or international bond markets*, taking advantage of the fact that, of the three Bank Group lending institutions, the IDA alone is empowered through its Articles of Agreement to lend to subnational governments. Through bond sales city governments could raise funds for urban infrastructure, water districts could raise funds for irrigation and drainage infrastructure, and state and local-level governments could raise funds for rural roads or other rural infrastructure. For subnational government bond sales to be successful, central governments would have to relinquish control over taxing and spending policies to subnational governments, and move away from ad hoc revenue-sharing schemes.

·*Although the IFC cannot lend to subnational governments, it can and does lend to private utilities, which may be associated with central or subnational governments.* The current interest in BOO (build-own-operate) and BOT (build-operate-transfer) schemes for electricity, gas, and other utilities and for infrastructure creates tremendous opportunities to promote efficiency through competition. But to the extent that the IFC accepts schemes that have been negotiated and contracted with central government agencies, those agencies' authority will expand and the opportunity to strengthen competition and to weaken bureaucratic centralism will be lost.

The IFC should consider establishing guidelines or quotas to direct BOO/BOT investments toward contracts with subnational governments. (For example, the IFC could limit support for BOO/BOT schemes for electricity generation or retail distribution to those negotiated with subnational governments such as city and state-level governments. This would encourage central government agencies to devolve electricity regulation to subnational governments; over time these changes could be expected to lead to the emergence of a wholesale market for electric power.)

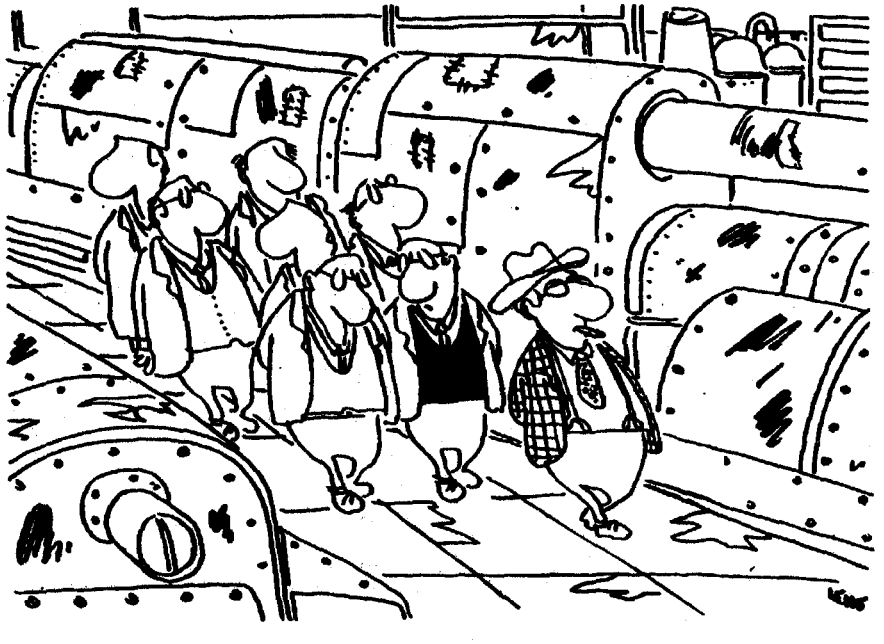
•*The World Bank and the IFC could set up separate units to deal with subnational government issues (including taxing, spending, and regulatory activities)* and to support initiatives to lend directly to subnational governments and to private utilities that contract with subnational governments. Those governments must have stronger tax bases and stronger management if IDA loans are to be collectible and if BOO/BOT contracts are to be sound.

The World Bank Group's endorsement of fiscal decentralization would create a tremendous opportunity to strengthen subnational governments' tax programs—and their legal and voting arrangements. Capital markets can be expected to respond favorably to reforms that will make local governments and associated utilities **autonomous** from central governments and **accountable** to local taxpayers and voters.

David Gisselquist

The author is an independent consultant, former university professor, and author of several books on international economics.

Foreign Direct Investment



Let's try to bargain. His last offer was 2 bars of American chocolates.

From the Budapest magazine *The Hungarian Economy*

How to Rejuvenate a Greying Pension System in Transition Economies

Suggestions of a New World Bank Study

In Eastern Europe and the former Soviet Union, which can no longer afford the formal old age security programs they introduced long ago, liberal early retirement provisions and generous benefits have required high contribution rates, leading to widespread evasion. (On "Reforming Pensions in the Transition Economies," see *Transition*, February–March 1994, p. 3.) The large informal sector reflects in part the efforts of workers and employers to escape wage taxes. The resulting labor market distortions reduce productivity, pushing contribution rates and evasion still higher, even as limited long-term saving and capital accumulation further dampen economic growth. Most of these countries have cut the cost of benefits by allowing inflation to erode their real value. The challenge is to devise a new system and a transition path that is acceptable to the old, who have been led to expect more, but that is also sustainable and growth-enhancing for the young.

Combining Arrangements

Three different financing and managerial arrangements for old age security are most common. They are:

•*Public pay-as-you-go plans:* the most common formal system, mandatory for covered workers in all countries. Coverage is almost universal in high-income countries and widespread in middle-income countries. Governments mandate, finance, manage, and insure public pensions, offering defined benefits that are not actuarially tied to contributions. Governments usually finance benefits out of a payroll tax (sometimes with supplements from general government revenues) on a pay-as-you-go basis, redistributing real income, both across and within generations.

•*Occupational plans:* privately managed, partially funded plans with defined benefits; offered by employers to attract and retain workers. Increasingly, however, contributions are specified and benefits depend on contributions plus investment returns. More than 40 percent of workers are covered by occupational schemes in Germany, Japan, the Netherlands, Switzerland, the United Kingdom, and the United States—but far fewer in developing countries.

•*Personal saving and annuity plans:* fully funded, defined contribution plans. Workers save when young to support themselves when they are old. Since benefits are not defined in advance, workers and retirees bear the investment risk on their savings. Mandatory saving plans are managed by government (as in Malaysia, Singapore, and several African countries) or by multiple private companies on a competitive basis (Chile).

A country's old age security program should provide for all three functions of saving, redistribution, and insurance, but with very different government roles for each. Countries should rely on multiple financing and managerial arrangements, that is, they should share responsibility among multiple *pillars:*

•***The public pillar would have the limited objective of alleviating old age poverty and coinsuring against a multitude of risks.*** Backed by government taxation, this pillar can pay benefits to people growing old shortly after the plan is introduced, redistribute income toward the poor, and coinsure against low investment returns, recession, inflation, and private market failures. The public pillar should be relatively small and based on pay-as-you-go. Eligibility could be limited to the poor, or could serve as a universal minimum pension guarantee to a mandatory saving pillar. As a third option, it could take the form of a flat benefit, applied universally or employment-related.

•***A second—mandatory—pillar, fully funded and privately managed, would link benefits actuarially to costs and fulfill the income-smoothing or saving function for all income groups.*** Full funding should boost capital accumulation and financial market development. It could take two forms: personal saving accounts or occupational plans. In either case, mandatory programs require regulation.

•***Voluntary occupational or personal saving plans would be the third pillar, providing additional protection for people who want more income and insurance in their old age.***

Step-by-Step Approach

Eastern European countries, rather than relying on an ever more costly public pillar to do it all, at high tax rates that inhibit growth and bring low rates of return to workers, need to make the transition to a mandatory multipillar system.

The *first step* is to reform the public pillar by raising the retirement age, eliminating rewards for early retirement and penalties for late retirement, downsizing benefit levels, and making the benefit structure flatter—to emphasize the pov-

erty reduction function—the tax rate lower, and the tax base broader.

The *second step* is to launch the second pillar in one of the following ways:
•Downsizing the public pillar gradually while reallocating contributions to a second, mandatory pillar.
•Holding the public benefit relatively constant (in cases in which it is low to begin with) but raising contribution rates and assigning them to the second pillar.
•Recognizing accrued entitlements under the existing system and agreeing to pay them off while starting a completely new system right away. This involves designing the new system, calculating the implicit social security debt that is owed under the old system, and figuring out how to finance it all in a way that is both politically and economically acceptable.

Reform Simulation

The demography of Hungary is used for this stylized transition from a single pillar to a multipillar system in a Central European economy (see table). For the initial situation in 1995 it is assumed that all people begin working at age 20 and retire at age 55. Although the statutory retirement age is higher, early retirement, disability, and other special provisions have brought the effective retirement age down to 55 in most Eastern European countries. The dominant public pillar offers an average benefit rate of 50 percent of the gross economywide average wage. A 15 percent overhead charge for administrative costs and evasion is added to system costs both in the initial situation and after the reform. The initial break-even contribution rate is 30 percent.

Reform of the public pillar begins in 1995. It has three components:
•The effective retirement age is raised one year per year until it reaches 60 in the year 2000. Thereafter, it is raised six months per year until it reaches age 65 in 2010. This means that no retirement takes place after 1995 until 2002, when all new retirees are 61. (Effectively, this could be achieved by eliminating special early retirement regimes.)
•Replacement rates in the public pillar are cut to 40 percent of the gross economywide average wage in 2000.
•After 2000 the real value of the pension is augmented by half the rate of real wage growth annually—that is, indexation is 50 percent to prices and 50 percent to wages. So if growth occurs, the real value of the pension rises, but not by as much as the average wage, requiring a declining contribution rate to finance the public pillar.

This "shock treatment" generates resources to reduce the tax rate and finance the second pillar. The rise in retirement age increases GDP, the total wage bill, and the tax base. In 2000 the reformed public pillar will require a contribution rate of only 17.5 percent, instead of 30 percent. At that point, a mandatory saving pillar is introduced, with a 10 percent contribution rate. The simulations show the benefits derived from and contribution rates required by this multipillar system, between the years 2000 and 2065, under two alternative scenarios: slow growth (1 percent annual wage growth, 2 percent real interest) and fast growth (3 percent annual wage growth, 5 percent real interest). The first pension from the mandatory saving pillar is received in 2010 and it is assumed to be wage-indexed. The last year shown is 2065, the year of retirement for children born in the first year of the reform.

Conclusions

•***The current benefit rate is not sustainable with a 30 percent contribution rate, as the population ages.*** By 2015 the required rate is 40 percent, and by 2035 it is 45 percent—on top of taxes for health and other purposes. The implied total tax rate could easily exceed 80 percent—a political and economic impossibility. Thus, benefits will inevitably decline—the only questions are how and when?
•***As a result of the reform, the dependency rate and required contribution rate drop sharply by 2000 and continue to drop thereafter.*** Even after a 10 percent contribution is allocated to the second pillar, the total contribution rate is cut almost in half by 2010. Most of the initial decrease is caused by the raise in retirement age. Subsequent decreases are due to the change in method of indexation.
•***The tax rate is much lower, and by the time middle-age workers retire, benefits are higher under the new system than they would have been under the old system.*** While the public pension drops relative to the economywide average wage, if the benefit from the mandatory saving pillar is added back in, the combined replacement rate climbs above 40 percent for cohorts retiring in 2010 and above 50 percent for cohorts retiring in 2020 (slow growth) and 2030 (fast growth). The combined pension rises above its 1995 real value even sooner.
•***The determination of winners and losers depends on how the rise in retirement age is valued, whether the new system has induced growth, and how long the old system would have been sustainable.*** Workers who retire after 2020 or 2030 (who are under 30 or 40 in 1995) are clear winners because they pay lower taxes and receive higher benefits than they would have under the old system. Workers and retirees who are age 53 or older in 1995 would seem to be clear losers, since their retirement age is raised, their pension rate is cut, and they do not benefit from lower taxes or from a buildup of savings in the second pillar. Workers ages 35 to 52 in 1995 are in an ambiguous category. If the

new system enables the economy to move from a no-growth to a fast-growth scenario, these workers receive higher monetary benefits and pay lower taxes. But offset against this is the loss of leisure time as a result of their delayed retirement. The older members of this group are likely to feel they are losers, while the younger members may feel they have come out ahead.

•***The implicit social security debt could be paid off by recapturing part of the tax cut and using it to finance higher pensions temporarily.*** For example, a payroll tax of 2 to 4 percent between 2000 and 2020 would bring the wage replacement rate to more than 50 percent while keeping the total tax rate below 30 percent. Additionally, older workers could be paid off by receiving a larger claim on the assets of privatized state enterprises.

To sum up, after a relatively short period of loss, pensioners get more for less—and the higher the wage growth and investment return, the more they receive. Policymakers should focus on two crucial questions: Will the multipillar system help shift the economy from no growth or slow growth to fast growth? And how can the current group of old people, particularly its lowest-income members, be protected from a short-term loss from which later retirees are likely to benefit?

Based on a new World Bank Policy Research Report, Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth, *Oxford University Press, 1994, 402 p. (To receive information on ordering and prices for World Bank publications see page 27.*

Simulated Pension Reform in Hungary *(percent)*

	Slow growth scenario[a]								
	Dependency rate		*Contribution rate*[b]			*Benefits*			
Year	*Old dependency rate*	*Reformed dependency rate*	*Payroll tax for old public pillar*	*Payroll tax for reformed public pillar*	*Contribution for new mandatory savings pillar*	*Reformed public pillar pension/ average wage*[c]	*New mandatory savings pension/ average wage*[d]	*New combined pension/ average wage*	*Combined new pension/ 1995 pension*[e]
1995	53	53	30	30	10	50	0	50	100
2000	55	38	31	18	10	40	0	40	86
2010	68	28	38	12	10	37	8	45	110
2020	73	36	41	14	10	35	16	51	150
2030	78	38	44	14	10	34	23	57	172
2040	81	41	45	14	10	32	31	63	208
2050	83	44	46	14	10	30	35	65	238
2065	83	44	47	13	10	28	35	63	267
	Rapid growth scenario[a]								
1995	53	53	30	30	10	50	0	50	100
2000	55	38	31	17	10	40	0	40	95
2010	68	28	38	11	10	34	8	42	135
2020	73	36	41	12	10	29	16	45	198
2030	78	38	44	10	10	25	25	50	297
2040	81	41	45	10	10	22	35	57	452
2050	83	44	46	9	10	19	40	59	631
2065	83	44	47	7	10	15	40	55	923

Note: Dependency rates based on demographic trends in Hungary as projected by the World Bank population data base. The old dependency rate is based on a retirement age of 55. The new dependency rate is based on a retirement age of 60 in 2000 and 65 thereafter. Labor force participation is assumed to begin at age 20. Under the old system, the ratio of average benefits to the average wage is 50 percent. As discussed in the text, these benefits would not have been sustainable. Under the reformed public pillar, benefits will drop to 40 percent in 2000; after that they are indexed 50 percent to wages and 50 percent to prices.

a. The slow growth scenario assumes 1 percent real wage growth, a 1 percent age-earnings profile, and a 2 percent real interest rate. The rapid growth scenario assumes 3 percent real wage growth, a 1 percent age-earnings profile, and a 5 percent real interest rate.

b. These simulations assume no unemployment, evasion, or administrative costs other than a 15 percent overhead added to the public pillar.

c. This is the flat benefit received by everyone, relative to the economy-wide wage, in the given year.

d. This is the average benefit rate from the mandatory saving pension, relative to the economy-wide wage received by the cohort retiring in a given year. Wage indexation is assumed, so this benefit rate remains constant for each cohort.

e. This is the average benefit rate from both pillars received by the cohort retiring in a given year, relative to the average pension in 1995.

Source: World Bank projections.

World Bank Links to Postsocialist Economies

Excerpts from the 1994 Annual Report

In fiscal year 1994 (which ended on June 30, 1994), many transition economies of Central and Eastern Europe were attempting to rebound in the face of continued economic slowdown by their major trading partners in Western Europe. Such slowdown contributed in part to a dampening of export expansion in Bulgaria, Hungary, Poland, and Romania. The successor states of the former Soviet Union (FSU) continued to face problems, including the breakdown of the former trade-and-payments system. Trade within the republics of the FSU contracted further during the year. Importers of energy from the FSU faced further terms-of-trade deterioration as energy prices from Russia and elsewhere moved closer to world levels. Terms of trade in Belarus, the Kyrgyz Republic, and Moldova, for example, deteriorated by more than 20 percent in 1993.

Transformation Pains

Most countries are experiencing rising unemployment associated with the downsizing of public sector enterprises. In Central and Eastern Europe, open unemployment continued to increase in 1993, while it has emerged more slowly in the republics of the FSU. "Hidden unemployment" at the enterprise level, in the form of short work hours or unpaid leave, is growing. Although registered unemployment remains at less than 2 percent of the labor force in Russia, the real level of unemployment is substantially higher. In many countries, employment and wages in declining industries are being maintained only through significant credits from the banking system.

Privatization accelerated during the past year. Today more people work in the private sector than in the public enterprise sector in the Czech Republic, Hungary, and Poland. Substantial progress has been made in Albania, Romania, the Baltic states, the Kyrgyz Republic, and Russia. Privatization is only beginning, however, in such countries as Belarus, Ukraine, and Uzbekistan.

The first wave of voucher privatization was completed in the Czech Republic and Slovakia during 1993, and a second was begun in the Czech Republic. Russia used a combination of voucher privatization and management/employee buyouts to privatize more than 8,000 medium-size and large enterprises during the year—including about a third of all state-owned industrial enterprises—and two-thirds of all small service enterprises. Investment funds participating in the voucher auctions exceeded 400 in the Czech Republic and Slovakia, 600 in Russia, and 300 in Lithuania; and mass privatization programs were adopted in Kazakhstan, Moldova, and Slovenia.

Reform of banking systems has continued. In Russia the number of commercial banks has expanded rapidly, to more than 2,000 by the end of 1993. Privatization of the banking sector was initiated in Latvia, Lithuania, and Poland. In the first wave of voucher privatization in the Czech Republic and Slovakia, the biggest commercial banks were partially privatized.

Lending Sample

During fiscal 1994 lending operations were initiated for the first time in Belarus, Kazakhstan, Macedonia, Slovenia, and Uzbekistan, as well as in the Czech Republic and Slovakia. World Bank loans in the past financial year include:

•*Balance of payments support.* Rehabilitation loans were provided to help redress strong output declines at the start of transition. During fiscal 1994 such rehabilitation operations were approved for Belarus, Kazakhstan, and Moldova; similarly, an economic recovery loan was approved for Macedonia and Slovakia. These loans were complemented by technical assistance for institution-building and support for infrastructure-maintenance investments. In Kazakhstan a project was approved to restore public transport services, and in Latvia and Russia, highway rehabilitation programs are being supported. To mitigate the effects of natural disasters a drought-recovery loan for Moldova in fiscal 1993 and an earthquake-rehabilitation credit for Armenia in fiscal 1994 were approved.

•*Privatization, restructuring, and financial sector reform.* Technical assistance is being provided to strengthen financial infrastructure in Belarus, Kazakhstan, Uzbekistan, and elsewhere in the former Soviet Union for the modernization of the interbank payments system. Twinning arrangements are being financed to strengthen commercial and savings banks. In Latvia a credit line, in parallel with an equity line provided by Sweden, will expand commercial bank capital and banking skills. The Russia Enterprise Restructuring Project supports initiation of term lending to private enterprises from a core of commercial banks. An on lending facility in Romania will finance private sector export and industrial investments.

•*Environment.* National environmental action plans were completed in fiscal 1994 for Belarus and Ukraine (adding to eight completed earlier) and work began on plans for the Kyrgyz Republic and Moldova. Bank assistance provides financing for conventional power investments while supporting policy reforms

critical for energy conservation, protection of the environment, and public safety. Russia's second oil rehabilitation project includes a component to prevent negative environmental effects from the project and to begin remedial actions to address past damage.

•*Social protection.* To facilitate targeting of social benefits to the neediest and the development of policies aimed at poverty reduction, the Bank is supporting collection and in-depth analysis of household survey data. In fiscal 1994 poverty assessment was carried out for Poland, and identical work was initiated in Russia. A Women in Development Fund was established in the Bank's Europe and Central Asia regional office to support new work on gender and transition. Study of the health sector in Russia was carried out during the year, laying the groundwork for the development of lending operations. Education projects were approved for Bulgaria and Romania.

Field offices are playing an increasing role in effective project implementation, In Belarus and Kazakhstan new resident missions were established in the past financial year, bringing the total in the region to 14. The number of field office staff has grown; and higher-level staff, including those locally recruited, are increasingly involved in implementation assistance to the borrower, including procurement administration.

Gross disbursements *to all member countries* amounted to $10,447 million, down $2,495 million from fiscal 1993. Net disbursements were negative at -$731 million, down from $2,331 million in fiscal 1993. The decline in net disbursements is the result of the lower level of gross disbursements combined with a high level of prepayments at $970 million in fiscal 1994.

World Bank and IDA Lending to Transition Economies in Europe and Asia *(in millions of dollars)*

Country/loans	Total loans and credits FY 1993		FY 1994		Project categories in 1994	
CENTRAL AND EASTERN EUROPE						
Albania	44.4	(IDA)	47.1	(IDA)	9.6	(education)
					10.9	(social sector)
					15.0	(urban development)
					11.6	(water supply and sewerage)
Bulgaria	178	(IBRD)	148	(IBRD)	50	(agriculture)
					98	(water supply and sewerage)
Croatia	------		128	(IBRD)		(urban development)
Czech Republic	------		80	(IBRD)		(telecommunications)
Hungary	413		129	(IBRD)	100	(oil and gas)
					29	(public sector management)
Macedonia	------		40	(IDA)		(multisector)
Poland	900	(IBRD)	146	(IBRD)		(agriculture)
Romania	120	(IBRD)	400.6	(IBRD)	50	(education)
					175	(industry)
					175.6	(oil and gas)
Slovak Republic	------		80	(IBRD)		(multisector)
Slovenia	------		80	(IBRD)		(financial sector)
Total	**1,655.2**		**1,278.7**			
CIS AND THE BALTICS						
Armenia	------		28	(IDA)		(urban development)
Belarus	------		170.2	(IBRD)	41.9	(agriculture)
					128.3	(multisector)
Estonia	30	(IBRD)	50.4	(IBRD)	38.4	(oil and gas)
					12	(transportation)
Kazakhstan	------		273.7	(IBRD)	218	(multisector)
					15.7	(oil and gas)
					40	(transportation)
Kyrgyz Republic	60	(IDA)	78	(IDA)	60	(public sector management)
					18	(telecommunications)
Latvia	45	(IBRD)	25	(IBRD)		(agriculture)
Lithuania	60	(IBRD)	26.4	(IBRD)		(oil and gas)
Moldova	26	(IBRD)	60	(IBRD)		(multisector)
Russia	1,370	(IBRD)	1,520	(IBRD)	320	(agriculture)
					200	(financial sector)
					200	(industry)
					500	(oil and gas)
					300	(transportation)
Ukraine	27	(IBRD)				
Uzbekistan	------		21	(IBRD)		(public sector management)
Total	**1,591**		**2,231.7**			
ASIA						
Cambodia	------		62.7	(IDA)		(multisector)
China	2,155	(IBRD)	2,145	(IBRD)	250	(telecommunications)
					670	(transportation)
					460	(agriculture)
					605	(oil, gas, and coal)
					160	(environment)
	1,017	(IDA)	925	(IDA)	815	(agriculture)
					110	(population, health, nutrition)
Laos	55	(IDA)	48.4	IDA)	9.7	(social sector)
					30	(transportation)
					8.7	(agriculture)
Mongolia	------		50	(IDA)	20	(multisector)
					30	(transportation)
Viet Nam	------		324.5	(IDA)	158.5	(transportation)
					96	(agriculture)
					70	(education)
Total	**3,227**		**3,555.6**			

Source: *World Bank Annual Report, 1993 and 1994.*

Quotation of the Month: "Privatization Policy in Poland Will Remain a Political Battleground"

Warnings of a Privatization Expert in the *Financial Times*

For the past two months Poland's Prime Minister Waldemar-Pawlak has had on his desk, unsigned, the implementation order for a mass privatization program, a process first introduced in Poland in July 1990. He has not signed the order because of continuing controversy and opposition to the program from many Poles.

The reasons for the controversy lie in mistakes made at the beginning of the economic transformation program. Polish privatization law defined two principal strategies: sales to foreign investors and initial public offerings on the newly organized Warsaw stock exchange. However, by the end of July 1994 there had been only 24 initial public offerings and about 60 sales to foreign investors. Such a strategy is more suitable for a Western country where only a few state enterprises are to be privatized than for the Polish economy, which was dominated by more than 8,000 state enterprises. As an afterthought, a provision was added for the "liquidation" of medium-size enterprises through employee ownership and leases. This resulted in about 1,000 privatizations, a great success.

A question arose, however, about what to do with large enterprises that did not qualify to be floated on the tightly regulated Warsaw stock exchange and where there was no foreign investor interest. The solution was to place them in groups and find foreign "turnaround" managers who would restructure and improve them so they could be floated or so that foreign investors could be found for them. But successive Polish governments and consultants developed the idea in ways that made the program politically unacceptable.

The objections center on two fundamental issues:

•The first objection is that the program is centralized and bureaucratic. Ministry officials are to organize 20 government investment funds, choose foreign managers, and divide between them 60 percent of the shares in 400 companies (the remaining shares belong 25 percent to the state and 15 percent to the employees). Each manager is a strategic investor in about 30 companies. Thus, the government is closely identified with the whole scheme, which raises fears of collusion (between bureaucrats and foreign managers), fraud, and conflicts of interest.

•The second and more important objection is that the program is inadequate as a means of mass privatization. The plan is to distribute to some 27 million adult Poles a voucher that, after a year or so, can be exchanged for one share in each of 20 investment funds, minus 15 percent of shares reserved for fund managers. The amount of the proposed asset transfer, however, is minuscule, considering that in addition to the expected 27 million voucher holders, the compensation claims of retirees and state employees, and possibly the claims of those holding restitution vouchers, must also be satisfied. And despite the large number of claimants, the 400 companies to be privatized represent only a relatively small segment of the Polish economy.

Critics claim that such a program is among the least far-reaching in East European countries and does not satisfy popular desires for participation and equity. In Estonia's mass privatization the asset transfer per adult averages $1,000, and participants can use their vouchers to buy housing, land, agricultural implements, shares of state enterprises, and a pension annuity. In Czechoslovakia's first wave of privatization the asset transfer was about $1,000 per voucher holder, and in the present second wave it is about $800. Czechs can bid for any of more than 2,000 enterprises, or they may deposit their vouchers with investment funds.

In contrast, Polish citizens may not choose how to use their vouchers or which investment fund—government or private—to deposit them with. This is ironic considering that Poland was the cradle of ideas about popular participation in the transformation and privatization of communist economies. The 1988 voucher coupon scheme eventually successfully applied in Czechoslovakia was proposed by Polish economists. Thus, Poland's 1990 transformation program confounded popular expectations by defining the strategy of privatization in a centralized and exclusionary manner.

Unless future Polish governments stop imposing arbitrary programs from above and start meeting citizens' reasonable demands for equity and participation in reforms, privatization policy in Poland will remain a political battleground where little gets accomplished.

Based on a recent article by Lucja Swiatkowski Cannon in the Financial Times.

The author, an Adjunct Fellow at the Center for Strategic and International Studies (CSIS) in Washington, D.C, has been involved since 1988 with postsocialist privatization processes in Poland, Estonia and, currently, Latvia.

Letters to the Editor

Major Problems with the Argument

In their recent article ("Living on Borrowed Time: Lessons of the Soviet Economy's Collapse, *Transition*, April 1994, pp. 1–3"), William Easterly and Stanley Fischer analyze the roots of Soviet economic collapse and draw lessons from the Soviet record for other countries.

Easterly and Fischer argue that the Soviet growth slowdown in the 1960s through the 1980s resulted from the fact that the Soviet planners failed to substitute capital for labor as capital accumulated more rapidly than labor. If market incentives were present, a variety of capital goods would have sprung up to economize on labor requirements. "In Western economies, capital (for example, machinery and equipment) can substitute rather easily for labor and thus sustain growth even when the labor force is not growing." "It was the Soviet's inability to replace workers with machines per se, that was their undoing."

There are two major problems with this argument.

First, Easterly and Fischer implicitly come down on one side of a longstanding and serious debate among Sovietologists: Did the slowdown result because "capital was an extraordinarily poor substitute for labor in the Soviet Union" à la Weitzman (1970), or alternatively because the rate of growth of factor productivity was declining from year to year (although capital was being substituted with ease for labor)? In short, was the underlying production function of the CES form with a low elasticity of factor substitution (and a constant rate of technical change) or the Cobb-Douglas type with unitary elasticity of substitution and a declining rate of technical change? In opting for the low elasticity of substitution Weitzman formulation as an explanation for Soviet growth slowdown, Easterly and Fischer overlook the fact that, in a later revision [Weitzman (1983)], Weitzman had come up with estimates that favored the Cobb-Douglas specification as against the CES of his earlier choice. I had also reported in 1987 a Cobb-Douglas, variable-rate-of-technical-change production function for the Soviet economy for 1950–1980.

In fact, the task of picking an ideal model for explaining Soviet growth slowdown is a tricky one. The result varies with the choice of the underlying data, the definition of the variables (for example, should labor be defined in manhours or number of workers; should capital data be adjusted for the overestimate in official series; should it be included in terms of the services of capital stock?) and the time period under consideration. Caution has therefore been the hallmark of scholarly work on this subject by Soviet-area specialists in the last two decades.

Second, regardless of which of the two alternative approaches to explaining Soviet growth retardation is accepted, Western scholars have long considered lack of market incentives to be the chief problem in the Soviet economy. The Easterly-Fischer suggestion that old time scholars in the field failed to emphasize the lack of market economy incentives and treated the economy's decline as a purely extensive growth phenomenon (marked by increasing applications of factors of production without concern for their productivity) is wrong, besides being unfair. Western scholars, Abram Bergson and Joseph Berliner among them, argued that the growth pattern was extensive and that it was costly (in terms of lost output) because it lacked the efficiency norms and incentives of the market system. In an applied neoclassical exercise, Desai and Martin (1983) estimated the resource-allocational losses in Soviet industry arising from the command economy methods of allocating excessive capital across industrial branches.

Professor Padma Desai
Columbia University

Reply to Padma Desai

Space constraints in the *Transition* newsletter prevented us from giving a comprehensive summary of the literature on declining productivity growth vs. low substitutability of capital for labor to which Professor Desai refers. However, we do discuss this literature, including Professor Desai's own important contributions, at length in our paper (*The Soviet Economic Decline: Historical and Republican Data*, World Bank Working Paper 1284, also issued as NBER Working Paper 4735), on which the *Transition* article was based.

Weitzman did not reverse himself in the 1983 article quoted by Professor Desai. Rather, he expressed the statistical caution recommended by Professor Desai while making it clear he found the low-substitutability explanation for declining Soviet growth more appealing than the declining productivity growth explanation. This literature used data through the 1970s; the additional data from the 1980s that we used seems to help confirm the low-substitutability explanation.

We certainly did not mean to give the impression that Western Sovietologists, whose work we respect and admire, played down the absence of market incentives in the USSR. What we meant to say was that the literature on Soviet

extensive growth did not sufficiently acknowledge that successful countries like Japan and Korea also had extensive growth. The challenge is to explain how the efficiency losses entailed by the Soviet system led not only to a depressed level of output, and not only to depressed long-run average growth, but also to falling Soviet growth over time. We think the key was the inability of administratively directed investment in a narrow range of capital goods to substitute for labor.

William Easterly (World Bank) and Stanley Fischer (IMF)

Estonia Should Be Left Alone

In his essay "Successful Privatization in Estonia: Unusual Features," John Nellis describes the success of Estonian privatization efforts. I would like to suggest that the process might have been even more successful if conducted with less outside interference.

The voucher program was the backbone of the economic transformation program after Estonia regained independence from the Soviet Union in 1991. However, in 1992 the previous transitional government brought in the German Treuhandanstalt to organize the Estonian Privatization Agency, giving it wide-ranging powers, not only to run the agency but also to interfere in any aspect of privatization policy and approve any foreign consultants. The Treuhand championed the use of tender offers and vehemently opposed the use of vouchers. Until recently, only those foreign consultants who agreed with this policy could function in Estonia.

Mart Laar's coalition government—which came to power as a result of the 1992 free elections—submitted a privatization law that was passed in June 1993, combining sales to strategic investors with a minority stake sold for vouchers. The Treuhand, however, refused to reserve any shares in enterprises sold by the Estonian Privatization Agency for eventual sale for vouchers. In the *Financial Times* April supplement on Estonia the Treuhand still claimed the Baltic state had no voucher program.

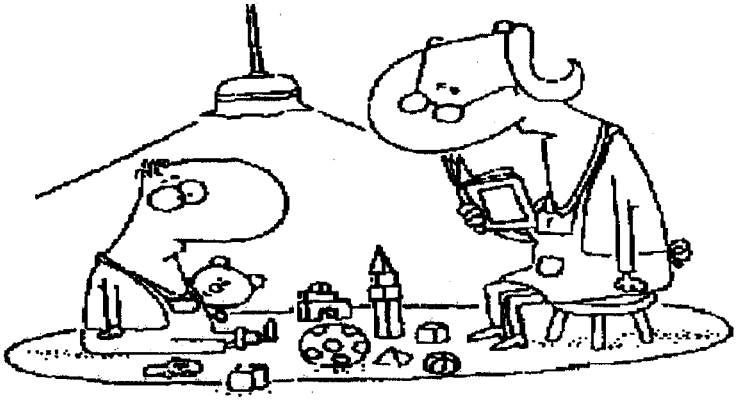
The government has had difficulty implementing its privatization policy. But in a pilot program this fall, four large enterprises with foreign majority are to sell about 30 percent of their shares for vouchers in the initial public offerings on the newly organized Tallinn stock exchange. And the government is diversifying privatization methods, beyond the tender offers. This is opposed by the Treuhand, and Prime Minister Laar was regarded as its defender. With tensions over the issue, and with other, unrelated charges Laar received a vote of no-confidence on September 26 and had to resign.

The integrity of the voucher program was also undermined by the recent agreement between Estonian President Lenart Meri and Boris Yeltsin on withdrawal of Russian troops from Estonia. About 10,000 retired Russian officers living in Estonia will be granted Estonian citizenship as well as privatization vouchers for their years of service not only in Estonia (as for everybody else), but anywhere in the former Soviet Union.

The Estonian privatization program has two serious defects. Privatization through tender offers was relatively successful, but implementation was narrowly conceived, excluding any combination with other methods. Furthermore, the sale of many enterprises without using vouchers, or the provision of vouchers to personnel beyond legitimate categories, has increased the number in circulation to the point where there are more vouchers than assets for sale. This places a heavy financial burden on future Estonian governments.

Lucja Swiatkowski Cannon (Former adviser to Liia Hanni, Estonia's deputy prime minister and the head of the Estonian Privatization Agency)

Contemporary Fairy Tale



"and then the youngest and brightest of the three brothers went on his way to claim his unemployment benefits."

From Budapest magazine *The Hungarian Economy*

Milestones of Transition

The government of China has unveiled a six-point plan to overhaul its ailing state-owned enterprises. The scheme aims at transforming government businesses into shareholding companies with management independent of official controls. As bloated state companies slash their work forces, official unemployment in China could jump by 1 million to a total of 5 million by the end of this year, the Labor Ministry predicts. The number of the "floating population"—the migrant rural workers who gravitate to the city for part-time employment and are partly unemployed—could range from 50 million to 60 million. Provincial leaders say the figure could be as high as 100 million.

China's economy expanded at an annual rate of 11.6 percent in the twelve-month period ending in June, according to the Ministry of Labor. Added-value industrial output rose by 15.7 percent in the first seven months of this year, compared with the same period 1993. The central bank has called for tight money policies, continued fiscal restraint, and curbs on capital spending to control inflation. Retail prices rose to 21.4 percent in July, from 20.0 percent in June. China's State Council is to start nationwide price inspections; grain, cotton, and chemical fertilizers are on top of the list. Capital spending is to be curbed following release of figures that showed a 73 percent rise in fixed assets investment in July compared with the same month in 1993. Credit ceilings will be tightened, and the government has announced that it will review all capital spending projects under the state plan.

Russian GDP slumped by 6.5 percent in the first eight months of the year, compared with the same period in 1993, the State Statistical Committee reported. Industrial output, which had fallen sharply for a year, had steadied in recent months, but output of steel had fallen by 22 percent, of vehicles by 20 percent, and of tractors by 78 percent. (The slump in industrial production, which has persisted for five years, with declines of 3 percent in 1990, 11 percent in 1991, and 16 percent in 1992 and 1993, could amount to 25 percent in 1994. Overall production dropped by 57 percent between January 1990 and June 1994.) The share of services in GDP increased dramatically to top the 50 percent mark for the first time ever.

The Russian government's Center of Economic Reforms believes that the production slump is gradually acquiring a structural character, while the structure and volume of goods produced have become increasingly dependent on market demand. Noting that the monthly inflation rate has slowed to less than 5 percent a month, the Center nonetheless warns that this price trend should not be taken for granted as long as the budget deficit remains at 10 percent of GDP.

Russia's top economic priority must be to resolve the problem of corporate debt because finding a solution is the key to future reform, Prime Minister Viktor Chernomyrdin said in an interview with *Rossiskiye Vesti*. (Mutual indebtedness of enterprises amounted to 15 to 16 percent of the GDP by the middle of 1994.) Many enterprises have stopped paying suppliers and their employees in the hope the government will step in. Chernomyrdin said there will be no universal debt settlement involving the government, but that settlements between individual enterprises are welcome. The prime minister added that **Russia** will launch the first phase of a $40 billion project to upgrade its antiquated phone system in early 1995, working with three Western companies: U.S. West, Deutsche Telekom, and France Telekom.

Russia's foreign trade surplus widened to $11.7 billion in January-August 1994 from $10.2 billion a year ago. Exports were up 9.3 percent to $28.8 billion; imports rose 5.5 percent to $17.1 billion. The figures represent Russia's trade outside the CIS. For much of this year, Russia has benefited from higher world prices for crude oil.

Russia will boost crude oil exports to non-CIS countries to 95 million-97 million tons a year, compared with 79.7 million tons in 1993, the Ministry of Economics reported. Officials forecast that Russia's oil exports to non-CIS countries this year will be about 85 million-87 millions tons. Deliveries to the CIS fell by 33 percent to 18 million tons in the first seven months of this year. (Sales to the CIS are being reduced to allow for the increased sales to non-CIS countries.) Russian producers are expected to sell more oil on Western markets once oil export quotas and licenses are scrapped on January 1, 1995. Russia's oil production in 1995 is projected to slump to less than 300 million tons.

Russian officials have indicated that **Russia** will seek to import 5 million-7 million tons of grain from America—mostly corn, soybeans, and higher-quality wheat. During the past seven months Russia has imported 1.8 million tons of grain, as compared with 11.1 million tons in 1993 and 25.5 million tons in 1992. Russia's grain harvest for 1994 is likely to be less than 90 million tons.

Russia has signed a breakthrough agreement with a banking advisory committee representing 600 of its bank creditors, paving the way for a deal to re-

schedule nearly $25 billion of debt and ending fifteen months of deadlock. Worked out on the sidelines of the World Bank-IMF Annual Meetings in Madrid, the agreement gives Russia a five-year grace period during which it is not required to pay back interest or debt principal. After that it will be given another ten years to pay off the debt in semiannual installments. Russia's chief debt negotiator, Deputy Prime Minister Alexander Shokhin, said the agreement does not involve Russia's waving its sovereign immunity. Instead, Russia will issue a declaration confirming its commitment to meet its obligations.

Negotiations will soon start on restructuring $6 billion in trade credits **Russia** inherited from the former Soviet Union. The amount represents less than 10 percent of Russia's total outstanding debt of $90 billion, according to Russian officials. The program involves the issuance of registered interest-bearing promissory notes denominated in U.S. dollars or other currencies in exchange for debt held by those trade creditors.

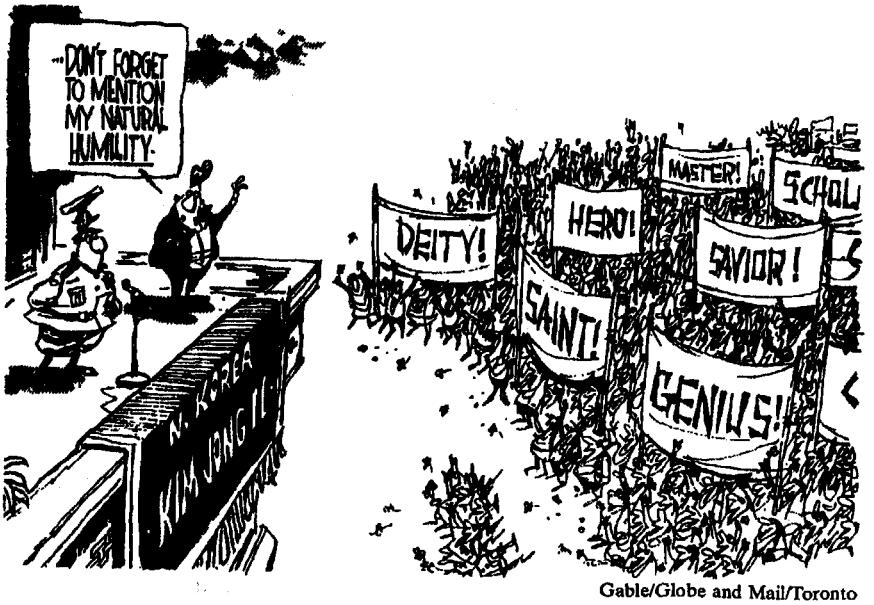
Russia's creditor banks have routinely rolled over every three months payments the country owes—while waiting for a rescheduling deal. Of a total foreign debt of about $90 billion, Russia owes about $45 billion to Paris Club governments and $35 billion to London Club banks (the remaining $10 billion are liabilities that sprang from trade credits.) Debts incurred by the former Soviet Union before 1991 are eligible for rescheduling. In 1994 Russia expended $29 billion for debt servicing, of which more than a third was paid in arrears to banks and $10 billion was paid to the Paris Club.

The **Commonwealth of Independent States** (CIS) Summit at its September meeting in Moscow signed a draft agreement to form a payments union and an economic committee to strengthen economic and financial ties. Of the 12 participating member countries, premiers of 10 republics signed the agreement. (Turkmenia and Azerbaijan did not sign the draft). The economic committee is the first body within the CIS to have supranational powers. It is to coordinate energy, transport, and communications links between the republics, analyze the economies and the course of their economic reforms, and draw up joint economic programs. Committee decisions require 80 percent of the membership's votes to be accepted. (Russia has 50 percent of the votes.)

Viet Nam has issued a decree allowing foreign residents and companies to buy bonds and shares issued by state-owned companies. A government economist said the planned issue of shares in state firms would amount to issuing new capital that would be privately held, diluting ownership by the state. In another development, a survey by the General Statistics Department reports that city dwellers are doing a lot better than the country's 72 million rural population (80 percent of the total). Average income in the cities is $20.20 a month; in the countryside it is only $8.60 a month.

Poland's government approved a legislative tax package on September 20. Contrary to earlier pledges of tax cuts, the tax rates of 21 percent, 33 percent, and 45 percent will not be lowered to the promised 20 percent, 30 percent, and 40 percent, respectively. The tax-free quota and tax brackets will, however, be raised by 36.6 percent to compensate for inflation and there will be more scope for tax relief. Finance Minister Grzegorz Kolodko claimed that the government's recent decision not to peg pensions to cost of living increases but to retain the current system of indexing pensions to wage increases had added some 8 trillion zloty ($360 million) to anticipated budget expenditure in 1995. The only way to finance the increased outgo was by giving up the planned tax cuts. (Under pressure, the government decided to put off the proposed changes until at least 1996.)

In **Poland** domestic prices have risen by 32.2 percent compared with August 1993, the Statistical Office announced on September 15. Unemployment fell by 0.6 percent over July; but the overall unemployment total of almost 3 million is still a 9.1 percent increase over Au-



Gable/Globe and Mail/Toronto

From the *World Press Review*

gust 1993. Polish industry sales in January-June were up by 11.2 percent over the same period in 1993. GDP growth in 1994 is expected to be on the order of 4.5 to 5.0 percent. By mid-1994 the private sector accounted for 27 percent of all industry sales.

Poland has signed a deal with nearly all of its Western commercial bank creditors, known as the London Club. Under the agreement, signed September 13 and backed by 495 of the 500 commercial banks Poland owes money to, Warsaw will be allowed to buy back a quarter of its main debt at 41 cents to the dollar and may turn the remainder into bonds. Poland's indebtedness to the commercial banks includes more than $8 billion in principal debt, about $4 billion in unpaid interest, and more than $1 billion in trade credits. Thus, the value of the debt reduction for Poland will rise to more than 49 percent from the 42 to 46 percent originally mooted. The agreement will initially cost Poland more than $2 billion, to be financed from foreign currency reserves and from IMF and IBRD loans.

In **Bulgaria** inflation is likely to fall to no lower than 80 to 85 percent by the end of 1994, as against a target of 30 percent, the National Employment Service (NES) reports. The broad money supply grew by 51 percent in the first eight months of this year, and is expected to increase by 105 to 110 percent by the end of 1994, well above the government's 45 percent target. The leva began falling sharply in August, causing the central bank to raise overdraft rates from 80 percent to 220 percent and to raise the minimum deposit requirements for banks. By the end of July the number of registered jobless in Bulgaria was 514,000, some 5,000 more than in June. The NES notes that 142,000 (27.6 percent) of the unemployed are less than 24 years old, and only about 25,000 (less than 5 percent) of the unemployed have education.

National Bank of **Hungary** Deputy President Frigyes Harshegyi has announced that the budget deficit for 1995 could be as low as 250 billion forints ($2.32 billion), or 5 percent of GDP. (The IMF had suggested a target of 3 percent of GDP.) Harshegyi said the budget deficit in 1994 would be 260 billion forints, or 6.5 percent of GDP, excluding 70 billion forints in debt repayments. It is possible that Hungary's economy will not grow at all in 1995, after forecasted growth of only 1 to 2 percent in 1994, Harshegyi said. Elaborating further on Hungary's economic status, the central bank reported that the current account deficit could fall from $2.5 billion in 1994, to $1.5 million-$2.0 billion in 1995. Foreign currency reserves currently stand at $6.4 billion (down from $6.7 billion at the beginning 1994). Foreign debt repayments will total $2.6 billion this year, rising to $3.0 billion in both 1995 and 1996. Gross foreign debt at the end of July was $26.6 billion, or 65 percent of GDP.

Hungary is to privatize 25 percent of each of its five gas distribution companies this autumn and plans to offer shares in the country's electricity company next year.

Soaring population levels and the extreme poverty of one-fifth of the world's inhabitants was a major topic for experts at the week-long **U.N. world population conference in Cairo**, September 5-12. The world's population—currently 5.6 billion—is increasing at an unprecedented rate (with more people of childbearing age than ever before). The population has doubled since 1950 and is increasing by 94 million each year. Long-term projections show the population rising to 8.5 billion in thirty years and to 10.0 billion by 2050, before stabilizing at the end of the twenty-first century. Ninety-five percent of this growth is in developing countries.

Kyrgyzstan's President Askar Akaev signed a decree in early September allowing foreign investors to take all their profits out of the country in hard currency or goods they have manufactured. The decree also cancels a 5 percent tax on profits taken abroad. In a move to halt the collapse of industry in Kyrgyzstan, Akaev has deferred debt repayment by state enterprises until October 1996.

During the past three years the number of **Albanians** receiving state pensions has sharply increased. By mid-year 1994 pensioners in Albania totaled 480,000 (of an estimated population of 3.3 million), compared with 282,000 in 1991. So far the pension plan has been financed by employer and employee contributions as well as by the state budget. As of this year, the state's contribution will be significantly reduced.

Czech Premier Vaclav Klaus considers 1996 as "optimal" for the Czech Republic's application to join the European Union. At a meeting of European politicians and economists in Cernobbio (Italy), Klaus noted that the "psychological attitudes" of EU members toward integrating Central European countries into the EU were changing. The membership of countries such as the Czech Republic, "which seemed far off some time ago," was now a "foregone conclusion," Klaus said.

President Meles Zenawi said that **Ethiopia's** World Bank-recommended structural adjustment program was the only viable way to revive an economy devastated by years of civil war and Marxist dictatorship. Meles also said that the devaluation of the Ethiopian birr had encouraged peasant farmers to pro-

duce more cash crops. The annual inflation rate has been cut from 22 percent to 10 percent during the past government's tenure.

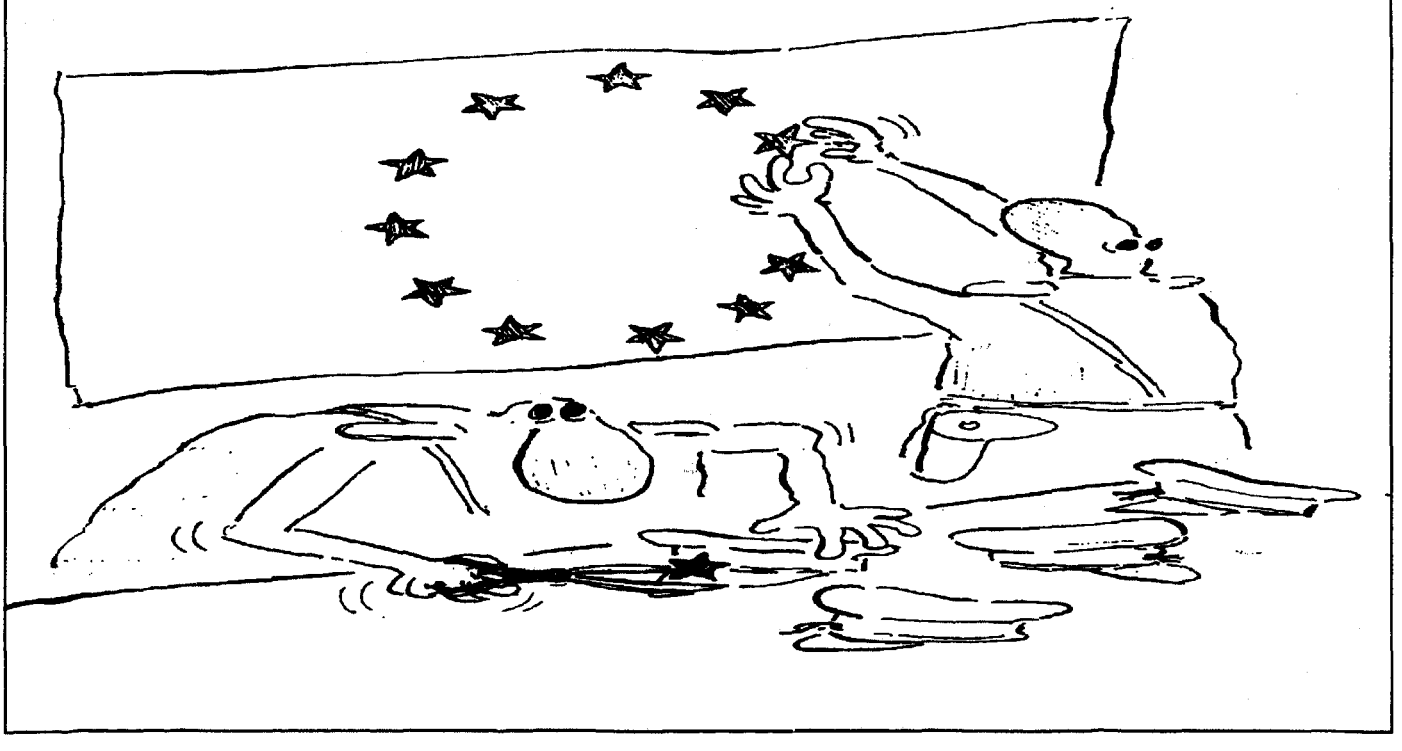
Multinational corporations' investments in developing countries in 1993 reached a record $80 billion, out of a global investment of $195 billion—itself a record high—the UN *World Development Report 1994*, released in September, reports. The bulk of this $80 billion was concentrated in 15 developing countries in Asia and Latin America. China led all developing countries with $26 billion in multinational investment. The former Soviet Union, Eastern Europe, Africa, and the world's "least developed" countries, however, are finding few takers.

The **European Bank for Reconstruction and Development** reported that its loss for the three months to June 30 widened to 6 million ecu from 66,000 ecu in the first three months of the year. Total losses for the first six months of 1994 were 6.12 million ecu compared with a profit of 557,000 ecu in the same period of 1993. The losses were due to significantly lower operating profits plus the effect of provisions against bad debts and share investment. Operating income declined from 77.53 million ecu in the first half of 1993 to 73.50 million ecu.

The **Radio Free Europe/Radio Liberty Research Institute** will close at the end of 1994. A new research institute, to be based in Prague in the Czech Republic, will begin operations in October 1994. This new research organization, the Open Media Research Institute (OMRI), is the product of an initiative involving the United States Board for International Broadcasting (Radio Free Europe/Radio Liberty's government oversight and funding agency) and the Open Society Institute (a Soros Foundation). It will publish a weekly analytic journal and a daily digest of events in the former Soviet Union, Eastern Europe, and selected other countries; provide current analyses and information to RFE/RL broadcasters and others; and undertake, as custodian, the preservation and automation of the RFE/RL archives to make them more accessible to the scholarly community. The new institute will engage in training and other activities in support of democracy and independent media throughout Eastern Europe and the territory of the former Soviet Union.

We appreciate the contributions from the RFE/RL Research Institute.

Back to Europe



From the Croat cartoonist Srecko Punntaric *(Felix)*

World Bank/IMF Agenda

SDR Allocation: Special Meeting of the Interim Committee?

The failure to strike an accord on special drawing rights (SDRs) is not irreversible and officials are still hoping for an agreement, IMF First Deputy Managing Director Stanley Fischer said in Madrid at the 1994 World Bank-IMF Annual Meetings. The G-7 called for a one-shot special allocation of SDR 16 billion (about $23.3 billion) to replenish the reserves of 37 new members including the ex-Soviet republics and the poorest countries.

Fischer said the managing director's proposal for an SDR 36 billion ($52.6 billion) general issue—supported by the developing countries—included a catch-up component for the recent entrants and would provide substantially more for the FSU countries.

Discussion will continue in the next few weeks in Washington, D.C., and if necessary, a special meeting of the Interim Committee could be called to solve the issue. By the end of 1994, the Systemic Transformation Facility [STF] expires, and renewal of the STF, which helps transition economies get their reforms off the ground, depends on the agreement of the SDR issue.)

Peking Invites Twins to Hong Kong

The Board of Governors of the World Bank Group and the IMF have accepted China's invitation to hold the 1997 Joint Annual Meetings in Hong Kong, September 23-25. (According to an agreement between China and Britain, Hong Kong, a British colony since 1887, will return to China in July 1997.) In 1995 and 1996 the Annual Meetings will convene in Washington, D.C.

IFC Doubles Financing by Decade's End

The International Finance Corporation (IFC), the World Bank's private sector arm, expects to double its financing in the next five or six years to $5 billion, to keep pace with the rapid growth in emerging markets and the shift toward private sector development. In its recently released Annual Report, the IFC said it approved a record $2.5 billion in financing in fiscal 1994 and increased its net income 82 percent to a record $258 million.

The Corporation is focusing on infrastructure (for which developing countries are spending about $200 billion annually); and on capital markets through support for the establishment of finance and leasing companies, commercial banks, pension funds, and life insurance companies.

World Bank Lends $2.4 Billion for Environment

The World Bank extended a record $2.4 billion in fiscal 1994 in support of environmental projects. In its report "Making Development Sustainable: the World Bank and the Environment," the Bank said it is currently implementing 118 environmental projects, representing around $9 billion in loans and credits, compared with only 15 similar projects in 1989. Poverty, population growth, and rising demands on agriculture and natural resources have had a critical impact on the environment. World Bank Environment Department Director Andrew Steer is quoted as saying: "One key challenge will be to ensure that the rapidly growing portfolio of environmental projects continues to perform well."

Poland to Get GEF Loan

The Global Environment Facility (GEF) will support Poland with a $26 million loan for a program to cut ozone-destroying air pollution. Poland will provide roughly matching funding for the program, under which hundreds of the country's coal-fed central heating systems are to be turned into cleaner gas-fueled facilities.

The portfolio of GEF activities has grown to 53 projects costing more than $450 million, including biodiversity projects in Ukraine and Laos, phasing out ozone-depleting substances in China, and accelerating cleanup operations in the Black Sea, Baltic Sea, and Danube River basin. Rehabilitation of the Aral Sea basin received pledges of $31.4 million from international donors at a Paris meeting in June. An additional $220 million in World Bank loans is being discussed. But as the *Washington Post* reported, Western analysts in Uzbekistan doubt that the region's cash-strapped governments will accept loans unless they will help increase production. Attention is turning now to cleaning up the Amu River, which once fed the Aral Sea and is the main source of local drinking water.

World Bank Budget Cuts

The World Bank plans to slash its operating budget by about $165 million over the next two years to respond to calls for a leaner organization. World Bank President Lewis Preston has asked vice presidents with responsibility for operational areas to cut their administrative budgets by 5 percent in the fiscal year starting next July, and by as much again in 1996. Support divisions, such as the research

arm of the Bank, have been asked for an ever-sharper 6.5 percent cut in administrative expenses. The Bank's administrative budget has climbed by 32 percent over the past three years to about $1.4 billion for the fiscal year that began in July. The proposed cuts would roll back spending to just above the fiscal 1993 level.

Independent Inspectors Ready

The World Bank's new, independent Inspection Panel has set up its office in Washington, D.C, to investigate complaints from parties directly and adversely affected by Bank-financed projects and to request the Bank to act in accordance with its own policies and procedures. Members of the Panel, appointed by the Executive Board, are Chairman Ernst Gunther Broder, Inspector Alvaro Umana Quessadaa, and Inspector Richard Etter Bissell. Eduardo G. Abbott, a lawyer, serves as the Panel's executive secretary. Requests should be sent by registered or certified mail or delivered by hand to the Office of the Inspection Panel, MC 11101, 1818 H St., N.W., Washington, D.C. 20433, tel. (202) 428-2617, or may be delivered to the Bank's resident representative in the country where the project is located.

IMF Outlook: World Economy Is Back

The Baltic countries are heading for economic growth this year, along with many other states of Central and Eastern Europe, including Albania, the Czech and Slovak republics, Hungary, Poland, and Slovenia, according to the latest IMF "World Economic Outlook" report. Output is still collapsing in much of the former Soviet Union, however. Asia's economic growth is expected to slow this year as China moderates its hectic pace of industrial expansion to a more sustainable path. The IMF expects the global economy to grow 3.0 percent this year and 3.5 percent in 1995. World trade is expected to expand strongly, growing by more than 7 percent this year, and by 6 percent in 1995. The recovery of world activity and trade became more firmly established during the first half of 1994, the report added, though it warned recovery might be difficult to sustain if industrialized countries do not act to reduce public sector deficits and are negligent about inflation. Public debt in the industrialized countries has risen to 70 percent of GDP from only 40 percent in 1978. Growth alone will not be sufficient to resolve the problem of high unemployment, the report said. Labor market reforms, including lowering benefits and liberalizing employment regulations and wage-setting practices, are needed.

China: $100 Million for Schools...

An IDA credit of $100 million will partly fund a $177 million government project to expand education for about 5 million children in China's poor and minority areas. The credit will fund rehabilitation and new construction of about 40,000 schools, management training, and development of improved curricula, including bilingual programs for ethnic minorities. China has set the goal of providing nine years of education for all school-age children as soon as practical. At present more than 95 percent of children ages 6 to 11 years are enrolled in primary schools, and more than 60 percent of 12- to 15-year-olds are in secondary classes.

...$175 Million for Shenyang's Industry...

A World Bank loan of $175 million will support a $363 million project aimed at restructuring the engineering industry in Shenyang, China's fourth-largest city. Funds will help the overhaul of Shenyang Machine Tool Co., the city's largest employer, and the construction of a hazardous waste treatment plant. The loan, which includes the Bank's first credit line to a Chinese enterprise, is for twenty years and carries a variable interest rate, currently 7.1 percent. (For more details on this path-breaking loan, see the next issue of *Transition*, October.)

...and another $150 Million for Highways

A World Bank loan of $150 million will help finance a $317 million plan to expand and improve the highway system in Xinjiang, China's largest province in the northwest. The project includes construction of a new 300 kilometer highway, along with improvements to the region's road maintenance and management operations.

Russian Mercedes with IFC Stake

The Ulyanovsk Automobile Plant (UAZ), together with Mercedes-Benz, is planning to manufacture Mercedes cars at Russian production facilities. Thirty percent of the authorized capital in this joint venture is to belong to UAZ; 30 percent, to Mercedes-Benz; 25 percent, to the International Finance Corporation and the European Bank for Reconstruction and Development; and 15 percent, to Russian investors. The project, estimated to cost DM 720 million (about $470 million) provides for manufacturing 25,000 jeeps and 20,000 minibuses a year. The first Mercedes cars made in Russia could be on sale by the end of 1996.

Belarus To Get $600 Million Loan

The World Bank is ready to extend up to $600 million in loans to Belarus over the next two years. The announcement came during talks between Belarus Prime Minister Mikhail Chigir and World

Bank Country Department Director Basil Kavalsky. Kavalsky commended the government's economic measures, in particular "the introduction of market prices on many goods, and the decisions not to subsidize loss-making enterprises and to protect low-income citizens."

Russia, IMF Discuss Standby

The IMF and Russia will hold talks by the end of October to pave the way for a $4 billion standby loan, Russia's Economics Minister Alexander Shokhin announced at the Madrid Annual Meetings. Shokhin also indicated that once an agreement is reached with the IMF, Russia will proceed to negotiate a long-term rescheduling of its debts to Paris Club creditors.

Reuters reported that the IMF is considering mobilizing a $6 billion currency stabilization fund for Russia to protect the ruble against speculative attacks, as part of what could be a $10 billion package to help Moscow steady its economy (including the $4 billion standby loan). The United States, Germany, Japan, and other industrial countries would provide the financing for the currency fund, lending the IMF the money through the General Arrangements to Borrow (GEB). Under the scheme, Moscow would peg the value of the ruble against other currencies as part of an overall anti-inflation program that would include big cuts in the budget deficit.

$700 Million in World Bank Loans to Russia

Russian Deputy Prime Minister Oleg Soskovets has signed two agreements with the World Bank in Washington. A $200 million loan is to help support the emerging private sector, while a $500 million loan is to boost oil production in western Siberia, rebuild pipelines, and promote environmental protection. Russia obtained its first oil rehabilitation loan, worth $610 million, from the World Bank in 1993.

Standby, World Bank Loan for Bulgaria...

The IMF doubled a standby credit to Bulgaria to support a commercial bank debt agreement signed in July 1994 with international creditor banks. The IMF issued a statement saying it had approved $102 million in new standby credit on top of a standby for the same amount it granted Bulgaria in April. For the April standby the IMF granted a waiver of the end-June performance criterion on net domestic assets.

Central Bank Deputy Governor Lyubomir Filipov admitted that Bulgaria's net domestic assets—net domestic credit provided by the banking system to the government, public enterprises, and the private sector—is expected to exceed IMF targets for 1994. Due to diminishing agricultural production and the depreciation of the leva, the broad money supply grew by 51 percent in the first eight months of this year, and is expected to increase by 105 to 110 percent by year's end, well above the government's 45 percent target. A $125 million World Bank loan will also help Bulgaria replenish its foreign exchange reserves, following its recent debt reduction agreement with commercial creditors.

...and Combined Support to Albania

The IMF approved a $21 million ESAF (enhanced structural adjustment facility) loan to help Albania's market reforms. A new IDA credit of $4 million will assist Albania's government to modernize tax administration with the scheduled introduction of a value-added tax in 1995. Another $15 million IDA credit will support development of a private banking system, continued privatization in industry, and downsizing or elimination of poorly run state enterprises. The country has received 11 IDA credits since joining the World Bank Group in 1991.

World Bank Loans to Latvia's Banks...

A World Bank loan of $35 million will help Latvia's commercial banks to make medium- and long-term investment loans to private enterprises. Part of the money will be spent to strengthen the Latvian Privatization Agency. The banking sector payment system will be shored up with computer technology.

...and Turkmenistan's Government

A broadly based technical assistance project, backed by a $25 million World Bank loan—the first to Turkmenistan—will help the Central Asian country implement its privatization program and the restructuring of its public enterprises; modernize parts of the financial system; conduct social surveys and develop a new pension system; and improve administration of joint energy ventures.

IFC Approves Investment in Madagascar

The IFC, the private sector arm of the World Bank has approved an equity investment of about $1.1 million in the foreign fund for investment in Madagascar. The investment in the Madagascar Capital Development Fund (MCDF), the first foreign fund in the Indian Ocean island state, would have a life of ten years. The fund would take minority positions in export-oriented firms in the Malagasy export processing zone.

Conference Diary

For the Record

Public Utilities in the Process of Systemic Transformation
October 3–4, 1994, Warsaw

Sponsored by the Institute of Economics of the Polish Academy of Science in Warsaw, the Regulatory Policy Research Centre (Hertford College, Oxford University), and the University of Muenster (Germany).
Information: Dr. Andrzej Szablewski, INE PAN, Warsaw, fax (48 22) 29 58 97.

Bretton Woods Revisited
October 15–17, 1994, Bretton Woods, New Hampshire (Mount Washington Hotel)

Sponsored by the Institute for Agriculture and Trade Policy, the conference was held to create an intergenerational dialogue on the ability of the Bretton Woods institutions (the International Monetary Fund and the World Bank) and the General Agreement on Tariffs and Trade (GATT) to respond to contemporary and future challenges. Keynote speakers include Edward M. Bernstein, Guest Scholar at the Brookings Institution; Harlan Cleveland, Professor Emeritus of Public Affairs and Planning at the Hubert H. Humphrey Institute of Public Affairs; Paul H. Nitze, Diplomat-in-Residence at the Paul H. Nitze School of Advanced International Studies, The Johns Hopkins University; and Tran Van-Thinh, the European Union's Ambassador and Permanent Representative to the GATT in charge of trade negotiations during the Uruguay Round.
Information: Institute for Agriculture and Trade Policy, 1313 Fifth St. SE, Suite 303, Minneapolis, MN 55414-1546, tel. (612) 379-5980, fax (612) 379-5982.

Doing Business with Southeast Asia
October 17–18, 1994, New York

This conference, hosted by the Institute for International Law and Business, focused on the following topics: the changing investment climate (a country-by-country briefing); new foreign investment regulations; choosing the appropriate structure for doing business; infrastructure projects; establishing manufacturing operations; resort and real estate development; environmental considerations; selling and marketing U.S. products in Southeast Asia; intellectual property and transfers of technology; financing investments and exports; available U.S. government support; creative tax structures; dispute resolution and litigation; privatization; and the role of U.S. capital markets.
Information: American Conference Institute, 175 Fifth Avenue, Suite 2182, New York, New York 10010, tel. (416) 926-8200, fax (416) 927-1563.

Telecommunications Development and Liberalization in Central and Eastern Europe and the Former Soviet Union
October 18–20, 1994, Prague

The conference, sponsored by KPMG, PTT Telecom, JP Morgan, and the Adam Smith Institute and administered by Business Seminars International, Ltd, analyzed the role of privatization in modernizing and speeding telecommunications development in Central and Eastern Europe and the former Soviet Union; the main features of past and impending privatizations and whether they conform to one model or vary from country to country; and the lessons to be learned by other countries in the region that are planning privatization. The conference provided a comprehensive picture of the financial, technical, and trading opportunities in the telecommunications industry in Central and Eastern Europe and the FSU, enabling conferees to make the right decisions about the nature, scale, and area of their commitments.
Information: Business Seminars International, Ltd., The Old Court House, Hurst Green, East Sussex, TN19 7QP, tel. (4471) 490-3774, fax (4471) 490-8932.

Forthcoming

Workshop on Enterprise Culture
October 24-26, 1994, Warsaw

Organized by the Warsaw School of Economics and the UNDP, the workshop will examine the key elements of enterprise behavior in a market economy, with special reference to an economy in transition in Poland.
Information: Professor Ryszard Rapacki, Warsaw School of Economics, 02-554 Warsaw, Al. Niepodleglosci 162 or Professor V. V. Ramanadham, Coordinator, Interregional Network, on Privatization, UNDP, New York, fax (980) 246-2799.

Emerging Capital Markets and Private Equity Investment in Russia: Year-End Update
November 17–18, 1994, New York

Sponsored by the Geonomics Institute and the U.S.-Russia Business Council, the conference prepares Western companies and individuals for investing in Russia's emerging capital markets and postvoucher privatization. It examines

Russia's progress in bringing order and predictability to its securities markets; familiarizes forum participants with emerging portfolio investment opportunities in Russia's regional exchanges; introduces investors to the emerging brokerage services industry in Russia; updates companies on the progress investment funds have made to date in identifying and financing projects; generates financing of good projects and new business opportunities by introducing companies and private equity investors to one another.
Information: Geonomics Institute, 14 Hillcrest Avenue, Middlebury, Vermont 05753, tel. (802) 388-9619, fax (802) 388-9627.

Workshop of the OECD Expert Group on Entrepreneurial Development in Economies in Transition
November 3–4, 1994, Bratislava

The conference, hosted by the Slovak National Agency for the Development of Small and Medium Enterprises, will discuss the role of intermediary organizations in entrepreneurship promotion. The meeting will bring together representatives from both countries in economic transition and OECD member countries.
Information: OECD, 2 rue André Pascal, 75775 Paris cedex 16, tel. 45 24 82 00, fax (33-1) 45 24 90 98.

Marketing Strategies for Central and Eastern Europe
December 1–2, 1994, Vienna

A primary goal of the conference is to promote an international dialogue between decisionmakers and business and government leaders from Eastern Europe and Western industrial countries. The conference will present information about the process of economic transformation in Eastern Europe, the stimulation of entrepreneurial activity, and the theory of global marketing. In addition, management education issues will be addressed. A central question raised will be whether, and how, marketing concepts can be adapted to foster development of markets in economies undergoing transition.

The following topics will be addressed: promotion/advertising; marketing strategies to reach Eastern European consumers; comparative analysis of conditions of market entry in Eastern European countries; market entry through exports versus market entry via capital investment; acquisitions as opposed to joint ventures in Eastern Europe; cultural conflicts or harmony in joint ventures; consumer behavior; distribution and logistical strategies; financial strategies for opening Eastern European markets; legal and tax issues; Eastern Europe's role and its future in the EU; and case studies of Western firms in Eastern Europe.
Information: University Professor Dr. Reiner Springer, Wirtschaftsuniversitat, Vienna, Austria, tel. (431) 313-36/4371, fax (431) 313-36/751 or Petr Chadraba, Ph.D., De Paul University, Chicago, Illinois, tel. (312) 362-6200, fax (312) 362-5647.

Safety Nets and Social Implications of Public Sector Restructuring
December 13-15, 1994, New Delhi

This international round table is organized by the Center for Industrial and Economic Research and Standing Conference on Public Enterprises, with technical assistance from Interregional Network on Privatization, UNDP. The conference will discuss aspects of safety nets related to the restructuring of the public sector. Participants include high-level enterprise executives and civil servants, and representatives of the World Bank and UNCTAD.
Information: Dr. S. R. Mohnot, CER, 7 Community Centre, East of Kailash, New Delhi 110065, India; Mr. M. A. Hakim, SCOPE, Lodi Road, New Delhi; Professor V. V. Ramanadham, Coordinator, Interregional Network, on Privatization, UNDP, New York, fax (980) 246-2799.

Corporate Governance in Central Europe and Russia
December 15–16, Washington, D.C.

The conference organized by the World Bank and the Central European University Privatization Project, it will present the results of in-depth research on the effects of different modes of privatization, ownership structures, and corporate governance arrangements in Central Europe and Russia. Experts on corporate governance and on transitional economies will explore in an interdisciplinary fashion such topics as ownership and governance by banks, investment funds, employees, managers, other enterprises, foreign firms, and governments (as residual owners).
Information: Cheryl Gray or Sabine Schlorke, the World Bank, PRDTE, tel. (202) 473-9188 or 458-5480, fax (202) 522-1152.

The Future of Central Europe
June 9–10, 1995, Vienna

This conference, organized by the Industrial Section of the Vienna Chamber of Commerce, the European League for Economic Cooperation, the Federation of Austrian Industrialists, and the International Vienna Council, will focus on economic interdependencies; financial markets and banking; infrastructure; and environment and energy.
Information: Industrial Section, Vienna Chamber of Commerce, Stubenring 8-10, 1010 Vienna, Austria, tel. (43 1) 514 50/204, fax (43 1) 514 50/455.

New Books and Working Papers

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

World Bank Publications

To receive ordering and pricing information for publications of the World Bank write: World Bank Publications, P.O. Box 7247-8619, tel. (202) 473-1155, fax (202) 676-0581; or visit the World Bank bookstores, in the United States, 701-18th St., N.W., Washington, D.C. 20433, or in France, 66 avenue d'Iena, 75116, Paris.

Policy Research Working Papers (WPS)

Brian Pinto, and Sweder van Wijnbergen, **Ownership and Corporate Control in Poland: Why State Firms Defied the Odds**, WPS no. 1308, June 1994, 36 p. *To order: Marylou Kam Cheong, room K6-115, tel. (202) 473-9618.* (See Brian Pinto's article in *Transition* vol. 4, no. 7, September 1993, p. 4.)

Justin Yifu Lin, Fang Cai, and Zhou Li, **China's Economic Reforms: Pointers for Other Economies in Transition?** WPS no. 1310, June 1994, 41 p. *To order: Cicely Spooner, room N8-037, tel. (202) 473-0464.*

Bartlomiej Kaminski, **The Significance of the "European Agreements" for Central European Industrial Exports**, WPS no. 1314, June 1994, 41 p. *To order: Minerva R. Patena, room R2-040, tel. (202) 473-7947.* (See Bartlomiej Kaminski's article in *Transition*, vol. 4, no. 7, 1993, p. 6).

Robert E. Anderson, **Voucher Funds in Transitional Economies: The Czech and Slovak Experience**, WPS no. 1324, July 1994, 47 p. *To order: Faten Hatab, room H8-087, tel. (202) 473-5835.*

Gerhard Pohl, and Stijn Claessens, **Banks, Capital Markets, and Corporate Governance: Lessons from Russia for Eastern Europe**, WPS no. 1326, July 1994, 16 p.

The bank and capital market reform in transitional economies should not be modeled too closely on patterns in Western economies, with their large institutions, complex financial instruments, and extensive regulation. A simpler process is required, compressing in a short period the historical development of financial systems, starting with small banks and accepting imperfect regulation and supervision as a fact of life.

Systemic risks remain manageable if financial institutions are small and numerous enough. A system with many private banks is more likely to produce a financial sector that plays an active role in enterprise restructuring, channels resources to the private sector, and thus accelerates restructuring and economic growth. Historical comparisons confirm the benefits of a liberal, weakly regulated banking system. *To order: Luz Hovsepian, room H8-093, tel. (202) 473-7297.*

Annette N. Brown, Barry W. Ickes, and Randi Ryterman, **The Myth of Monopoly: A New View of Industrial Structure in Russia**, WPS no. 1331, August 1994, 68 p. *To order: Maxine Berg, room N11-017, tel. (202) 473-6969.*

Peter Orazem, and Milan Vodopivec, **Winners and Losers in Transition: Returns to Education, Experience, and Gender in Slovenia**, WPS no. 1342, August 1994, 50 p.

Winners and losers in Slovenia's economic transition are identified by tracing changes in returns to education, experience, and gender, and changes in wage inequality from 1987 to 1991. Some of their findings:

- Relative wages and employment rose for the most educated and fell for the least educated, in all industries.
- Relative wages and employment rose with years of work experience until pensionable age.
- Using pension policies to encourage early retirement drastically reduced the supply of very experienced workers. At pensionable age, relative wages increased very rapidly and relative employment was greatly reduced.
- Women gained relative to men in both wages and employment primarily because their training and jobs are more "transition-proof."
- Setting minimum wages, fixing ranges of pay, and indexing wages to inflation did not prevent increases in wage differentials.

To order: Jennifer Walker, room N11-023, tel. (202) 473-7466.

Wafik Grais, and Kangbin Zheng, **Strategic Independence in the East-West Gas Trade,** WPS no. 1343, August 1994, 18 p. *To order: Kangbin Zheng, room H2-092, tel. (202) 473-6974.*

Bernard M. Hoekman, and Petros C. Mavroidis, **Linking Competition and Trade Policies in Central and Eastern European Countries**, WPS no. 1346, August 1994, 43 p. *To order: Faten Hatab, room H8-087, tel. (202) 473-5835.*

Ishrat Husain, **Why Do Some Economies Adjust More Successfully Than Others? Lessons from Seven African Countries;** and **The Macroeconomics of Adjustment in Sub-Saharan African Countries: Results and Lessons**, WPS nos. 1364 and 1365, October 1994, 44 and 22 p. *To order: Joy Schwartz, room J5-255, tel. (202) 473-2250.*

Other World bank Publications

MIGA: The First Five Years and Future Challenges, 1994, 24 p. [The Multilateral Investment Guarantee Agency (MIGA), set up in 1988, deals mainly with investment risk insurance, but it also provides technical assistance to promote foreign direct investment through its Investment Marketing Services (IMS) Department.]

Andrew Keck, Narendra Sharma, and Gershon Feder, **Population Growth, Shifting Cultivation, and Unsustainable Agricultural Development: A Case Study in Madagascar**, World Bank Discussion Paper no. 234, 1994, 78 p.

Trends in Developing Economies 1994, 1994, 576 p. [The volume highlights the recent economic performance of 116 economies, including the transition economies. Indicators include data for 1991-93 and for selected years in the 1980s. Some key topics: progress in privatization and institution building in Eastern Europe; economic stabilization efforts in the FSU. Regional extract volume 1 covers 20 economies of Central and Eastern Europe and Central Asia. (For the first time, the book is available on diskette.)]

Stephen Haggard, and Steven B. Webb (eds.), **Voting for Reform: Democracy, Political Liberalization, and Economic Adjustment**, 1994, 536 p. [Drawing on case studies from Chile, Mexico, Nigeria, Poland, Senegal, Spain, Turkey, and Thailand, the volume assesses the interaction between global trends of political liberalization and market-oriented reform.]

Slovakia: Restructuring for Recovery, World Bank Country Study, September 1994, 279 p.

Turkmenistan, World Bank Country Study (Russian edition), September 1994, 279 p.

Financial Flows and the Developing Countries, World Bank Quarterly, August 1994, 35 p.

Global Outlook and the Developing Countries, World Bank Quarterly, July 1994, 27 p.

Robin Bates, Janusz Cofala, and Michael Toman, **Alternative Policies for the Control of Air Pollution in Poland**, World Bank Environment Paper no. 7, 1994, 84 p.

H. Quan Chu, and Wafik Grais, **Macroeconomic Consequences of Energy Supply Shocks in Ukraine**, Studies of Economies in Transformation no. 12, 1994, 54 p.

* * * * *

International Monetary Fund

Donald J. Mathieson, and Richard D. Haas, **Establishing Monetary Control in Financial Systems with Insolvent Institutions,** IMF no. 94/10, 1994, 25 p.

During the period when market discipline and prudential supervision are weak in the transition economies, indirect monetary policy instruments, based on a narrow banking structure, direct monetary policy instruments, or specially structured auction, will be needed to deal with the problems created by insolvent institutions. None of these approaches is a panacea, and all three have drawbacks. The narrow banking option would lead to credit being created outside of the banking system and could impede the development of the financial system. Direct instruments will necessarily involve the bureaucracy in the credit allocation process and are unlikely to rapidly eliminate insolvent banks from the system. An auction-based system especially designed to mimic the important features of markets in developed economies might result in collusion and insufficient competition.

William R. M. Perraudin, **A Framework for the Analysis of Pension and Unemployment Benefit Reform in Poland**, IMF WP no. 94/40, 1994, 41 p.

Three major findings of the study:

•Authorities should increase the averaging period used in the calculation of pension benefit entitlement. (This is effectively a way of reducing the total benefit since averaging over a long period will provide a lower pension base than simply averaging over the best years of a period relatively late in life.)

•Further reductions in unemployment benefits do not seem advisable. Such benefits are already very low, especially for the long-term unemployed.

•If benefits have to be cut, curtailing the early retirement benefit has the advantage of generating fairly substantial extra revenue while providing an inducement to saving. The welfare losses are not negligible but they are at least lower than those incurred if, say, a large pension income taper is applied.

Jacek Rostowski, **Interenterprise Arrears in Post-Communist Economies,** IMF WP no. 94/43, 1994, 38 p.

In postsocialist economies healthy expansion of interenterprise debts (IED) should be distinguished from pathological (or excessive) growth. The former is mainly the result of previous repression of trade credit by central planners (an example is IED growth in Czechoslovakia in 1990 and 1991). In the latter case, IED expands as enterprises doubt the credibility of the government's stabilization program, and extend trade credit to their customers. State-owned firms of the FSU and Romania provide examples of such pathological IED expansion. The best policy is to do nothing to solve the IED problem; multilateral clearing in IED will result in moral hazard. A second-best solution is the forced securitization of IED, which allows the development of secondary IED markets, enabling creditors to improve their liquidity and debtors to improve their balance sheets.

Dongpei Huang, and Sayuri Shirai, **Information Externalities Affecting the Dynamic Pattern of Foreign Direct Investment: The Case of China**, IMF WP no. 94/44, 1994, 23 p.

Uncertainty about China's overall investment environment declined over the decade, as the number of investors grew dramatically and a recent increase in publications about FDI in China provided investors with general information. But more regional or industry-specific information about high technology and heavy manufacturing industries, or about regions other than the special economic zones and coastal areas, would accelerate FDI.

The role of information is to provide signals not only to potential investors regarding the profitability of the market, but also to governments in host countries, to help them recognize the problems associated with FDI in the earlier stage. Thus, it is important to understand that the role of information is far more important than just reporting whether projects are successful or not.

Ehtisham Ahmad, Sergio Lugaresi, Alex Mourmouras, and Jean-Luc Schneider, **Pensions, Price Shocks, and Macroeconomic Stability in Transition Economies: Illustrations from Belarus**, IMF WP no. 94/52, 1994, 23 p.

Daniel Daianu, **Inter-Enterprise Arrears in a Post-Command Economy: Thoughts from a Romanian Perspective**, IMF WP no. 94/54, 1994, 24 p.

To order IMF publications: IMF Publication Services, 700-19th Street, N.W., Washington, D.C. 20431, tel. (202) 623-7430, fax (202) 623-7201.

* * * * *

CEPR Discussion Papers

Bankim Chadha, and Fabrizio Coricelli, **Fiscal Constraints and the Speed of Transition**, CEPR Discussion Paper Series no. 993, 1994, 32 p.

If the transition process is viewed as the release of factors of production from a declining state sector to an expanding private sector, there are several reasons to expect that a successful process of reallocation would be accompanied by a deterioration of the budget balance:

- The decline of the state sector represents a decline of the established traditional tax base.
- Replacing tax revenues by the private sector takes time.
- The reallocation process is likely to result in unemployment.

Thus, the desired process of reallocation of resources can therefore be expected to generate growing budget deficits. To finance those deficits, governments are constrained due to large external debt inherited from previous regimes, underdeveloped domestic bond markets, and stabilization programs. Most postsocialist economies have therefore had to embark on the transition process with tight fiscal constraints.

So it is important to establish an effective system of private sector taxation at an early stage in the transition process. An externally financed "restructuring fund" or "social benefits fund," would effectively remove unemployment expenditures from the budget constraints, thus removing an important budgetary incentive for the government to subsidize and maintain the state sector.

Damien Neven, **Trade Liberalization with Eastern Nations: How Sensitive?**, CEPR DPS no. 1000, 1994, 53 p.

Alan Winters, **The Liberalization of European Steel Trade**, CEPR DPS no. 1002, 1994, 54 p.

A simple model of the steel sector in Europe distinguishes eight West and two East European regions. It models the production of steel and also the various trade restrictions extant in 1992. It uses this model, first, to calculate the output and welfare effects of rationalizing the sector to remove the excess capacity experienced in 1992 and, second, to explore the consequences of the mutual trade liberalization between Eastern and Western Europe envisaged under the Europe Agreements (EA). The latter allow major increases in output in the East (18 percent) and offer Western steel users significant welfare benefits (ECU 190 million). Eastern consumers and Western producers suffer (smaller) losses, but total output in the EU falls by only about 1.5 percent.

Any attempt to integrate the East and West European steel industries by planning is likely to fail, and it is even more likely to be at the expense of the Central and East European countries (CEECs). The steel industry in the EU has to undertake major rationalization; the EAs are not the cause of this, and the CEECs should not be asked to pay the price for it by distorting their comparative advantage in cheaper types of steel.

Cristina Corado, **Textiles and Clothing Trade with Central and Eastern Europe: Impact on Members of the EC**, CEPR DPS no. 1004, 1994, 35 p.

Carmela Martin, and Jordi Gual, **Trade and Foreign Direct Investment with Central and Eastern Europe: Its Impact on Spain**, CEPR DPS no. 1006, 1994, 55 p.

To order: Center for Economic Policy Research, 25-28 Old Burlington St., London W1X 1LB, tel. (4471) 734-9110, fax (4471) 734-8760.

* * * * *

OECD Publications

Investment Guide for Ukraine, 1993, 142 p.
Methods of Privatizing Large Enterprises, 1993, 208 p.
National Accounts for the Former Soviet Union, 1993, 152 p.
Short-term Economic Statistics: CIS, 1980-1993, 1993, 176 p.
Transformation of the Banking System: Portfolio Restructuring, Privatization, and the Payment System, 1993, 219 p.
Valuation and Privatization, 1993, 120 p.
Short-term Economic Indicators: Central and Eastern Europe, 1994.
The Labor Market in Poland, 1994, 130 p.

To order: OECD Publications and Information Center, 2001 L Street, N.W., Suite 700, Washington, D.C. 20036-4910, tel. (202) 785-6323, fax (202) 785-0350.

* * * * *

WIIW Publications

Gábor Hunya, Hermine Vidovic, and others, **Leichte Erholung Folgt Einer Schweren Rezession: Die Wirtschaft der Oststaaten 1993-94,** WIIW no. 152, Vienna Institute for Comparative Economic Studies, October 1993-94, p. 288-304.

Constraints on Growth: Reports on Poland, the Czech Republic, and Hungary (contributions from Friedrich Levcik, Zdenek Lukas, Leon Podkaminer, Josef Poschl, and Sandoe Richter), WIIW no. 205, Vienna Institute for Comparative Economic Studies, April 1994, 44 p.

Josef Poschl (ed.), **Czech Economists on Transformation**, WIIW no. 206, Vienna Institute for Comparative Economic Studies, May 1994, 63 p.

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

* * * * *

Institute for World Economics (ICEG) Publications (Budapest)

Financing Hungarian Agriculture, no. 26, 1993, 16 p.
Privatization of the Hungarian Service Sector, no. 27, 1993.
Export Promotion in Hungary, no. 28, 1993, 16 p.
Foreign Direct Investment and the Restructuring and Modernization of the Hungarian Economy, no 29, 1994, 15 p.
The Public Perception of Privatization, no. 30, 1994, 13 p.
The Regulatory Framework for Consumer Protection in Hungary, no. 31, 1994, 9 p.
Exchange-rate Policy in Hungary, no. 32, 1994, 20 p.

To order: Institute for World Economics, Hungarian Academy of Sciences, 1124 Budapest, Kállo esperes u. 15, 1531 Budapest, P.O. Box 36, Hungary.

* * * * *

Institute of National Economy (Romania)

Constantin Grigorescu, **Poverty Pattern and Alternatives for the Protection of the Poor in Post-Communist Romania**, RRT no. 7, June 1994, 19 p.

Constantin Grigorescu, Marla Peonaru, and Maria Molnar, **Social Security in Romania**, RRT no. 7, May 1994, 16 p.
To order: Institute of National Economy, Romanian Academy, Bulv. General Magheru 28-30, Sector 1, Bucharest, cod 70159 Romania, tel. (401) 659-5680, fax (401) 650-6631.

* * * * *

Other New Publications

Raita Karnite, **Development of Latvian Telecommunications**, RRT no. 8, July 1994, 21 p. *To order: Institute of Economics, Latvian Academy of Sciences, Turgeneva 19, Riga LV-1018, Latvia, tel. (371) 882-1289, fax (371) 882-1289.*

Klaus E. Meyer, **Direct Foreign Investment in Central and Eastern**

Europe: Understanding the Statistical Evidence, CIS Discussion Paper Series no. 12, London, 1994, 53 p. *To order: London Business School, Sussex Place, Regent's Park, London NW1 4SA, United Kingdom, tel. (+44) 071 262-5050, fax (+44) 071-402-8979.*

Paul R. Gregory, **An Economic History of Russia from Emancipation to the First Five-Year Plan**, Princeton University Press, August 1994, 188 p. *To order: Tel. (609) 258-5165, fax (609) 258-1335.*

Economic Survey of Europe in 1993-1994, Economic Commission for Europe, New York and Geneva, 1994, 215 p.

Per Ronnas, and Orjan Sjoberg (eds.), **Economic Transformation and Employment in Central Asia**, International Labor Office, Ankara, 1994, 136 p. *To order: International Labor Office, 4 route des Morillons, CH-1211, Geneva 22, tel. (22) 799-6111.*

Carolyn L. Gates, and David H. D. Truong, **Foreign Direct Investment and Economic Change in Vietnam**, NIAS Report no. 20, 1994, 51 p. *To order: Nordic Institute of Asian Studies, Njalsgade 84, DK-2300, Copenhagen S, Denmark.*

Bartlomiej Kaminski, **The Institutional Dimension of the Transition from Communism**, PPRG no. 26, Warsaw, 1994, 23 p. *To order: PPRG Discussion Papers, Department of Economics, Warsaw University ul. Dluga 44/50, PL-00241 Warsaw.*

Arturas Kazlauskas, and Helen Jensen, **Lithuania's Household Expenditures and Income: March 1992-January 1883**, Center for Agricultural and Rural Development (CARD), Iowa, July 1994, 47 p. *To order: CARD, 578 Heady Hall, Ames, Iowa 50011-1070, tel. (515) 294-7519.*

Partnership for Growth, a report of the February 1994 seminar: Reshaping Trade and Investment Patterns: New Approaches to Assisting Central and Eastern Europe, The European Institute, Washington, D.C., February 1994, 136 p. *To order: The European Institute, 4910 Massachusetts Avenue, N.W., Suite 223, Washington, D.C. 20016, tel. (202) 895-1670, fax (202) 362-1088.*

Pocket Handbook of the Russian Far East: A Reference Guide, Russian Far East Update, 1994, 150 p. *To order: Russian Far East Update, P.O. Box 22126, Seattle, Washington 98122, tel. (206) 447-2668, fax (206) 628-0979.*

The Politics of Intolerance, RFE/RL Research Institute, Washington, D.C., 1994. *To order, U.S. Office, RFE/RL Research Institute, 1201 Connecticut Avenue, N.W., Suite 410, Washington, D.C. 20036, tel. (202) 457-6907, fax (202) 457-6992.*

Walt Patterson, **Rebuilding Romania: Energy, Efficiency and the Economic Transition**, Earthscan, August 1994, 144 p. *To order: Earthscan Publications, 120 Pentonville Road, London N1 9JN, tel. (071) 278-0433, fax (071) 278-1142.*

Olivier Jean Blanchard, Kenneth A. Froot, and Jeffrey D. Sachs (eds.), **The Transition in Eastern Europe,** volume 2, **Restructuring: A National Bureau of Economic research Project Report,** University of Chicago Press, 1994, Chicago and London, 374 p.

Yordan Hristoskova, **Unemployment and Labor Market in Bulgaria**, RRT no. 17, Center for the Study of Democracy, 1994, 16 p.

United Nations Catalogue, 1994-95, United Nations Publications, New York and Geneva, 200 p.
To order: United Nations Publications, Sales Section, 2 United nations Plaza, room DC2-853, New York, N.Y. 10017, tel. (212) 963-8302, fax (212) 963-3489, or United Nations Publications, Sales Office and Bookshop, CH-1211 Geneva 10, Switzerland, tel. (41 22) 917-2614, fax (41 22) 917-0027.

World Economic and Social Survey 1994, United Nations, New York, 1994, 308 p. *To order: United Nations Publications, room DC2-8053, New York, New York 10017.*

The euphoria that accompanied the start of transition from command to market economies in Europe and Central Asia has been followed by signs of disillusionment at the widespread impoverishment and unemployment and concern about the loss of personal security and prospects for the future.

A rapid differentiation of incomes and wealth is bringing a new stratification to societies that were relatively egalitarian. By early 1994 growth has returned only in Poland. In Russia the pace of divestment of state-owned enterprises has been rapid, but the state cannot afford to abandon all inefficient enterprises it owns, and needs to continue temporary financial support. For one thing, the political and social cost of mass bankruptcy would be unacceptable: the country suddenly would be deprived of essential production and services. Furthermore, it is hard to assess the viability of firms in the absence of operational market mechanisms.

Bibliography of Selected Articles

Postsocialist Economies

Amsden, A., J. Kochanowicz, and L. Taylor. **From Pseudo-Socialism to Pseudo-Capitalism: Eastern Europe's First Five Years.** *Politik und Gesellschaft* (International) pp. 107–16, 1994.

Balcerowicz, L. **Economic Transition in Central and Eastern Europe: Comparisons and Lessons.** *Australian Economic Review* (Australia) 105:47–59, January–March 1994.

Brabant, J. M. Van. **Lessons from the Wholesale Transformations in the East.** *Comparative Economic Studies* (U.S.) 35:73–102, winter 1993.

Carrington, T. **Efforts to Ease Social Pain of Transition to Market Economy Often Can Backfire.** *Wall Street Journal* (U.S.), May 2, 1994, p. A13.

Changes, Additions, and Deletions in World Bank and European Bank for Reconstruction and Development Projects Pipelines. *Eastern Europe Finance* (U.S.) 5(14):3–10, July 31, 1994.

Gerard, R., and T. Verdier. **Privatization in Eastern Europe: Irreversibility and Critical Mass Effect.** *Journal of Public Economics* (Netherlands) 54:161–83, June 1994.

Gomulka, S. **Economic and Political Constraints during Transition.** *Europe–Asia Studies* (International) 46(1):89-106, 1994.

Rider, C. **Privatization in the Transition Economies: A Critique.** *Journal of Post-Keynesian Economics* (U.S.) 16:589–603, summer 1994.

Sachs, J., and W. T. Woo. **Structural Factors in the Economic Reforms of China, Eastern Europe, and the Former Soviet Union.** *Economic Policy: A European Forum* (U.K.) 9:101–45, April 1994.

Smirnov, A. D. **Catastrophe Economy: A Nonlinear Model of the Transition Economy.** *Studies on Russian Economic Development* (Russia) 5:200–14, May–June 1994.

Sulc, Z. **Some Theoretical Issues on Transformation.** *Eastern European Economics: A Journal of Translations* (U.S.) 32:23–38, March–April 1994.

Central and Eastern Europe

Albania: Financial Times Survey. *Financial Times* (U.K.), July 21, 1994, pp. 23–25.

Bankzak, R. A. **Role of Labor in Postsocialist Hungary.** *Journal of Economic Issues* (U.S.) 28:519–32, June 1994.

Bokros, L. **Abandon Corporate Debt Consolidation** [in Hungary]. *Hungarian Economic Review* (Hungary) 20–21:6–7, June–August 1994.

Cornia, G. **Poverty, Food Consumption, and Nutrition during the Transition to the Market Economy in Eastern Europe.** *American Economic Review* (U.S.) 84:297–302, May 1994.

Csaba, L. **Is the Hungarian Economy Turning Left? The French Way.** *The Hungarian Economy* (Hungary) 22(2):3, 1994.

Czarnecki, E. G., and M. Michalski. **Telecom Sector Is Ripe for Investment.** *Development Business* (U.S.) 391, May 31, 1994.

Deutsch, A. **The New Pension and Health Insurance Legislation in Hungary.** *The Hungarian Economy* (Hungary) 22(1):9, 1994.

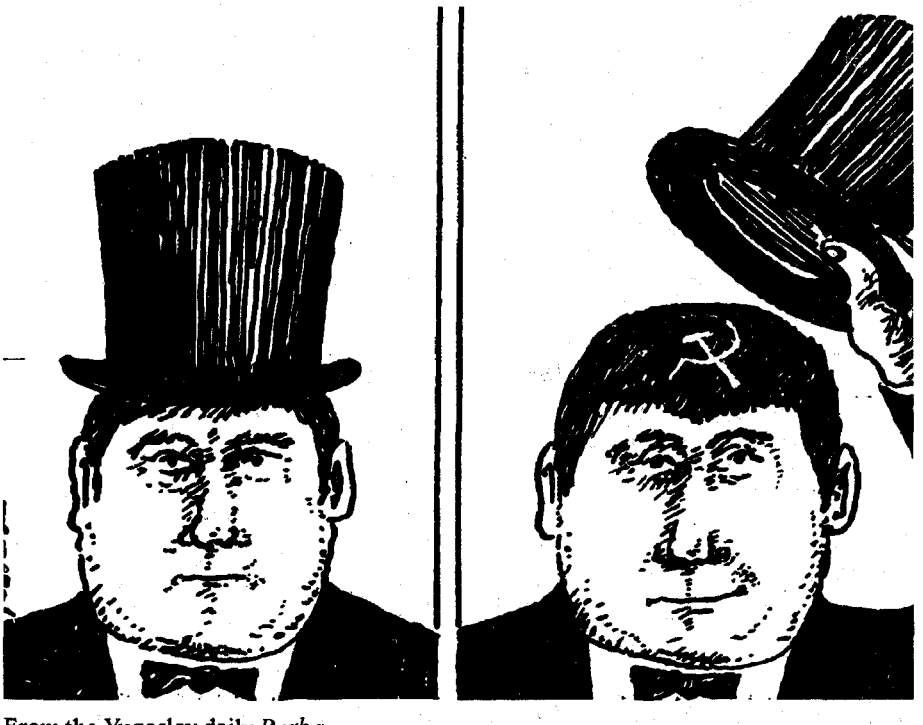
Ensor, T. **Health System Reform in Former Socialist Countries of Europe.** *International Journal of Health Planning & Management* (U.K.) 8:169–81, July–September 1993.

Estrin, S., and X. Richer. **Industrial Restructuring and Microeconomic Adjustment in Poland: A Cross-sectoral Approach.** *Comparative Economic Studies* (U.S.) 35:1–19, winter 1993.

Funke, M., S. Hall, and M. Sola. **Rational Bubbles during Poland's Hyperinflation: Implications and Empirical Evidence.** *European Economic Review* (Netherlands) 38:1257–85, June 1994.

Mejstrik, M. **The Second Wave of Voucher Privatization: Auction Results of the Second Round.** *Privatization Newsletter of the Czech Republic and Slovakia* (U.S.) 23:1–3, June 1994.
To order: CIPE, 1615 H Street, N.W., Washington, D.C. 20062, fax (202) 887-3447.

Minassian, G. **Bulgarian Economy in Transition: Is There Anything Wrong with Macroeconomic Policy?** *Europe-Asia Studies* (U.K.) 46(2):337–51, 1994.



From the Yugoslav daily *Borba*

Bibliography of Selected Articles *continued*

Old and Unaffordable. *Economist* (U.K.) April 30, 1994, p. 55.

Paarlberg, P. L. **Sectoral Adjustments in Eastern Germany Due to Market Forces.** *Review of International Economics* (U.K.) 2:112–22, June 1994.

Panayotou, T., R. Bluffstone, and V. Balaban. **Lemons and Liabilities: Privatization, Foreign Investment, and Environmental Liability in Central and Eastern Europe.** *Environmental Impact Assessment Review* (U.S.) 14:157–68, March–May 1994.

Perlez, J. **Hungarians Cooling to Foreign Investment.** *New York Times* (U.S.) May 3, 1994, p. A12.

Raiser, M. **Searching for the Hole in the Public Pocket: The Institutional Legacy of Soft Budget Constraints and the Polish Transformation Process.** *Economic Systems* (Germany) 17(4):251–78, December 1993. *To order: Economic Systems, Germany, tel. (89-983) 821/987-341.*

Slovenia—Country Update. *Eastern European Soviet Telecom Report* (U.S.) 5(8):10–11, August 1, 1994.

Varga, G. **The IMF Is Not Dictating.** *Hungarian Business Weekly* (U.S. edition) 1 (2):3, August 1994.
To order: 2 Wisconsin Cir., Suite 700, Chevy Chase, MD 20815, tel. (301) 961-1525.

CIS and the Baltics

Belkina, T. **Housing Statistics and the Condition of the Housing Sector.** *Problems of Economic Transition: A Journal of Translations from Russian* (U.S.) 37:56–71, May 1994.

Clarke, S., and others. **Privatization of Industrial Enterprises in Russia: Four Case Studies.** *Europe-Asia Studies* (U.K.) 46(2):179–214, 1994.

Fedorov, B. **Russia: The Good, The Bak and The Ugly.** *International Economy* (U.S.) 8:18–21, 61, May–June 1994.

Holt, D. H., D. Ralston, and R. Terpstra. **Constraints on Capitalism in Russia: The Managerial Psyche, Social Infrastructure, and Ideology.** *California Management Review* (U.S.) 36:124–41, spring 1994.

Intriligator, M. D. **Reform of the Russian Economy: The Role of Institutions.** *Contention* (U.S.) 3(2):153-70, winter 1994.

Jahjah, S. **Opening-up of Russia: Beyond Convertibility.** *Economic Systems* (Germany) 18(1):15–33, March 1994.

Johnson, D. G. **Trade Effects of Dismantling the Socialized Agriculture of the Former Soviet Union.** *Comparative Economic Studies* (U.S.) 35:21–31, winter 1993.

Maevskii, V., and others. **Scenarios for the Reorganization of the Economic Structure of Russia.** *Problems of Economic Transition: A Journal of Translations from Russian* (U.S.) 37:6–24, May 1994.

Markina, E. **Russia: Results of Initial Implementation of Tax Reform.** *Bulletin for International Fiscal Documentation* (Netherlands) 48:338–46, June–July 1994.

Martyanov, V. **Developing Bonds Market in Russia.** *Delovie Lyudi* (USSR) 6:20, February 1994.

Paeglis, I. **Latvian Fiscal Policy in the First Quarter of 1994.** *RFE/RL Research Report* (U.S.) 3(31):48–54, August 12, 1994.

Russian Far East: Sources of Foreign Equity Capital. *Russian Far East Update* (U.S.) 4(8):6–7, August 1994.

Shmeleva, N. **Property Reform and the Financial System.** *Problems of Economic Transition: A Journal of Translations from Russian* (U.S.) 37:25–37, May 1994.

The Emerging Russian Stock Markets: Bull Market on the Horizon. *Geonomics Bulletin* (U.S.), summer 1994.

Vishnevskii, A. G. **Land and Money.** *Problems of Economic Transition: A Journal of Translations from Russian* (U.S.) 37:72–92, May 1994.

Volkonskii, V. A., and others. **Approaches toward Designing Russia's Long-term Economic Development Programs.** *Studies on Russian Economic Development* (Russia) 5:187–99, May–June 1994.

Wegren, S. **Yeltsin's Decree on Land Relations: Implications for Agrarian Reform.** *Post-Soviet Geography* (U.S.) 35:166–83, March 1993.

Asia

Li, J. **Value-added Tax in the People's Republic of China.** *International VAT Monitor* (Netherlands) 5:130–46, May–June 1994.

Overhold, W. H. **Rise of China's Economy.** *Business Economics* (U.S.) 29:29–34, April 1994.

Sidler, P. **Power, Religion and the Economy in Viet Nam.** *Swiss Review of World Affairs* (Switzerland) 5:14–17, May 1994.

Thang, T. P. **Tendencies of Change in the Vietnamese Social and Class Structure in the Present Transitional Period.** *Vietnam Social Sciences* (Vietnam) 2(40):3–10, 1994.

Cuba

Ritter, A. **Exploring Cuba's Alternate Economic Futures.** *Center for Latin American Studies* (U.S.) 23:3–31, 1994.

TRANSITION is a regular publication of the World Bank's Transition Economies Division, Policy Research 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, tel. (202) 473-6982. Jennifer Prochnow-Walker is the research assistant and desktop publisher. If you wish to receive *Transition*, send name and address to Jennifer Prochnow-Walker, room N-11023X, the World Bank, 1818 H Street NW, Washington, D.C. 20433, or call (202) 473-7466, or fax (202) 522-1152. Information on upcoming conferences on transforming economies, indication of subjects of special interest to our readers, letters to the editor, and any other reader contributions are appreciated.