Managing World Bank Operations in the Balkan Hot Spot—Interview with Country Director Christiaan J. Poortman

Country Director Christiaan J. Poortman is responsible for World Bank operations in Albania, Bosnia-Herzegovina, Kosovo, FR Yugoslavia, and Macedonia, a region that is considered one of the most dangerous hot spots in the world. What are the strategic priorities of the Bank considering its limited resources? How can the Bank contribute to peace and stability in this area? These were some of the issues discussed with Transition Editor Richard Hirschler in the following interview.

Q. Does the Bank have a regional policy for this area, or do you deal with the individual countries separately?

A. As you know, we are providing loans on a country by country basis; individual country programs are the focus of our work. But we are trying to follow a more coordinated, regional strategy, especially since the crisis in Kosovo. We increasingly collaborate with Andrew Vorkink, Country Director in charge of operations in Bulgaria, Croatia, and Romania, on a regional approach. So, for example, under a Trade and Transport Facilitation Project, we provide similar loans or credits to Albania, Bosnia-Herzegovina, Bulgaria, Croatia, FYR Macedonia, and Romania to update customs administrations and improve

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The Virtual Economy and Economic Recovery in Russia

by Clifford G. Gaddy and Barry W. Ickes

Clifford Gaddy and Barry Ickes coined the term "virtual economy" to describe the complex relation between the barter and cash sectors of the Russian economy. This relation exists, they argue, because unprofitable enterprises seek to protect their value-destroying activity. In an article published in Transition Newsletter (Vol. 9, No.4, August 1998) and in more detail in Foreign Affairs (Vol. 77, No. 5, September/October 1998), they explain Russia's economic crisis in terms of the virtual economy. Now that Russia is showing signs of recovery, is the virtual economy shrinking? Is this model still a useful one for analyzing the Russian economic situation?

Russia is in the midst of an economic recovery. GDP is growing for the first time since transition began. Signs of improvement appear widespread. Immediately after the financial collapse of August 1998, the future of the economy was spoken of in apocalyptic terms. More recently, optimism has returned. One recent evaluation asserts that the "current performance of Russia's macroeconomy could not be more impressive." Since the crisis, it is argued, there has been "a positive reversal in all the indicators of the so-called 'virtual' economy." The question then arises whether the virtual economy model remains applicable to Russia.

We argue that the answer is "yes." The virtual economy hypothesis remains the best way to understand current economic developments. The recent performance of the Russian economy does not pose a puzzle for the virtual economy hypothesis but is fully

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border control, and thus promote trade flows across the borders in Southeast Europe.

Our regional approach is coordinated with the Balkans Stability Pact, signed by countries of the region and the international community after the Kosovo crisis. The Bank, together with the European Commission, is charged with coordinating development assistance to the area. Last year the Bank produced a regional strategy paper, "The Road to Stability and Prosperity in South Eastern Europe," which served as a background document at the first Regional Balkans Donor Conference (see box). So we are increasingly looking at the regional dimensions of our country assistance programs.

Q. If implemented, the strategy will radically change the political and economic landscape of the Balkans. But recent events in Macedonia remind us that the region can easily become destabilized, that ethnic conflicts can erupt with frightening force. What are the chances that the Stabilization Pact holds?

A. This being the Balkans, we cannot plan with certainty. After Milosevic was overthrown and a democratic Yugoslavia emerged, it seemed finally that regional integration could become a reality. But this optimism is being overshadowed by the crisis in Macedonia, which erupted so quickly and unexpectedly. We are also facing new problems in Bosnia-Herzegovina, where Croats threaten to create their own entity. A split between Montenegro and Serbia also is a distinct possibility.

We still hope that economic development and greater political stability will elevate these countries to a higher plateau, where conflict is increasingly seen as the wrong way to resolve issues. Significantly, these countries aspire more than anything else to get closer to Europe. The European Commission has indicated a path toward eventual integration into the European Union—the path of collaboration and coordination among the Balkan countries—and the Bank is helping that process along.

Q. Certainly, but as you were pointing out, ethnic hostilities can rise to the surface quite unexpectedly, upsetting ambitious reconstruction and development plans, as is happening right now in Macedonia.

A. These conflicts will continue to be a problem and a challenge. Economic development, poverty alleviation, and across the board income generation will certainly contribute to stability and peace among the various ethnic groups, but we are also dealing here with political issues, vested interests, and criminality. In Macedonia, for example, the Albanian minority complains about being treated as second-class citizens—in the political but also frequently in the economic sense. The Macedonian government, in which the Albanians are also represented—has been trying to address that concern.

Q. They are certainly racing against time. Aided by the World Bank, the reconstruction of Kosovo is making impressive progress, but its economy is run by foreign experts. Locals are not involved in a substantive way in the work of the "fiscal authority" or the "monetary authority," as the Ministry of Finance and the National Bank are called in this territory.

A. This is the result of the United Nations Security Council resolution that created UNMIK, the Interim Administration Mission in Kosovo. It is Special Representative of the U.N. Secretary General who has ultimate authority. But UNMIK's administrative departments, which are analogous to ministries in a national administration, are headed jointly by international civil servants and local officials. A joint interim council has been set up in which both Albanians and Serbs are represented. This is an advisory council, it lacks executive power, but it reviews a wide range of issues.

At the beginning of this year Kosovo held municipal local elections, which went well. Local people now represent the population at the local level. The next step may be elections for an assembly with delegated responsibilities. The recent donor conference underlined the need to train local Kosovars, give them more responsibility, and make sure that they are ready to assume administrative duties. Part of our
program is focused on building up local capacities, so that Kosovars can one day manage the economy themselves, whatever political settlement is reached.

Q. So, you have no clue about the political future of Kosovo?

A. No, and that is not my business either. But it would be useful to get some clarity, because political developments affect the environment for economic development, too. Uncertainty and insecurity do not create a good climate for private investment. This is the greatest handicap the region faces.

Q. Yugoslavia's membership in the IMF, and the European Bank for Reconstruction and Development (EBRD) has been established, but its World Bank membership is still not settled.

A. Although FR Yugoslavia is not yet a member of the Bank that does not mean that we are not very active there. The Bank’s Board recently approved a $30 million Trust Fund to provide grants to Yugoslavia. We will commit that Trust Fund very quickly to bridge the period between now and the time membership be established and we are up and running with the regular program. In addition, together with the European Union, the Bank co-chaired the first donor conference on supporting FR Yugoslavia. We are also working with the authorities on a major medium-term structural reform program, which will be submitted to the donor conference to be held sometime in May or June. Membership is a complicated issue, because of Yugoslavia's arrears. Arrears to the IMF were relatively small ($150 million) and were financed with a bridge loan. Yugoslavia’s debt to the Bank is much larger ($1.7 billion). So we have to work out an arrears clearance plan, which is not easy. All this takes considerable time. But we are making good progress and intend to take the membership recommendation to the Board next month. It was easy for Yugoslavia to join the EBRD, as it had no

The Road to Stability and Prosperity in Southeastern Europe—A Regional Strategy Paper

The Southeast European region—Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Federal Republic of Yugoslavia, the former Yugoslav Republic of Macedonia, and Romania—is a diverse region of 56 million people. Per capita income in the region is about US$2,200—roughly half the income level of five Central European countries. As a region, these economies have recovered only 75 percent of their pretransition income levels. In the past several years, growth has declined in aggregate, increasing the gap between these economies and the rest of Europe. Living standards have deteriorated, as evidenced by higher poverty, inequality, and unemployment.

The poor economic performance can be attributed to four sets of factors:

- Adverse initial conditions (unbalanced industrial structures, weak institutions, and fragmented civil societies) at the onset of the transition.
- War, civil strife, and ethnic conflict.
- Inconsistent macroeconomic stabilization policies.
- Weak structural reform policies and lagging progress in trade liberalization, privatization, enterprise reform, competition policies and financial sector development, and institutional, social, and environmental policies.

A credible and predictable path should be established to integrate all countries in the region with European and global structures, particularly those of the European Union. The international community must provide financial, technical, and political support. Four broad thrusts for action are designed to help achieve peace, stability, and prosperity in the region:

- Move rapidly toward trade integration with the European Union and within the Southeast European region itself, creating a stable, transparent, and nondiscriminatory environment for private sector development.
- Foster social inclusion and social change within the region to reduce tensions and create the conditions for peace and stability (the region has about 1.7 million refugees or internally displaced people).
- Improve institutional capacity and governance structures and strengthen anti-corruption efforts in the region, through greater transparency and accountability in the functioning of state institutions; better internal controls, including auditing and financial management; a reduction in administrative discretion; and greater participation and oversight from civil society.
- Invest in regional infrastructure, including initiatives that safeguard the environment, to integrate the region physically with the rest of Europe.

arrears there. Arrears with the European Investment Bank have not been cleared yet.

Q. You outlined three major areas where the Bank is involved in Kosovo: building institutions, strengthening the private sector, and helping the poor. Are these also the priorities of the Bank’s strategy elsewhere in the region?

A. Yes. We need in particular to support the private sector in the region, creating favorable conditions for private investment, bringing in foreign investors. The conflict in Macedonia could not have come at a worse time: it can destroy the investment climate that was built up in that country over the past 10 years. Macedonians were introducing the right macroeconomic policies, but for a long time investors were absent and the economy stagnated. Later things started to look better. The country was settling its differences with Greece, investors became interested in Macedonia, and the economy started to expand. And then came this crisis, which can harm not only the Macedonian economy but the region as a whole. For example, the tourist industry in Croatia is hoping for another bumper year on the Adriatic, but if the armed conflict drags on, there may be fewer visitors.

Q. Even without conflicts, the governments in the region are pressed hard by the transitional recession: the postsocialist economies must adjust to a free-market economy, which means, at least in the early phases, shrinking GNP, cutting back on living standards, and accepting price hikes and increased unemployment. This can easily turn societies against their governments. Is the Bank ready to adapt its strategy to these realities? How will it be able to help defuse the escalating social conflict?

A. Very much in the same way it has in other countries. We are combining our investment operations with social programs for the truly needy and vulnerable, while promoting new job creation. It is also important to help micro, small, and medium-size enterprises. We have introduced in the region some extremely successful small and microenterprise projects, but obviously it takes some time before they start to have major effects. Privatization often fails to bring about the desired employment creation and economic growth. Many state enterprises have been stripped of their assets and are in need of radical restructuring, including downsizing their labor force. They require new investment. New private investment is really the key to accelerated development, because that is eventually where the strong supply response is going to come from, which will generate the employment that is so badly needed to deal with these social problems.

Q. There are heated discussions within and outside the Bank about its future role, all underscored by budget cuts and staff downsizing. In Southeast Europe, however, the Bank has responsibilities to maintain if not increase its activities. Will you be allocated more funds to use in Southeast Europe?

A. The short answer is no. Of course, the Bank will continue to be involved in these countries, where per capita income is in the lower range. Most of the countries are IDA recipients, but the pool of IDA money we can offer is limited. On the other hand, many of these countries are only gradually becoming creditworthy, so the amount of IBRD loans we can offer them is relatively small. They also have problems of how to absorb reasonably the borrowed money. Macedonia, beginning this July, will "graduate" and receive only IBRD loans. As a result, none of them may be able to borrow as much as they did earlier. Kosovo might receive more, and new lending is expected to FR Yugoslavia. To sum up, with the exception of FR Yugoslavia, there won’t be dramatic changes in our level of total lending.

Q. So, you have to manage operations with limited resources. What will be your priorities be in the next couple of months?

A. First of all, in all these countries—Albania, Bosnia-Herzegovina, Macedonia, and potentially Yugoslavia—we are going to work more intensively with the governments on poverty-reduction strategies. We will continue with private sector development and public resource management. We will assist capacity-building in Kosovo and support private sector expansion in Macedonia and Bosnia—Herzegovina. In Albania we will finance relatively more infrastructure investment. We continue to provide budgetary support through adjustment operations. In all of these countries operations reflect a change in the Bank’s overall activity: we are gradually reducing our infrastructure investment and moving increasingly toward a radical approach on poverty alleviation.

Permissive Tax Measures

"I can proudly announce the new tax relief, for example no flogging this year."

From the Hungarian magazine Hócipő
Latvia’s Dilemma: Financing Accession Costs While Maintaining Fiscal Constraint

by Inna Steinbuka

Latvia places high priority on joining the EU and participating in the Economic and Monetary Union soon after accession. Through monitored programs, the Fund assists the Latvian authorities in meeting some of the most difficult targets in order to comply with the Copenhagen and Maastricht economic criteria. Coordination and consistency between the Fund and the European Commission are lacking, however, because of the different and even conflicting mandates of the two institutions.

Since the start of transition in Latvia, the IMF has been the main agency supporting macroeconomic stabilization, while increasingly helping implement “transition packages” on the structural front. When Latvia applied for EU membership (in 1995), and particularly after the Helsinki Summit approved Latvia as a candidate for EU membership (in December 1999), the Fund’s programs became an integral part of the EU accession strategy.

By carrying out successive economic programs endorsed by the Fund and supported by its stand-by arrangements, Latvia was able to accelerate the accession process and the convergence with EU member states. (Stand-by arrangements are IMF credits that finance temporary balance of payments deficits of member countries and must be repaid within 3 1/4-5 years.) The new program, under a “precautionary” stand-by arrangement for 2000-01, seemed to be consistent with the accession strategy. (The arrangement is considered “precautionary” because the money is available, but the Latvian authorities are not supposed to use it, only in case of a crisis.) However, Latvian policymakers realize that they face a rather difficult tradeoff between the extra budgetary spending implicitly required by the EC for EU membership and the tight fiscal policies required by the Fund.

The IMF Insists on Tight Fiscal Policies...

Fear that high current account deficits leave the Baltic countries vulnerable to external shocks is the key reason why the Fund requires tight fiscal policies in all of these countries. Although the outlook for Latvia’s external sector has improved since 1998 (table 1), the current account deficit remains relatively large. Current improvement probably cannot be sustained in light of the expected acceleration in domestic demand. Latvia exports low value-added items, such as food products, textiles, and wood, while importing high value-added products, such as transport equipment and electronics. The need for imported capital equipment to modernize industrial production is likely to grow rather than diminish, as will demand for oil and gas. As a result, the current account deficit is likely to increase.

In the past decade, the current account deficit was comfortably covered by foreign direct investment. This trend continued in the first three quarters of 2000, despite delays in large-scale privatization. Ensuring external sustainability remains one of the key challenges over the medium term.

Table 1. Current Account Balances in the Baltics, 1996–2001 (percent of GDP)

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<tbody>
<tr>
<td>Estonia</td>
<td>-9.2</td>
<td>-12.1</td>
<td>-9.2</td>
<td>-6.2</td>
<td>-6.5</td>
<td>-6.5</td>
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<tr>
<td>Latvia</td>
<td>-4.2</td>
<td>-5.1</td>
<td>-9.8</td>
<td>-9.7</td>
<td>-7.2</td>
<td>-6.3</td>
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<tr>
<td>Lithuania</td>
<td>-9.1</td>
<td>-10.2</td>
<td>-12.1</td>
<td>-11.2</td>
<td>-6.9</td>
<td>-6.7</td>
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* IMF projections.
Source: International Monetary Fund.

There, however, modest overshooting of the target reflected the ongoing recession and the impressive reduction of the current account deficit. In contrast, in Latvia the economy is expanding rapidly, thus fueling imports, and the difference between the actual and the target fiscal deficit was larger than in Lithuania. In Estonia, where economic prospects look good, the government did not request a new arrangement with the IMF after the successful completion of its last program, in 2000. By early 2001 Lithuania was the only Baltic country that had an economic program supported by an IMF precautionary stand-by arrangement.

The Latvian government is now ready for a new 20-month program, which it expects the IMF to support. The new program includes the typical medicines used to com-
Table 2. Consolidated Fiscal Balances in the Baltics, 1996–2001
(percent of GDP)

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<tr>
<td>Estonia</td>
<td>-1.6</td>
<td>2.2</td>
<td>-0.3</td>
<td>-4.7</td>
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<tr>
<td>Latvia</td>
<td>-1.8</td>
<td>0.3</td>
<td>-0.8</td>
<td>-4.2</td>
<td>-1.9</td>
<td>-3.5</td>
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<tr>
<td>Lithuania</td>
<td>-4.5</td>
<td>-1.8</td>
<td>-5.9</td>
<td>-8.5</td>
<td>-2.8</td>
<td>-3.3</td>
</tr>
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* Precautionary Stand-by Arrangement.

Source: International Monetary Fund.

but an increase in external imbalance and potential pressure on local currencies: tightening of fiscal policies and accelerating structural reforms.

... While the European Commission Requires New Spending

The European Commission (EC) requirements and guidelines for macroeconomic and structural reforms are addressed in the "Joint Assessment of Economic Policy Priorities," prepared jointly by the EC and the Latvian government. This document is generally consistent with the Fund-supported programs. Three differences are noteworthy, however. First, the joint assessment is aimed at medium-term priorities, while the Fund programs focus on near-term objectives. Second, the Fund-supported program clearly lays out the government's responsibilities and provides a timetable for full and timely implementation. It is more specific than the EC-Latvia Assessment, which allows the authorities flexibility in selecting and adjusting their policy mix in order to achieve the medium-term priorities. This document thus provides a framework for dialogue between the Latvian authorities and the EC rather than specifying a set of policies. Third, implementation of Fund-supported programs is well monitored through a set of quantitative performance criteria, indicative targets, and structural benchmarks. In contrast, compliance with the accession strategy is monitored by the government and EC staff.

The EC's "Progress Report on Latvia," which evaluates Latvia's ability to assume the obligations of EU membership, presents an overall assessment of the chapters on the acquis communautaire. That implicitly imposes some potential pressure on Latvia's fiscal position, because it requires that Latvia adopt EU environmental and other standards. Some experts estimate that the extra spending requirements for EU accession may be as high as 5 percent of GDP for several years in all candidate countries. The EC Office estimates that the costs of meeting environmental requirements alone could amount to 2–5 percent of GDP a year. EU transfers to Latvia to finance at least part of such spending could be somewhat above 1 percent of GDP in 2001, at best these transfers would rise only modestly over the medium term.

Financing these costs under the tight fiscal framework will be difficult for Latvia. The only sensible way to do so is to improve prioritization and management of public spending.

The preparation of a Pre-Accession Economic Program has already helped policymakers focus on medium-term budgetary targets. In the years to come, however, the Latvian government will have to handle the difficult tradeoff between fiscal discipline and extra spending.

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**Nightmare**

...And then, in my dream the world becomes one huge experimental lab and I turned to a plain human resource...

From the Hungarian magazine Hőcipő
The World Bank Is Not Giving Up on Middle-Income Countries
by James D. Wolfensohn

In a speech given in Berlin in April, World Bank President James D. Wolfensohn confirmed that “the Bank is not turning its back on the middle-income countries.” He responded to critics (see box) who would like to see the Bank play a smaller role in international development.

How can we further sharpen our focus on poverty and maximize the catalytic role we can play in the development community? In January this year, we discussed with our shareholders a Strategic Framework for how we will carry reform forward over the next few years. Underscoring that agenda are five fundamental ideas that we are operationalizing in all our work:

- The Bank must retain a global competence and a global diagnostic capacity. But we want to see more selectivity and a much better division of labor among all the players—international institutions, the United Nations, bilateral donors, NGOs, and the private sector.
- We must focus to help achieve the International Development Goals [that envisage] reducing by half the proportion of people living in extreme poverty by 2015; a two-thirds decline in infant and under-five mortality and a three-fourths decline in maternal mortality; universal primary education for all by 2015; gender equality in education by 2005; national strategies for sustainable development by 2005; and ensuring that the current loss of environmental resources is reversed globally and nationally by 2015.
- We must focus on two areas in particular: building the climate for investment, jobs, and sustainable growth; and empowering poor people to participate in development. Development must be done by them and with them, not to them.
- Development must be country owned and country driven.
- We must embrace all the players [in the development world]: civil society, including NGOs, foundations, universities and research institutions, and faith-based community groups; the private sector; bilaterals; the other multilaterals; and governments and their parliaments.

Creating an Investment-Friendly Milieu in Low-Income Countries

[In low-income countries] the Bank has a crucial role to play in working with governments to put in place good and strong governance, effective legal and judicial systems, and a robust financial system and to assist in the fight against corruption. Without these initiatives it will be impossible for countries to attract foreign and domestic private investment, which are so crucial as engines of growth and poverty reduction.

We need to continue our work in the rural sector, home to 70 percent of the poorest. We need to help put in place safety nets for the vulnerable and work with governments to focus on education, health, and nutrition. We need to step up the fight against AIDS, malaria, and TB and work with governments to meet their basic infrastructure needs: clean potable water, sanitation, power, communications, roads, and telecommunications systems.

We will push ahead with streamlining conditionality, focusing more on outcomes and less on itemizing what steps a government must take to reach them. We know that no amount of conditions can replace domestic commitment to reform. A new instrument, the Poverty Reduction Support Credit, by focusing on programmatic lending, will reduce conditionality.

Remaining Engaged in Middle-Income Countries

We need to remain engaged in middle-income countries. Eighty percent of the world’s poor live in middle-income countries. Let there be no mistake: we are not about to turn our back on them. Not only are these countries important for global financial stability, but many of them have yet to put in place crucial structural and social reforms that will move them to the next stage of development.

At the request of our Board, we are reviewing our plans dealing with the scope and nature of our support and the principles of costing of services. We do not intend to replace sources of funding available from private markets. The economic well-being of the middle-income countries can translate into trade opportunities for low-income countries; on the other hand, financial instability, environmental degradation, and the proliferation of communicable diseases can have deleterious effects far outside [these countries’] own borders.

The Bank's engagement will be focused on providing secure long-term funding and advisory services, creating the right policy and institutional framework, addressing weaknesses in social, structural, and sectoral policies and institutions. With its global reach, broad sectoral knowledge, and specific engagement with the private sector through the International Finance
Clipping the World Bank’s Wings: A Critic Speaks Out

The World Bank has become in large part superfluous. That may sound provocative, but it is accurate. Demand for World Bank long-term investment loans and policy-based lending in middle-income countries is diminishing, as developing countries gain increasing direct access to capital markets and receive foreign direct investment.

In fact, only aid to poor countries, which the Bank administers through its International Development Association (IDA), the body that provides long-term loans at below-market interest to the poorest countries, remains in high demand. But aid by itself is failing to affect growth and poverty in recipient countries. The Bank needs to adapt to changing circumstances. Yet it seems to be doing the opposite. Indeed, it is fighting to keep up both its lending and aid, while not doing enough to sponsor sound development policies.

Private net flows to middle-income countries have increased enormously. In the past 10 years, about 40 out of the 60 middle-income World Bank borrowers received on average net private lending and investments equivalent to at least 3 per cent of their gross national product per year. For 25 of the borrowers, annual private capital inflows exceeded 5 per cent of GNP. Net private flows to all middle-income countries were on average equivalent to 4 per cent of GNP. World Bank net flows were 40 times smaller. The Bank obtained these underwhelming results in spite of pushing loans in noncore areas and mixing loans at market terms with aid for some countries that already had ample access to foreign capital. China, for example, became the largest World Bank borrower in the 1990s.

The Bank also continued to administer aid in the guise of investments to countries unable to use it effectively. This is either the result of the recipient countries’ incompetence and corruption or because of their poor domestic policy environments.

Much of this transfer of resources was done under the banner of “fighting poverty” or pursuing other worthwhile social objectives. But the results have been disheartening. The knowledge that providing aid is futile where good policies and good government are not in place did not make much difference, even though the Bank’s own research had confirmed this.

To deflect public attention from these failures, the Bank resorted to sponsored debt forgiveness for the most indebted poor countries—often also the most profligate and incompetent of them. In doing so, it advocated a policy that has never been shown to exert positive growth effects.

Financial intermediation is, in fact, being performed by private capital markets, and where they do not yet reach far enough, it could be done by existing regional development banks. In this respect the World Bank could become expendable. But the Bank still has a useful and unique role to perform: encouraging the right development policies and transferring the right development knowledge are functions that cannot easily be shifted to other existing public institutions or market mechanisms.

The Bank’s big shareholders, starting with the U.S., should keep this in mind when they re-examine the strategic functions of the Bank, a task that cannot be delayed. The World Bank’s overarching aim is the pursuit of economic growth where conditions for it are not yet present and market reach is not wide enough. It should, therefore, focus its future lending activities in low-income and lower middle-income countries not yet capable of accessing capital markets and external technology on their own.

In countries without sound macroeconomic policies, establishing them should be the priority. Lending for balance of payments purposes should be left to the International Monetary Fund. In addition, IDA should make passable governance and accountability in the use of resources and actual performance indispensable conditions for the continued supply of aid to poor countries. The objectives pursued should be strictly economic and developmental. Bank engagements in noneconomic areas should be stopped.

A smaller and more effective organization would emerge from all this. The alternative is to let the World Bank gradually become just another aid lobby, indistinguishable from any other international lobby or pressure group. This would hardly be a valid raison d’être for a Bretton Woods institution.

Enzo Grilli is professor of international economics at the Paul Nitze School of Advanced International Studies, Johns Hopkins University. This article appeared in the Financial Times in mid-April.
Understanding the Communist Election Victory in Moldova

by Arcadie Barbarosie

After almost 10 years of reform, parliamentary elections in Moldova ended with a landslide victory by the Communist Party in February. The Communists now have a comfortable majority, permitting them to make any decision, including modifying the Constitution. In April the chairman of the Communist Party, Vladimir Voronin, was elected Moldova’s third president.

With almost 51 percent of the popular vote, the Communist Party won 71 seats in the Parliament. The remaining 30 seats are shared by the Popular Christian Democratic Party, a far-right party favoring integration with Romania, which holds 11 seats, and the Bragis Alliance, an ad hoc amalgamation of small and almost unknown parties and movements headed by former Prime Minister Dumitru Bragis, which has 19 seats. (The high threshold of 6 percent needed to win a seat in Parliament prevented any of the other 14 parties and movements from winning representation in the Parliament.) Election turnout was high (69 percent), and international observers confirmed that voting took place in a democratic, free way, with no fraud reported.

Poor Economic Performance

Moldova’s economy did not improve during the transition years (see table), and the conditions for economic growth were not created. Instead, real GDP in 1999 shrank to 33.7 percent of the 1990 level. As the Wall Street Journal put it, “Moldova’s improvised, political and managerial classes failed to pursue market reforms with any consistency. That failure led to economic collapse and general pauperization, which the electorate perceived to be consequences of market economics, not of the absence thereof.”

Widespread Poverty

Ninety percent of the population in Moldova—some 4.5 million people—live on less than $1 a day. About 80 percent of the population live on less than $20 (233 lei) a month—that is, below the subsistence level—according to the Moldovan Department of Statistical and Sociological Analysis. The average salary covers only 40 percent of the minimum consumer basket. Increases in nominal wages have lagged behind the inflation rate, causing living standards to drop significantly. During eight years of transition, real income per capita also fell sharply. Salaries are not only low, they are also not paid on time: arrears by enterprises and state organizations constitute more than 381 million lei in February 2001.

Income inequality has also grown. The income of the top 20 percent of the population is more than 11 times that of the bottom 20 percent, and the Gini coefficient is 0.44, indicating a high level of income inequality. (A country with a Gini coefficient of more than 0.35 is generally considered to have a high level of income polarization.) Most of the country’s 800,000 pensioners are socially marginalized, and their average monthly pension of 82 lei ($7) puts them under the poverty level. No wonder a large majority of pensioners voted for the Communist Party.

The continuing deterioration of the quality of life and the impoverishment of the

The World Bank Carries On in Moldova

“Regardless of the election results, the World Bank is ready to help Moldova’s reform efforts while paying strong attention to institutional factors. We will engage the new authorities in a policy dialogue,” said Carlos Elbirt, the Bank’s Resident Representative in Chisinau. In contributing to the government’s Poverty Reduction Strategy, the Bank will continue to emphasize:

• Modernizing the public sector through management reform.
• Promoting legal and judicial reform to improve the investment climate and reduce corruption.
• Privatizing energy, telecommunications, and commercial activities, such as wineries, in a competitive manner.
• Improving efficiency in education through training, curriculum development.
• Providing basic health services.

Since Moldova joined the World Bank in 1992, the Bank has approved 14 projects totaling about $394 million.

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TRANSITION, February-March 2001
population seriously diminish the social basis for further reforms. As recent public opinion polls show, 80 percent of the public believe the country is heading in the wrong direction. The majority of the population—some 70-90 percent—think that before 1991 (the year Moldova gained independence) the quality of governance, social protection, living standards, and even respect for human rights and liberties were better or much better than they are today.

**Missed Transition Targets**

Transition proved to be a much more complex and dramatic process than policymakers had expected. The government’s “Program of Transition to a Regulated Market Economy,” approved by Parliament in 1990, was supposed to create the framework for developing a market economy and a democratic society in a matter of a year and a half or two years. It is now clear that it was naive to assume that society could change that rapidly.

Despite creating the legal and institutional framework for a market economy, reform in Moldova did not achieve the government’s declared goals. The populist voucher privatization process, which sought to give all Moldovans a chance to become “capitalists,” did not improve corporate management or attract real investments in the privatized companies.

Industry in the former Soviet Republic of Moldova was oriented toward Soviet military needs; the dissolution of the Soviet Union was not followed by an efficient conversion program of military-oriented enterprises. Prolonged state control of enterprises in key industries (energy, tobacco, and wine) led to the rapid deterioration of their balance sheets. Delaying privatization presumably gave state managers enough time to strip these companies of their assets. The foreign loans and grants for supporting structural reforms were used mostly for consumption; total government debt increased to 135 percent of GDP.

**Inefficient Agriculture**

Reforms in the agriculture sector were intended to change land ownership and implicitly to increase the efficiency of land use. The first step has almost been completed: 75 percent of agricultural land concentrated in 989 large collective farms has been distributed to some 800,000 farmers. But the measure did not increase efficiency, as it is impossible to create an efficient agricultural sector based on farms of one or two hectares. Consolidating small parcels into larger farms on a voluntary basis has only just begun.

Ethnic and linguistic differences in voting habits are clear from the results of the last election, in which the Communist Party gained the support of 80 percent of Bulgarians, 63 percent of Ukrainians, 58 percent of Russians, and only 27 percent of Moldovans/Romanians.

**Campaign Promises**

The economic and social situation in Moldova is so difficult that the new government will have little room for maneuvering. The new government’s top priorities are to transform institutions that remain serious impediments to economic growth and to settle the Transnistria conflict. (This breakaway territory with a large Russian population enjoyed Moscow’s backing throughout the 1990s. A settlement is now more likely as Moldova’s new parliamentary majority appears prepared to accept federalization and grant Russia the status of a state language in exchange for closer economic ties with the CIS.) The new government will also have to deal with fighting corruption, reducing tax evasion, shrinking the size of the shadow economy (equal to some 60 percent of official GDP), creating a stable legal environment for business, and consolidating the fiscal budget.

These efforts are more or less consistent with the Communists’ electoral program; other necessary reforms are not. Key tobacco, wine, energy, and telecommunication enterprises need to be privatized, for example. Agrarian reforms that will help create a market-oriented agricultural sector—such as developing the land market and establishing independent commodity exchanges—must also be undertaken.

**Pragmatism Prevails?**

Several commitments made during the Communists’ electoral campaign could have severe negative consequences if fulfilled. One example is the promise to redraw the administrative districts by reintroducing the old rayons. Increasing pension payments and subsidies to energy, public transportation, and other goods and services would put tremendous pressure on the budget. Joining the Russia-Belarus Union could escalate social and interethnic tensions.

Will the Communist Party insist on implementing its pre-electoral program, or is the party pragmatic enough not to commit itself to a counterproductive antireform policy? Only the future will tell.
Meeting the Challenge of Globalization in China
by Chi Fulin

Globalization is exerting great pressure on Chinese policymakers to make fundamental changes to the administrative system, accelerate enterprise reform, and open up the financial system to foreign competition. Accession to the World Trade Organization (WTO) has brought economic reform in China to a critical stage. Further progress will require deep structural changes and an acceleration of the process toward a market-oriented economy.

WTO membership will further integrate China into the world economy, enabling it to participate in setting the rules of international trade, not just standing on the sidelines. It will also force China to gradually reduce tariffs in the next five years and open up its finance, insurance, telecommunications, accounting, consulting, and tourism sectors to foreign competitors. This schedule lends particular urgency to reform efforts. The government will have to further relax control of the economy, including restrictions on foreign trade and investment. At the same time, it will have to enact new laws and regulations and establish new rules. China’s many years of central planning preserved too many direct and arbitrary interventions, which still restrict many economic activities. The institutions needed to promote the enactment and implementation of new rules that have been lacking. Accelerating the reform of government agencies and their operations will thus be very important.

Recession Can Be Prevented in China

Some $4.6 billion in foreign direct investment has poured into China in the first three months of 2001, a 24 percent increase over the same period a year ago. The doors to sectors once closed to foreign investment have been thrown open. Contracted FDI skyrocketed a year-on-year 47.1 percent since January, indicating that foreigners will probably increase their investments in China.

China’s export industries have ceased to contribute to gross domestic product since late last year. Industrial output has slowed along with exports, a trend that is likely to continue in the coming months. A malfunctioning financial system is also constraining demand by distorting the allocation of capital for investment and consumer spending. Moreover, narrow growth of the money supply, a leading indicator of spending, has decelerated.

China’s policymakers, however, are aware of these drags on the economy, and are thus unlikely to commit any major policy errors, like Japan did in August 2000 by tightening up liquidity prematurely. Their concerns about inflation will prove unnecessary, since rising competition and structural changes will continue to curb any pressure on prices.

A significant loss of consumer confidence also seems unlikely, since the government appears determined to prevent the economy from faltering in the run-up to the change in leadership in the second half of 2002. Beijing has planned yet another $18 billion fiscal stimulus package and wants to hike wages and unemployment benefits for more than 100 million unemployed workers to help reduce any friction exacerbated by economic restructuring this year.

Such domestic dynamics point to continuing albeit constrained growth. Retail sales have recovered on the back of a slowdown in the growth of household saving deposits. This suggests improving consumer confidence, as households save less and spend more. The dampening of China’s high savings rate appears to have been affected by successive interest rate cuts and a new tax on interest-bearing deposits levied in November. Consumer spending, which accounts for half of the economy, is likely to remain strong.

Deflation has ended; consumer prices are rising at an annual rate of 1.2 percent. This is in sharp contrast to the falling price of exports, which is contracting at an annual rate of more than 1 percent. This price divergence suggests that the domestic sector remains relatively resilient. Consumption is growing at more than 9 percent annually, stronger than the 3 percent growth in the U.S. Domestic sector growth and supportive macroeconomic policy thus should prevent a recession.

the WTO requirement to gradually remove nontariff barriers means that China will become more dependent on indirect regulatory means of controlling the balance of payments (monetary, fiscal, and exchange rate policies). To respond to these challenges, Chinese policymakers will need to take several steps immediately.

**Develop the Rural Economy and Improve Farmers’ Living Standard**

The lack of a well-functioning social security system and a rational income distribution system are lowering public expectations as to the benefits of reform. Increased unemployment has led to new social problems. Corruption should be eliminated at its roots, but administrative control over resource allocation and the lack of an effective supervision mechanisms make doing so difficult.

**Separate Government from Enterprises**

Administrative interventions by party organizations and government agencies endanger sound corporate governance. Reorganization of the state sector according to market principles requires several steps:

- Large and medium-size manufacturing enterprises should be converted into joint stock companies.
- The conversion of public service sector companies in the telecommunications, railway, civil aviation, and electricity sectors into joint stock companies should be accelerated. Reforms that promote investment and financing on commercial terms, eliminate excessive concentration, break up monopolies, absorb nonstate and social capital, and encourage competition should also be implemented.
- State-owned commercial banks should be restructured. This reform will have a major impact on the entire economy. Opening up the financial sector and adopting market-oriented interest rates is also urgent.

**Develop the Nonstate (Private) Economy**

Private investment in China failed to reach the desired level in the past two years, despite the government's expansionary policy. Institutional barriers should be eliminated and legal protection extended to nonstate enterprises, including private property. Barriers to market access must be eliminated, financial support to private enterprises increased, and investment of private capital in the financial sector promoted.

**Expand Social Policy Reform**

Policymakers need to address at least four issues:

- Policies need to be implemented to help narrow the huge income disparity among different professional and social groups.
- Individual social security accounts should be introduced, reducing state involvement. Pension reform should be financed through floating special treasury bonds. The government should play a leading role in strengthening the social security system, at the same time encouraging private capital to invest in social security funds.
- Human capital development should become a major focus of structural reform. In a knowledge economy and information age, human capital development is decisive for the competitiveness of a nation.
- Urban development and rural reform should be coordinated. Rural reform—which affects 800 million people in China—is at a critical stage. Farmers need long-term and secure land use rights. In the next 10–20 years, rural reform is expected to help 100–200 million farmers to leave the agricultural sector. To absorb this influx, the process of urbanization needs to be accelerated.

**Proceed with Political Reform**

Economic reform calls for grassroots democracy. Political reform could also help eliminate corruption, which results from rent-seeking, lack of an effective management system for state assets, lack of an effective supervisory system to check power, the way public sector employees are hired and awarded. The relation between the government and the public should correspond to the relation between China's socialist market economy and the people—it major beneficiaries. The wide participation of the public in the reform process could be the most important driving force to stimulate vigor in Chinese society. Such participation requires transparency, a continuous information flow, and accountability of those in positions of leadership. If civil society is well informed and can participate in the decisionmaking process, reform can be carried out even if means temporary belt-tightening.

Reforms will determine China’s future. If successful, they will lead to economic development and social stability and ensure that China enjoys the benefits of globalization.

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From the Moscow based magazine Business in Russia
The Income Gap in China: Rural Areas Need a Lift
by Zhao Manhua

By the end of 1999, China's population exceeded 1.2 billion people, 69 percent of whom live in rural areas. The situation in China's countryside is thus a good indicator of economic development and reform progress in the country as a whole. One important indicator is farmers' income level, which is closely related to their living conditions.

Since 1998 the economic situation in China has changed dramatically. Shortages ended, and there is now an oversupply of most industrial goods. Weak demand has slowed China's economic growth. Given these conditions, farmers' consumption is particularly important for expanding domestic demand and propelling economic growth. With a vast population and low living standards, China's rural areas represent a huge potential market. If farmers' income can be increased, this potential market will play an important role in promoting economic development in China.

Rural-Urban Income Gap Narrows in Early 1980s ...

Since economic reform began in 1978, farmers' living conditions have improved and their income has gradually increased. In 1978 the annual per capita net income of rural households was a mere 134 yuan (1 US$=8.3 yuan). By 1999 it had increased more than 15 times, to 2210 yuan. Despite these improvements, the gap between urban and rural dwellers has grown.

In 1978 the annual per capita income of urban residents was 343 yuan—two and half times the 134 yuan average income of rural residents. This ratio reflects the fact that urban residents enjoyed free medical care, free housing, good education, and convenient amenities—all of which were lacking in the countryside.

In early 1980s the income gap between urban and rural residents narrowed. In 1984 the income ratio dropped to 1.6:1, a historic low that was never repeated thereafter. The gap narrowed because economic reform focused on rural areas and policies were favorable to the agricultural sector. Before reform farmers were worried that they had too little grain to live on. In the mid-1980s, they produced so much grain they worried about the lack of storage capacity. As a consequence, grain producers were able to achieve bumper harvests in a row. By the mid 1980s, agriculture grew at an annual rate of 7 percent. The successful rural reform resulted in a steady and quick increase in rural income, narrowing the income gap.

... But Grows Again as Focus of Reform Shifts to the Cities

Beginning in 1985 the focus of China's economic reform shifted to cities, and the income gap grew. In 1994 the ratio of urban to rural incomes reached a record 2.9:1. In 1999 the gap narrowed slightly to 2.7:1. In the first three quarters of 2000, per capita cash income in rural areas increased 2.5 percent, while income in urban areas rose 8.4 percent, leaving the income gap a little wider than it was in 1978.

The change in income distribution is consistent with the inverted U-shaped curve first put forward by U.S. economist Simon Kuznets in 1955. According to Kuznets, rising inequality in income distribution is inevitable as economic development takes place. When economic development reaches a higher stage, income distribution becomes more equitable. Is Kuznets' hypothesis compatible with China's income distribution? What is the relation between income and development? When is the income gap still reasonable and acceptable?

In 1998 per capita consumption was 1,892 yuan in rural areas and 6,201 yuan in urban areas—a ratio of 3.2:1. Refrigerators and washing machines, which most urban households now own, are still uncommon in the countryside, where only 10 percent of rural families own refrigerators and just 21 percent own washing machines.

Because the profit from agricultural investment is relatively low, many farmers decided to shift their investment out of agriculture, into other more profitable sectors. If this trend continues, grain output in China could drop significantly, possibly forcing China to import grain, thereby weakening the foundation of the economy.

Narrowing the Income Gap through Rural Urbanization

To narrow the income gap between urban and rural areas and improve rural living standards, China should take the following steps:

- **Speed up the development of agricultural production.** Sixty-one percent of farmers' income comes from agriculture. The government should invest more in improving agricultural infrastructure facilities and encourage individual investment in agriculture.

- **Develop nonagricultural sectors in rural areas.** About 39 percent of farmers' income comes from nonagricultural sectors, including agricultural produce processing, commerce, transportation, and services. To promote these sectors, China should accelerate urbanization in rural areas. Rural urbanization can revitalize commerce and services and create a favorable environment for rural enterprises, which have become
major sources of farmers' income in recent years. As rural areas become more urbanized, many unemployed or underemployed people will be able to find jobs, and rural incomes will rise.

- **Deepen rural reforms across the board.** In 1978 China began to put the household responsibility contract system into practice. This system has proved its viability. China is now introducing industrial management in agriculture in order to integrate agricultural production, processing, and marketing. These reforms will make agriculture more commercialized, specialized, and modern, increasing farmers' competitiveness and incomes. At the same time, the government should set up a mechanism that makes transfer of farmland possible, so that production can be adjusted to market demand.

- **Improve other policies that affect the rural economy.** The government should institute a legal system that protects farmers' rights and interest, establishes a rural credit and mortgage system, and takes more active measures to eradicate poverty.

Zhao Manhua is assistant professor at Taiyuan Teacher's University.

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**MIGA Launches Improved Privatization Information Service: www.privatizationlink.com**

by Birgit Braunwieser

The Multilateral Investment Guarantee Agency (MIGA) of the World Bank Group recently launched a new version of PrivatizationLink (www.privatizationlink.com), its free online information service on privatization in emerging markets. The service provides up-to-date, searchable details of upcoming privatization transactions, including profiles of state-owned enterprises being divested and information about the bidding procedures and the environment for foreign investment in the country. In addition to an enhanced search engine on the home page, the new version includes several new features:

- **The practitioners' corner** identifies the staff of privatization agencies and their advisers—the people involved in marketing and structuring transactions. It contains various hands-on learning and networking resources, detailed profiles of companies for sale, and the World Bank's databank of statistics on earlier privatization transactions.

- **The investors' corner** provides information about investment and advisory opportunities, including tender announcements and procurement notices for advisory services. A new option allows users to customize by sector, region, and subject.

- **The best practice section** includes case studies and resources with useful information for privatization practitioners, classified by topics, such as structuring transactions, institutional framework, valuation, foreign participation, and labor, environmental, gender, and postprivatization issues. To promote interaction between privatization practitioners, users can provide ratings and written feedback.

- **Country fact sheets** provide background, institutional framework, status, programs, and outlooks, all related to privatization.

PrivatizationLink lists hundreds of enterprises being offered for sale to domestic and foreign investors. Information is provided by privatization agencies in more than 70 transition economies and developing countries. It also provides links to useful resources, such as sector and business environment analyses from the Investment Promotion Network (www.ipanet.net), MIGA's portal site for international corporate investors, privatization-related news, and overviews of MIGA's guarantee activity.

In addition, the site provides contact information on more than 8,000 privatization professionals and potential investors through a searchable online directory.

Formed in 1988, MIGA is a member of the World Bank Group. Its mandate is to encourage foreign direct investment in transition economies and developing countries by providing political risk insurance against transfer restriction, expropriation, breach of contract, and war and civil disturbance. MIGA also offers capacity building and information dissemination services.

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consistent with it. The real puzzle is why the recovery is so weak relative to the massive change in Russia's external competitiveness. As we show, the recovery occurred because of the exchange rate shock and the rise in world market prices for oil and other resources that Russia exports, not because of any essential change in the behavior of enterprises in Russia. This suggests that although postcrisis developments have given Russia a window of opportunity, this window is likely to close before any serious structural reforms take root.

Depreciation of the Ruble Improves Exporters' Balance Sheets

Understanding the current state of Russia's economy has to begin with an examination of the real devaluation of the ruble that occurred in the wake of the crisis. Thanks to a nominal depreciation that exceeded the ensuing inflation rate, the real value of the ruble at the end of 1998 was only about 36 percent of its immediate precrisis value.

In view of this dramatic real depreciation, it should hardly be surprising that Russia has shown signs of recovery. This exchange rate shock has hugely increased the real value of exports. Hence even without any behavioral changes, the balance sheets of exporters improve significantly.

One important mitigating factor slowing recovery is that the increase in competitiveness has coincided with a dramatic fall in household incomes. This was especially true in 1999, when incomes were roughly 75 percent of the 1995 level. This decrease in real incomes depressed domestic consumption. The increased competitiveness of domestic manufacturing has caused expenditure switching in favor of domestically produced goods, but the extent of this import substitution has been constrained by the decline in real incomes.

Perhaps the more important reason for the limited response to the real depreciation is that the incentives to undertake costly restructuring activities remain weak. Hence enterprises continue to operate as before. Poor quality means that producers are unable to reap the benefits from the huge improvement in their external competitiveness: despite the improvement in the terms of trade, Russian producers are exporting less than they did before the financial crisis.

How can we account for the fact that while Russian unit labor costs (measured in dollars) are still much lower than before the crisis (figure 1), machinery exports (measured in dollars) are below the levels achieved in 1998? One reason is that the real depreciation increased the cost of imported inputs, and the possibilities for import substitution in components for machinery manufactures may be slim—much smaller than in, say, food processing. Machinery producers may thus see their cost advantage dissipate.

There is an ironic paradox here. Consider the plight of enterprises that had invested to improve their competitiveness before the crisis. They may have purchased foreign-made machinery or retooled to be able to use high-quality imported components and materials, incurring dollar-denominated debt to purchase them. Although their efficiency improved, they now face an increased burden to import components and service debt. Were it possible to switch to domestic producers, they would be in a better position. The data on machinery exports suggest differently.

Level of Barter Declines

There has been a significant decline in barter as a share of industrial sales in Russia since the August 1998 crisis. There has also been an increase in tax payments paid in cash. These trends are widely interpreted as a sign of a healthy behavioral change on the part of manufacturers, even as an indication of the demise of the virtual economy.

To understand why these signs may have been misinterpreted, it is important to dispel a common misunderstanding. Barter is not the essence of the virtual economy. The essence of the virtual economy is the transfer of value from value-producing sectors—primarily, but not exclusively, energy and raw materials—to value-destroying sectors. Before the August meltdown, barter was a means of implementing this transfer.

One needs only to think about the effect of the real ruble depreciation on barter to understand what has been happening. The extent to which enterprises use money or barter is an economic decision. Because barter is costly, enterprises used cash for some transactions even when use of barter was at its peak. Enterprises traded off the transactions cost of barter against the cost of using money. (In the current Russian environment, that cost is primarily increased visibility, which implies greater tax liability.) When cash is more plentiful, the margin between using barter and using...
money shifts. Real depreciation thus shifts behavior toward greater use of money. This is a behavioral change, but it does not represent restructuring.

A second effect of the depreciation on barter—one that involves no behavioral change at all—is probably much more important. The depreciation of the ruble increases the size of the export-oriented part of Russia's economy (which is predominantly value adding and cash based) in ruble terms relative to the dinosaur part of the economy (which is largely value subtracting and noncash based). Hence the nonmonetary transactions that are needed to subsidize production at value-destroying enterprises shrink in ruble terms. This does not reduce the cost to the economy of this value transfer, however: the opportunity cost of the transfer rises with the increased profitability of exports.

Real depreciation will necessarily reduce the dollar value of the value-destroying sector. Think of it this way: a large enough ruble depreciation would shrink the dollar value of the virtual economy to zero. But that would still not end value-destruction as long as the industries responsible continue to operate. If there is no behavioral change, resources are still being destroyed.

Understanding the Relationship between Growth and Remonetization: A Simple Accounting Example

The fact that a large real depreciation can make economic performance look strong without any change in behavior is a rather simple point, yet it seems to be lost amid the glowing statistics. A simple accounting example can illustrate just how this phenomenon works.

Imagine an economy (which we call a "pre-August" economy) that appears in terms of the recorded value of output or sales to be half barter and half monetized. Assume, too, that the monetized sector is itself composed of two equal parts: one part sells to export markets (for dollars), the other sells domestically (for rubles). The barter sector is exclusively domestic. Say that total output in the economy is 100 rubles at official prices. This means that the breakdown between the sectors is as shown in table 1.

Let us now subject this economy to an "August 17"-like event. That is, we devalue the ruble against the dollar by a factor of four and let domestic prices double. This means that the cash export sector's output is now worth 100 rubles instead of 25, the domestic cash sector's sales are priced at 50 rubles instead of 25, and the barter sector's recorded sales are 100 rubles instead of 50. Table 2 shows the new ruble values and the percentage of the total economy that each sector now represents.

Finally, let us deflate these values to account for inflation, using a deflator of 2.0. That is, the barter sector's inflation-adjusted output is 50 rubles, the domestic cash sector's is 25, and the export cash sector's is 50 (table 3).

The point of this exercise is to underscore that barter is not the essence of the virtual economy. Barter is not the main problem real value of exports due to the devaluation: neither growth nor "remonetization" involved a change in enterprise behavior. All the enterprises in all of the sectors continue to produce exactly what they did before, in the same amounts (absolutely and relatively), selling to the same customers as before. They use (and perhaps waste) the same physical amounts of inputs (gas, electricity, steel, labor, and so on) as before. In fact, it is easy to see that the positive effect of the increased value of exports could even offset (and conceal) negative developments elsewhere. For instance, the barter sector could grow in size (in terms of physical volume of goods produced and traded) or the domestic cash sector could actually shrink. But if the growth of the export sector—thanks exclusively to the devaluation—were large enough, the overall figures could still show net growth and net remonetization.

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<th>Table 3. The Post-August Economy (Inflation-Adjusted Values)</th>
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in the Russian economy, it is a symptom of the problem. The essence of the virtual economy is enterprise behavior that exploits what we have called relational capital to protect and maintain value-destroying activity—soft goods production. Barter is important because it facilitates that behavior. The real question for the Russian economy is what happened to enterprise behavior as a result of the positive cash shock and the shift in relative prices between hard and soft goods production? This stylized example tells us that simply looking at figures on the percentage of barter in the economy tells us nothing about behavior.

Impressive Figures May Conceal Harsh Truths: The Case of Sakha

There is another important lesson here. It is that aggregate statistics can often distort reality. While the virtual economy permeates the Russian economy, it does not do so in a uniform way. Often we can gain real insight into its operation only by looking at specific regions or industries.

A case study of one (admittedly extreme but not unique) case, the Republic of Sakha (Yakutia), shows just how misleading statistics can be. During the first half of 1999, the economy in Sakha appeared to be performing impressively:
- Industrial output was up 80 percent in constant prices (160 percent in current prices).
- Gross regional product was up 1 percent.
- Fixed capital investment was up 30 percent in constant prices.
- Corporate profits were up 1,400 percent.
- Budget revenues were 21 percent over target and spending was 38 percent under target.
- Tax revenues were up 120 percent.
- Cash revenues were up 300 percent, and cash in the first half of 1999 made up 85 percent of budget revenues (up from 48 percent in the first half of the previous year).

These statistics would suggest that Sakha’s economy is growing, monetizing, and modernizing. Yet other indicators raise some questions. The percentage of loss-making companies rose from 57 percent to 63 percent, and only 14 percent of enterprises were technologically solvent. Nonpayment problems were also getting worse.

How can these conflicting trends be reconciled? The answer is one word: diamonds. The region’s largest enterprise is ALROSA, which accounts for 69 percent of all industrial output. Although the region’s industrial output, measured in rubles, rose 80 percent, the physical volume of output barely increased at all. The reason is that ALROSA, which exports nearly all of its diamonds for dollars, earned four times as many rubles on the same volume of exports as before. Aggregate net profits in the republic in the first half of 1999 were Rub 5.4 billion, and ALROSA’s net profits were Rub 5.6 billion. This means that taken together, the region’s other 19,300 corporate entities had a net loss of Rub 0.2 billion. Thus the increased ruble value of ALROSA’s diamond exports alone—its positive cash shock—explains the region’s higher profits, increased industrial output, and improved fiscal performance. There is little to indicate that anything else changed in the region.

Consumption and Investment Recovery

The most important positive sign during 2000 has been the recovery in consumption and investment. We have seen that increased monetization is not necessarily indicative of real change, but a rebound in consumption and investment may signal that recovery is sustainable. Of course, as we have shown with our simple accounting example, real depreciation causes an increase in real income. This increase ought to manifest itself in higher consumption and investment. The real question is whether this recovery is more than just that.

The recovery in consumption is an important positive sign. During 1999 recovery was fueled almost exclusively by the depreciation of the ruble. The high cost of imports led to increased consumption of domestic goods, but this effect was seriously limited by the decline in household income in the wake of the August crisis. The fact that consumption is increasing means that there are some domestic sources of demand. Though still not at the 1995 level, consumption does appear to be on a steady increase.

The recovery in consumption is a welcome sign for Russia. But it is important to recognize that consumption has yet to achieve the levels reached in 1997 and early 1998. At this point there is no evidence to suggest that this is more than a cyclical recovery from the depths of the crisis—a "catching up" from the earlier decline. There is no evidence that Russian consumers are more optimistic about the future and have altered their consumption behavior, generating a new source of aggregate demand. Whether or not consumption growth is sustainable will depend on what happens to income, which in turn depends on whether the recovery itself is more sustainable. The recovery in consumption is not an independent variable in this recovery.

The steady growth in investment appears to be an even more positive sign. Investment grew robustly in the past year, rising 17 percent over the same period the previous year between January and August 2000. But the increase is from an extremely low level. Real expenditures on new construction and equipment are about 12 percent higher than in the summer of 1999, but they are still below the level of 1995 and 1996, and the average age of the capital stock rose from 8.4 years in 1970 to 16 years in 1998. It is hard to believe that the recent upsurge in investment can make a serious dent in this trend. Moreover, direct foreign investment was actually 22 percent lower in the first half of 2000 than in the same period in 1999.
The real question, however, is not the volume of investment but what this investment is used for. It could be that enterprises are using their export windfall to make necessary changes that will increase competitiveness. But it is also possible that enterprises are using this windfall as breathing room to avoid having to make such changes. Enterprises may be continuing to invest in good relations with officials and workers rather than in better productive processes. The critical question is whether this investment is an indicator of restructuring. An illuminating discussion of how the export windfall has translated into investment comes from a recent discussion of reform in the region. Some view [the devaluation] as the latest removal of a hard budget constraint and an opportunity to recreate the firm [sic] which existed before the collapse in Production. They are reinvesting in social assets to create a better environment for their workforce, and see their major task as increasing production to pretransition levels with little thought to efficiency or profitability. The General Director of Uralsyazinform, one of Russia’s most successful and potentially promising regional telecoms, in the same breath mentioned that he was planning to sell 8 percent of his company in the form of ADRs to increase liquidity (perfectly laudable) and that his number one aim for investment was to improve the quality of his firm’s social assets, which included hospitals and kindergartens.

The General Director of Uralsyazinform is investing—but not necessarily in reducing the competitive disadvantages of his enterprise. Investing in relationships may be advantageous to the director—and even to the enterprise in its negotiations with officials—but it does nothing to improve the economy as a whole. Investment may thus rise in response to the improvement in the financial condition of enterprises; whether that investment will be directed toward restructuring will depend on how durable agents expect the recovery to be.

Is the Windfall Disappearing?

The real depreciation of the ruble ended in January 1999. Since then the ruble has appreciated gradually in real terms, as a result of inflation, which averaged more than 19 percent during 2000 while the ruble held fairly steady. The rise in inflation has been due to rapid money growth, a consequence of unsterilized capital inflows, the counterpart to Russia’s large current account balance.

This raises the question of whether the windfall is disappearing—an especially troublesome question given the lack of restructuring that seems to have taken place during this window of opportunity. Some evidence can be inferred from recent profit data. In the first four months of 2000, real profits in large and medium-size enterprises in Russia were up about 50 percent over January-April 1999. However, most of this growth came from the resource industries. Excluding oil and oil products, real profit growth was only about 10 percent. Excluding metals (ferrous and nonferrous), profits were 13 percent lower in January-April 2000 than in the same period in 1999.

Infrastructure Remains Weak and Capital Flight Continues

One barrier to a robust recovery in Russia is the still fragile nature of its infrastructure. The sorry state of Russian infrastructure was highlighted, to some extent, by the events of last summer: the Kursk tragedy and the fire at the Ostankino TV tower. Generally, though, Moscow is somewhat of an outlier with regard to infrastructure. The situation elsewhere is much worse.

Perhaps the most important sign of the state of the Russian economy is capital flight, an important indicator of how agents view the stability of the economy. Capital flight from Russia remains high. The net outflow as of mid-2000 was about $18.4
billion—double the 1999 rate and about 18 percent of GDP. This increase coincides with a massive improvement in the current account balance. To some extent this is a blessing for Russia. If capital flight were not so high, inflation would be worse, because the Central Bank of Russia cannot effectively sterilize inflows. Given the lack of behavioral change, it is likely that a substantial share of domestic investment is going into production capacity typical of the virtual economy (that is, soft goods production). Given that likely alternative, capital flight at least preserves some of Russia’s wealth until it can be used more productively.

One thing that is clear is that banks do not seem to have identified profitable investment opportunities. They are still flush with cash: bank credit (loans and interbank credit) accounted for less than 38 percent of total banking assets during the first half of 2000 (in the West the figure is 80–90 percent). The banks hold about 45 percent of their assets in foreign exchange and another 14–15 percent in noninterest-bearing accounts at the Central Bank of Russia.

Conclusion

The August 1998 devaluation represented a pure windfall for Russia’s raw materials exporters, whose earnings rose by a factor of four as a result. The devaluation represented a massive, positive cash shock for these enterprises and for local economies based on them. As a result of the devaluation, tax revenue also increased, and wage, pension, and tax arrears fell. The devaluation also had modest benefits for a small sector of the economy that gained a price advantage relative to foreign imports. But these benefits carried a heavy cost. Incomes fell drastically, and they remain down. The poverty rate rose by nearly 50 percent.

The squeeze on households has been important. If there has been pressure to change anywhere in the economy, it has been not on enterprises but on households. The rise in profits has come largely at the expense of a decrease in real wages. The consequent pressure on households has not led to a push toward the market. The virtual economy is a protective mechanism. When it prevails, further pressure merely tightens the cocoon of protection against the market. The greater the hardship, the less likely people are to leave the cocoon.

The real depreciation of the ruble, followed by the rise in commodity prices on the world market, gave Russia a window of opportunity to alter the course of its transition. The depreciation could have provided the cushion needed to begin extricating Russia from the grips of the virtual economy. To date, however, there are few signs that such an effort is underway. This window opened at great cost to the Russian population, and it is now starting to close.

Even if this opportunity is not seized, there will no doubt be another in the future. But lessons from this current experience must be drawn. The key question is why behavior has not responded to the real depreciation, why the opportunity provided by the devaluation is being dissipated. The most basic answer is that structural factors that generate the incentives facing enterprise directors have not appreciably changed. The underlying structure of the virtual economy remains intact—value producers are still subsidizing value destroyers. Costly restructuring that could make an enterprise more competitive is still inhibited by fear of tax consequences and an end to subsidies. The economy is still stuck in the virtual economy trap.

The power of that trap is clearly huge. One would think that a 70 percent real depreciation would be a large enough shock to change the expectations of all players in the virtual economy. And yet if such a shock is viewed as temporary and if departing from the behavioral strategies of the virtual economy has long-term consequences, it should not be a surprise that agents are wary. To induce behavioral change it is necessary to convince them that the policy regime has changed.

What, then, can we say about policy, both in the postcrisis period and in the future? Since the financial crisis, the primary imperative of Russian leaders, including Yegenvi Primakov and Vladimir Putin, has been national security and domestic stability, not radical economic reform. This is not surprising. Radical reform would require wrenching economic change at a...
time when real income is already declining due to the real depreciation. As a result, the windfall in tax revenue that these governments enjoyed was used to pay arrears rather than to close plants that need to be shut down. Given the absence of government leadership, enterprise directors most likely concluded that the window of opportunity was not likely to remain open. For the overwhelming majority, the response has been to pocket the windfall rather than make painful adjustments.

Clifford Gaddy is an economist at the Brookings Institution. Barry Ickes is a research fellow of the William Davidson Institute and professor of economics at Pennsylvania State University.

Ukrainian Bankruptcy Law Offers Alternative to Liquidation
by Richard Wolfe and Gleb Glinka

January 1, 2001, marked the first anniversary of an important and progressive new law in Ukraine: the Law on Restoring the Solvency of the Debtor or Declaring It Bankrupt. Enacted in June 1999 and signed into law six weeks later by President Kuchma, this powerful and flexible legal instrument became effective January 1, 2000. Before the new law was enacted, it was virtually impossible for a Ukrainian enterprise to reach a global debt settlement with its creditors. As a result, heavily indebted but potentially viable enterprises continued to deteriorate with little or no hope of recovery.

The new law provides thousands of heavily indebted industrial enterprises with an alternative to liquidation. Since the law became effective, with the consent of their creditors, more than 20 industrial firms engaged restructuring cases in commercial court, converted liquidation cases filed by their creditors under Ukraine’s old (1992) bankruptcy law to restructuring cases, or reached amicable settlements with their creditors establishing a workable schedule of debt forgiveness and repayment. As information about the opportunities available under the new law spreads around the industrial, financial, and legal community, hundreds of new cases are likely to be filed.

So far the law has proved far more effective than similar laws in other former Soviet Republics, with the possible exception of the Russian law, under which a number of amicable settlements have been reached since its enactment in 1998.

Crisis in Ukraine’s Industrial Sectors

You pass through the iron gate and drive through a tree-lined prospect into an industrial park with factories, machinery, rows of workshops, a garage, an imposing administrative building, medical facilities, kindergartens, a recreation center, dining halls, residential housing, and all the components and amenities of a complete factory town—except that the buildings are dilapidated, freezing cold, and eerily empty, as in a second-rate science fiction movie. All of the physical infrastructure for production is in place—but nothing is being produced. There are almost no people.

Such an enterprise represents an extreme example of the paralysis that has overtaken entire industries in Ukraine, including textile mills; manufacturers of heavy producer goods, such as agricultural and construction machinery; and producers of electronic components. Some factories have shut down, others are operating at 5 or 10 percent of capacity. Most transactions are typically in barter, as bank accounts of heavily indebted enterprises are frozen by the state for arrears in tax and pension system payments, leaving no cash available to pay wages, debt service, or trade payables. Some manufacturers of consumer goods are equally distressed, although certain manufacturers of fast-moving consumer goods, such as processed foods, have been able to find cash customers and operate more or less normally.

The current situation began to unfold in the early 1990s, when the breakup of the Soviet Union severed trade relations, causing industrial enterprises to lose both customers and suppliers. Conditions worsened in the mid-1990s, when the government, under budget pressure, eliminated direct subsidies to the enterprises as well as subsidies for their major inputs, such as energy. By this time, most industrial enterprises were accruing economic losses, although under Soviet tax accounting rules, many were still “profitable” and incurring profits tax liability. Eleven consecutive years of economic decline in Ukraine, through mid-1999, combined with poor enforcement of the rights of shareholders and creditors shut off the flow of new investment to the industrial sector. Faced with massive loan defaults, banks stopped making industrial loans.

This story is no doubt familiar to the reader. With some variations, the same scenario has occurred throughout the former Soviet Union. In very depressed economic environments, it is still possible to revive individual enterprises and begin generat-
ing operating profits using a combination of restructuring measures (cost reduction, product portfolio adjustment, strengthening of marketing and sales functions, and so forth.) The necessary preconditions include a good product, a good market for that product, and progressive enterprise management. Even in the presence of these conditions, however, an enterprise’s solvency and financial health will not be restored if debt service requirements exceed operating profits, causing continuing negative cash flow. Tax penalties for late payment will generate new losses, exacerbating the cash flow problem. Enterprise management, constantly short of cash, will be forced to make second-best decisions. Heavy debt burdens will discourage potential investors and lenders. Without new investment, aging production equipment will fail or become obsolete, and the enterprise will eventually lose its entire market share to domestic—or more often—foreign competitors.

As part of the initial privatization process, Ukraine, like most of the other former Soviet republics, enacted a basic bankruptcy law facilitating the liquidation of insolvent enterprises. In healthy economies, liquidation of insolvent enterprises serves to redeploy idle and underused assets into more productive uses, as well as provide at least partial compensation to creditors while there is still some residual value left. In a moribund economy like Ukraine’s during the 1990s, liquidation must contend with the failure of markets for used assets (plants and machinery), which exist in abundance. The 1992 law was used primarily by the tax authority for “housekeeping,” to rid the tax rolls of completely defunct enterprises, most of which had already been stripped of all assets. The law did not provide any useful mechanism to revive the industrial sector and put people back to work. Instead, the government addressed the problem by creating a government agency charged with restructuring enterprises. That agency failed in its mission, as did its counterparts elsewhere in the region.

In 1997 an initial attempt failed to enact a new law that would facilitate restructuring enterprises by commercial entities. The law was opposed by the Communist Party, then dominant in the legislature, largely because it was viewed primarily as a law that would merely make liquidation procedures more efficient. In 1998 proponents of the law worked with the Communist Party to create a new law that would allow enterprises to be restructured as going concerns. Although liquidation procedures were also improved and the rights of creditors strengthened, the Communist faction in the legislature sponsored the law because of its potential to restore employment in the industrial sectors.

Major Features of the Ukraine Law on Restoring Solvency

The Ukrainian bankruptcy law draws heavily on U.S. bankruptcy law but also contains special provisions that adapt it to the realities of the Ukrainian legal system as well as the country’s politics and culture. Under Article 53 of the Ukrainian law, as in Chapter 11 of the U.S. law, debtor enterprise management can petition to reorganize and retain control of the enterprise.

The bankruptcy law defines a set of “sanation” procedures that govern the financial restructuring of a debtor enterprise as a going concern. Under Article 53, with the consent of a majority of its creditors, the debtor enterprise takes the initial step by submitting a restructuring petition. After claims are filed and the court approves the claims register, creditors with approved claims meet and elect a committee on the basis of debt-weighted voting. The debtor enterprise nominates a “sanation manager,” who must be approved by the creditors’ committee and the court. The sanation manager assumes responsibility for the day-to-day operation of the enterprise, under the supervision of a trustee, who is nominated by the creditors’ committee and approved by the court. The sanation manager is required to prepare and submit a sanation plan, which must be approved by the creditors’ committee and the court. At any time during the proceedings, an amicable settlement agreement can be negotiated with the creditors’ committee. Once approved by a majority of creditors, the agreement, which includes a debt repayment schedule, is binding on all creditors, whether or not they voted for the sanation plan or the agreement.

The presence of a trustee representing the interests of the creditors in a debtor-managed restructuring provides a mechanism of control to the creditors’ committee that is usually lacking (no such provision exists in Chapter 11 of the U.S. Bankruptcy Code, for example). The Ukrainian law is thus more balanced between creditors and debtors than Chapter 11, which is generally considered by insolvency experts to be rather lenient on debtors.

The most important features of the new law that provide financial benefit to the debtor enterprise are discussed below. In the successful restructuring cases we have seen to date under this law, all except the last two provisions have constituted significant sources of internal capital generation. Together with various operational restructuring measures, these provisions have allowed firms to move from negative to positive cash flow in a relatively short period of time.

1. **Moratorium (Articles 12.2–12.5).** Introduced upon acceptance by the court of the debtor’s petition, the moratorium prohibits the debtor enterprise from paying any pre-petition creditors, including the tax and pension authorities and secured claims (except wages, alimony and child support, claims for injury to life or health, and royalties). It prohibits creditors from taking any measures to secure payment. The moratorium remains in force for 12 months, plus an additional 6 months at the discretion of the court. Imposition of new fines and penalties (such as fines for late tax and pension payments) is also suspended during the moratorium.
The amount of the debt is fixed as of the moment of filing, and penalties are suspended for the duration of the sanation.

2. **Elimination of Claims Not Filed before the Deadline (Articles 14.5 and 31.5).** After acceptance of the petition, notice of insolvency proceedings must be published; claims must be filed by creditors within a specified time period after the publication of the notice. Claims that are not filed on time or that are successfully contested by the debtor are eliminated.

3. **Automatic Tax Forgiveness (Article 36.2).** Under the amicable settlement provisions of the law, debtor enterprises concluding such an agreement, by majority vote of the creditors' committee, receive automatic forgiveness of all tax and pension debts (including interest and penalties) that are more than two years old and the opportunity to pay the remaining tax and pension debt over a six-year period, providing that the enterprise remains current on new tax obligations. This provision is loosely based on U.S. bankruptcy law.

4. **Debt Forgiveness by Commercial Creditors (Article 18.2.4).** Commercial creditors may forgive debt or agree to a deferred repayment schedule. Under Ukrainian tax law, the amount of forgiven debt can be deducted by the creditor and is taxable to the debtor. (Under the U.S. law, the forgiven debt is deductible by the creditor but is not taxable to the debtor.)

5. **Transfer of Social Assets (Article 18.2.12).** Worker housing, kindergartens, and other facilities inherited by enterprises during Soviet times, all of which represent sources of financial loss to enterprises, may be transferred to local governments quickly and without cost to the enterprise as part of a court-approved sanation plan.

6. **Debt to Equity Swaps (Articles 18.2.12; 37.4).** Under a consensual, court-approved plan, the enterprise may issue additional stock to convey to creditors in satisfaction of debts.

7. **Rejection of Contracts (Article 17.10).** Although not much used yet, the new law includes a provision allowing a sanation manager to reject within 3 months of sanation economically burdensome contracts that have not been fully performed. As under the comparable provision of the U.S. Bankruptcy Code, the other party to the rejected contract may file an unsecured claim for damages.

8. **Preferences and Fraudulent Transfers.** As yet untested under the law, voidable preferences and fraudulent transfers represent an additional potential source of internal capital generation. The sanation manager may pursue payments made to unsecured creditors at the expense of the remaining pool of creditors within six months of filing or conveyances to "insiders" (defined by Article 1) for less than equivalent value. In addition to forestalling the dismemberment of the debtor as it slides into bankruptcy, ensuring equality of distribution, and combating corruption, these provisions, modeled on U.S. law, can provide sources of funding for the debtor.

We are not aware of any other law in the region that contains this potent combination of tools for sanation. Most of the laws we have reviewed contain provisions for a moratorium and a claims register similar to the Ukrainian law. We are not familiar, however, with any other law in the region containing automatic tax forgiveness or voidable preferences. Some laws (such as the Croatian law) do not bind dissenting creditors to the plan or agreement.

**Successful Restructuring of Enterprises During the First Year of the New Law**

Effective bankruptcy laws are characterized by a high degree of flexibility. No two insolvency cases are exactly like, and different circumstances require different solutions. The diverse paths that the enterprise restructuring cases have followed under the new law in Ukraine demonstrate its flexibility. To date, we have seen five major variants, each of which we illustrate below with a case example. We also discuss a sixth variation, which is allowed under the law but as yet untested. We expect that as use of the law develops and the various provisions of the law are tested, additional variations will arise.

1. **Article 53 plans.** The standard route under the new law begins with submission of a petition with the support of a majority of creditors, proceeds through submission and approval of a sanation plan by the creditors and the arbitration court, and concludes with a negotiated amicable settlement. The first case successfully completed under the new law involved a furniture factory in western Ukraine. The process took less than six months from the filing of the petition to conclusion of the amicable settlement. An export customer agreed to provide needed investment for retooling upon approval of a plan that included some debt reduction and the rescheduling of the remaining debt. Creditors agreed to a two-year grace period without any debt repayment. The portion of the debt that was not forgiven is to be paid in equal quarterly installments over the next four years.

2. **"Prepackaged" Article 53 plans.** A significant variation on the Article 53 plan involves not only an agreement to the sanation plan but also an agreement in principle to an amicable settlement even before the petition is filed with the court. The amicable settlement, however, cannot actually be approved until the claims register is established, a prerequisite to constituting the creditors' committee. A meat factory in eastern Ukraine followed this path, taking about eight months from commencement to the conclusion of an amicable settlement. The cornerstone of the settlement was the conversion of all the factory's commercial
debt to equity, with no future cash payments. Commercial creditors accounted for 93 percent of the debt. The official debt-for-equity swap was unprecedented in bankruptcy in Ukraine.

3. **Sanation.** The new law also contemplates cases in which a sanation plan is negotiated with the committee and approved by the court but no amicable settlement is reached. In cases in which an enterprise can be operationally restructured by taking advantage of the moratorium and the reduction of the creditor pool confirmed in the claims register only, such sanation without an amicable settlement may be enough to turn the debtor around. A bakery in southeastern Ukraine whose cash flow would support its existing debt service requirements under these circumstances used this type of arrangement.

4. **Creditor-filed case concluded with amicable settlement.** A case originally initiated to liquidate the debtor can, with the consent of the creditors’ committee, change course and conclude in an amicable settlement. One such a case—involving a sugar mill in western Ukraine, initially brought by a minor creditor under the old bankruptcy law—was converted in March 2000. After conversion the case proceeded along customary lines, with the moratorium, a redetermination of the creditors’ claims register, and the formation of a creditors’ committee. The ability under the new law to make important decisions and bind dissenting creditors with a simple majority of creditors—a substantial difference from the old law—enabled the case to reach a successful conclusion 10 months later in an amicable settlement. In this case, the creditors forgave 90 percent of the debt.

5. **Case filed by a friendly creditor.** In some situations, it is virtually impossible to use Article 53, even though the management of the enterprise would like to conduct a restructuring. It may not, for example, be able to mobilize the shareholders to file a petition—as is sometimes the case when the state owns a majority of the enterprises’ shares. Similarly, if a majority of the debt is held by the state, it can be difficult to obtain consent of a majority of the creditors to file a petition (especially if it is nontax debt, such as a loan). Article 53 can be circumvented by persuading a friendly creditor to file a petition against the enterprise. The creditors’ committee can then vote for sanation (rather than liquidation) and approve the debtor enterprise’s current manager as sanation manager. Because the procedure ostensibly continues to be filed by the creditor, it is not necessary to appoint a trustee. A textile mill in southeastern Ukraine, owned mostly by the state, followed this path. The friendly creditor that filed at the request of the enterprise management was the pension fund.

Conversion of creditor-filed to debtor-led case. Article 53.8 allows for cases that were initially brought by creditors to be converted to debtor-led cases with the approval of the creditors’ committee. To our knowledge, no such cases have occurred.

A set of amendments that should improve the efficiency of the law is awaiting debate in Parliament. The bankruptcy law has now become a cornerstone of the commercial law system in Ukraine and will undoubtedly assist in Ukraine’s transition to a vibrant and successful free market economy.

*Richard Wolfe is an economist and Gleb Glinka a bankruptcy attorney with the international accounting and consulting firm Deloitte Touche Tohmatsu. The firm has been assisting the Ukrainian government with its bankruptcy program since 1995, through donor funding provided by the U.S Agency for International Development.*

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*Continued on page 33*
Economist Prescribes Slow, Steady Reform for “Sick” Asian Economies

According to Bernard Yeung, a leading emerging markets expert on Asian economies at the William Davidson Institute, the entire Asian region is on the verge of its second economic crisis since 1998. Little leadership is coming from the United States, and the ongoing political crises in both Japan and the Philippines underline the lack of leadership in the region. Taiwan (China) is already on the verge of a crisis because of its property and stock market slump. What the economies of Asia need most is patience and determination to stay the course they have plotted.

There is no source for optimism in the economic outlook for any Southeast Asian country, Yeung believes, largely because of their overreliance on the financially troubled high-technology sector. By tying their manufacturing hopes to high-tech industries in the United States and Europe, the Republic of Korea, Singapore, Thailand, and other East Asian nations have left themselves highly vulnerable to instability in the global technology market.

At the same time, none of the recovery measures prescribed by the IMF or the World Bank since the 1998 economic crisis have been taken. After the 1998 economic crisis, Asian countries needed to install more checks and balances in their governments and better corporate governance to assure local and international investors of their stability. Only the Republic of Korea took steps in this direction. To make matters worse, there is no end in sight to Japan’s economic illness, to the continued political turmoil between China and Taiwan (China), to the imminent economic slowdown in the United States, and to rapidly rising energy prices, which could be fatal to nations like the Democratic People’s Republic of Korea as winter approaches. In the long run, industrial pollution of the environment is a serious concern as well.

“Japan, Taiwan (China), the Philippines, and other East Asian Tigers need to sweat out this economic slowdown if they are not to repeat the broad collapse of 1998,” says Yeung, “They must not rush to make rapid changes in the expansion of their fiscal supply, boosting their government spending, or in their economic diversification. A sick body needs rest, and Asia should simply try to gather its strength for a slow—but certain—recovery. If you try to boost the economy, you get inflation, currency devaluation, and a repeat of the old problems.”

According to Yeung, Asian governments should implement the following measures to ensure their recovery:

- Create transparent capital markets that provide entrepreneurs with healthy incentives and market investments at a reasonable cost.
- Improve the transparency of corporate governance to allow more efficient allocation of resources, better corporate decisions, and broader scope for professional managers to apply and leverage their capabilities.
- Create healthy public governance that upholds the rule of law and makes prudent investments in infrastructure.

Bernard Yeung is Area Director for Research on Foreign Investment at the Davidson Institute and the Abraham Krasnoff Professor of Global Business at the Stern School of Business, New York University.

Davidson Institute Conference Announcements

Value Creation Tools for Financial Services: A Workshop for Financial Service Managers
May 22–26, 2001, Prague, Czech Republic

The Davidson Institute and the CMC Graduate School of Business are sponsoring an interactive five-day workshop for financial service managers who want to develop new skills. The workshop will introduce participants to experts’ insights into local, regional, and global economic development; value-creation strategies to enhance shareholder value; cutting-edge approaches to leadership and teamwork; and best-practice tools for strategy definition and implementation. The program is designed for financial sector managers who direct the daily operations of organizational units and whose decisions guide the future of their companies or whose success depends on working with other managers or a professional staff. Program fee: $4,800. Information: Katerina Mitasova, CMC Graduate School of Business, tel.: 420 202/899, fax: 420 202/892 150, email: mitasova@cmc.cz.

Marketing Challenges for Post-WTO China
June 8–9, 2001, Shanghai, China

This two-day intensive executive workshop is targeted at senior managers responsible for their firms’ marketing strategies in China.
Through seminars and open exchanges by marketing experts and world-class scholars, participants will be exposed to recent developments in China's post-WTO market environment and will learn how firms build sustainable competitive advantage in their operations in China through their marketing strategies. Participants will interact with professionals and experts on how best to manage their marketing strategies in China. They will also be exposed to the latest developments in support systems that can help them understand, plan, make decisions, and implement their marketing strategies. The workshop is being jointly sponsored by the Davidson Institute, the China European International Business School, and the Chinese Management Centre, University of Hong Kong. Program fee: $800.

Information: Nell Gao, Senior Program Coordinator, China European International Business School, email: gnell@mail.ceibs.edu.

The Third European Conference of the Fondazione Rodolfo Debenedetti—Immigration Policy and the Welfare State
June 23, 2001, Trieste, Italy

Continued from page 31


I feel like I'm constantly searching for something.'

From the UK magazine The Spectator
From Regatta to Big Bang?
The Impact of the EU Accession Strategy on Reforms in Central and Eastern Europe
by Erik Berglöf and Gérard Roland

Eastern enlargement of the EU became a realistic possibility only once the Central and Eastern European countries had embarked on their transition from socialism toward modern democracies with market economies. Since then the desire to "return to Europe" has played an important role in breaking political constraints and sustaining the momentum of reform in many countries. Perhaps never before in history has the attraction of joining an association of countries had such profound impact on the political and economic development of an entire region. In the countries in which membership has been a realistic option, the past decade has witnessed perhaps the most radical reorientation of trade and structural adjustment in modern history. The impressive record of the accession countries stands out even more clearly when contrasted with the disappointing record of the transition economies left out of the accession process.

Whether by design or through its slow decisionmaking, the EU anchor has had a strong impact on the pace of reforms in Central and Eastern Europe. This effect is increasing over time, as the nature of transition changes and the date for the accession decision approaches. Given the leverage of a threat to exclude, it makes sense for the EU to postpone membership and use it to apply pressure on would-be members to reform. The EU has converged on a strategy that makes sensible use of this leverage. However, the policy has changed significantly over time, creating uncertainty about the EU's intentions. Recently, new elements were introduced, undermining the incentive effects of the EU anchor.

What do we know about the effects of prospective EU membership on reform in the transition economies of Central and Eastern Europe?

- The EU has played an important role as an "outside anchor" to the reform process. Causality runs both ways, but the likelihood of becoming an EU member has been one of the most important predictors of reform. The importance of the leverage exercised by the EU is particularly apparent when we compare the reform records of Central and Eastern Europe with those of the former Soviet republics. Prospective membership in the EU has helped focus expectations and create initial momentum.

- EU leverage grows as transition proceeds but may decline once accession grows near. It has been difficult to sustain the momentum of reform as the costs of transition have become more visible, as initial enthusiasm for reforms has faded, and as idealism has given way to cynicism and self-interest. As willingness to make personal sacrifices declines, pressure from the EU becomes a more important tool to maintain reform efforts. There is one important sense in which leverage may be decreasing over time, however. An important reason for the strength of the EU as an outside anchor is the broad popular support for accession in candidate countries. As the EU's leverage grows the closer accession comes, it also becomes more intrusive. The attitude of the population is likely to grow more negative as bargaining gets tougher and shifts toward issues of EU self-interest.

- The EU's enlargement policy has evolved over time, with increasing emphasis on the incentives of individual candidates to reform. The EU has gone from dividing candidates into two distinct groups to allowing mobility and eventually replacing the groups with a queue. By opening the door to substantial exceptions, the EU has allowed for considerable variation and created uncertainty over the meaning of membership. The prospects for early accession have increased for some countries, while the date has been postponed for the frontrunners. The net effect of these changes is uncertain, but they have probably strengthened the incentives of the countries originally at the top of the second echelon and weakened those of the countries in the top group.

- A shift to a "big bang" strategy, in which all or most of the candidate countries would be allowed to enter simulta...
neously, would seriously weaken the leverage of the outside anchor. Such a strategy would seriously undermine the incentives for countries to differentiate themselves by accelerating reforms. It would also postpone entry for the frontrunners. Moreover, a big bang strategy would be possible only if many individual exceptions to the entitlements of membership were made.

- Sequencing entry to the EU has important costs. New temporary barriers will have to be erected between early and late entrants. Some countries may lose existing preferential access, and the tariffs they are charged on particular goods will increase. Excluded countries will also be excluded from the broader access accorded to members. The effects of exclusion are enhanced through agglomeration effects and loss in competitiveness.

- The failure of the EU to implement internal reforms weakens the leverage of the outside anchor. By postponing its own reforms, the EU creates uncertainty about the value of membership. A more important, but indirect, effect stems from the widespread perception inside the EU and among the candidate countries that the pace of enlargement is linked to EU reforms. Since the speed of these reforms is beyond the control of the individual candidate countries, such a link increases uncertainty and thus weakens leverage.

The European Monetary Union (EMU) provides an “internal” anchor to continued reforms once countries are members. The lure of joining the EMU thus serves as an important incentive once countries join the EU.

Erik Berglöf is Director of the Stockholm School of Economics (SITE) and a member of CEPR.

Gérard Roland is professor of economics at ECARES, Free University of Brussels and a member of CEPR. An article based on the ideas presented here will appear in the World Economic Outlook.

Research on Labor Mobility in Russia Receives Global Development Network Award

An Interview with Winners Guido Friebel and Sergei Guriev

"Should I Stay or Can I Go? Worker Attachment in Russia," a paper by Guido Friebel and Sergei Guriev, has won the first annual research award in the category of institutional dimensions of a market economy. The award was presented at the Global Development Network conference held in Tokyo in December 2000. The network (www.gdnet.org) supports linkages between research institutes and policy institutes involved in development related issues. We asked the winners about their research.

Q. How did the idea for this paper come up and how did it develop into a paper?

Guriev: The paper stems from our work at the Russian European Center for Economic Policy (RECEP) in 1998–2000. Together with a team of young economists and experienced researchers from the EU, we did research and provided policy advice on labor and social issues for the Russian government. We were stunned by the low interregional mobility of Russian workers. Indeed, it is a mystery that given the huge differentials in wages and unemployment rates, mobility is so low. Partially, this may be due to administrative barriers to mobility, like the infamous propiska (city passport) system, but it does not explain the magnitude of the problem.

Friebel: The problem of low interregional mobility is important, since structural changes require substantial worker mobility. We found it interesting that low mobility coincides with the massive demonetization of wages. Enterprises have ac-cumulated huge wage arrears; they pay wages in kind and through fringe benefits, ranging from kindergartens to housing, although the government promised to transfer social assets to municipalities.

Guriev: At some point, we saw a link between these two features of the Russian labor market. Our main point is that low mobility may actually be a result of firms’ strategies to “attach” workers to regions. Workers who are paid in nonmonetary ways find it harder to move. We also show that these strategies can prevail only if the local labor market is not too competitive. In other words, labor market competition can protect workers against the risk of being "attached."

Friebel: It should be noted that firms may have an interest in attaching workers for a very simple reason: workers who cannot move have less bargaining power and can thus be hired at lower costs. So, in general, we should expect that less mobile workers are worse off.

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The Art of “Attachment”

Our paper investigates the strategies firms in an economically declining local labor market may use to restrict migration of their workers. “Attaching” workers to a local market has rather obvious advantages for firms, since less mobile workers have less bargaining power. But how can firms implement attachment, and should one not expect that attachment can be sustained only in monopolistic local labor markets?

We argue that in the presence of wealth constraints, firms can attach workers by paying wages in nonmonetary forms. This makes it difficult for workers to raise the cash needed for migration. We show that monopsony is not a necessary condition for attachment. Oligopsonies can sustain the strategy as well, provided that there are not “too many” firms in the local labor market. Our model also highlights that attachment involves the risk of worker exploitation.

Modern Russia is an interesting testing ground for this theory. Here, wealth constraints are important, many regions are subject to structural change, and local labor markets are highly concentrated. We investigate the main prediction of our theory—that controlling for regional and personal characteristics, out-migration should be higher in more competitive local labor markets—with data from the Russian Longitudinal Monitoring Survey and find some supporting evidence. Our theory has novel implications for the understanding of firms’ market power on labor markets and for the emergence of endogenous labor market imperfections.

Abstract of the award-winning paper. The paper can be downloaded at http://www.gdnet.org/files.fcgi/783_guriev.PDF.

Q. What was the context for the collaboration between you? And what was the role of your home institutions and the links between them?

Guriev: The collaboration worked very well. We worked together both via email and by visiting each other for a few days. Actually, our joint work has grown into a personal friendship. Our home institutions were very helpful in this work. We were both part-time faculty at RECEP. Now the Center for Economic and Financial Research (CEFIR) provides an excellent platform for such policy-relevant research in economics. Our full-time employers [the New Economic School in Moscow for Guriev and the Stockholm School of Economics for Friebel] encouraged us to work together and provided all the support needed.

Q. Are you conducting any further research in the area? How is this area of research evolving?

Friebel: We are going to do more work in this field. We now believe we have an analytical framework that can be used to better understand unregulated labor markets in other countries and comparable situations in history.

Guriev: Russia is a great testing ground for a theory that argues that firms may use strategies to make their workers immobile and dependent. One of the largest structural changes in history is taking place there, and understanding geographical labor mobility is both interesting and important. But even in Western countries, firms have used attachment strategies, such as company housing and company stores.

Q.: What have been the most problematic aspects of this investigation?

Friebel: Even in OECD countries, relatively little is known about geographical labor mobility in general and worker attachment in particular. The data are scarce. This makes the work both difficult and exciting. It would be wonderful to have better data on mobility and firms’ policies. We have just started taking steps to generate such data.

Guido Friebel is assistant professor of economics at SITE, Stockholm School of Economics, affiliate of the Center for Economic and Policy Research (CEPR), and affiliate of the Center for Economic and Financial Research (CEFIR). Sergei Guriev is assistant professor at the New Economic School and CEFIR, and affiliate of CEPR.

Borrowing “Doesn’t Pay”

From the Moscow based magazine Business in Russia
Privatization, Competition, and Transition Policy Strategies: Theory and Evidence from Russian Enterprise Panel Data
J. David Brown and John S. Earle, SITE, Stockholm School of Economics

The interaction between the effects of private ownership and market competition on enterprise behavior has been a crucial unknown for policy design in transition economies. While most economists have been ready to believe that the efficiency of state-owned enterprises might be increased through both privatization to improve corporate governance and price and entry liberalization to open up competition, the implementation of privatization has faced many practical and political problems in the transition economies. As a result, privatization has proven slow and difficult, and a central debate among policymakers and analysts of transition has arisen concerning the urgency of privatization.

An important, but largely implicit, assumption in this debate concerns how the forces of competition and privatization interact. On one side of the debate are advocates of “big-bang” transition strategies, who see competition as ineffective in the absence of private ownership and effective corporate governance, which is generally supposed to be achieved through concentrated ownership by outside blockholders. During the early transition period, several economists emphasized the desirability of rapid privatization, seeing liberalization as necessary but not sufficient to inducing restructuring. At the same time, they did not favor privatization without market liberalization. According to this view, competition and privatization are complements in their effects on enterprise performance: privatization may be enhanced by more competitive markets, but competition cannot substitute for privatization.

On the other side are critics of privatization, who believe that competition can improve performance in the absence of private ownership. Given the difficulties of designing and carrying out effective privatization policies, a more cautious, “gradualist” approach is implied. According to this view, privatization and competition are substitutes, or at least independent, in their effects on firm behavior, in the sense that the marginal gain from market liberalization is not increasing with the extent of privatization. Market liberalization need not be followed up by immediate privatization, as state-owned enterprises are disciplined by the market even as they await privatization. Some advocates of the delayed privatization approach stress the need to demonopolize industry in advance of privatization, suggesting that privatized monopolists would simply raise prices in lieu of restructuring.

The substitutability or complementarity of the forces of market competition and private ownership is therefore a critical determinant of the choice of transition policy strategy. While stabilization and liberalization policies were generally introduced rapidly and with relatively little controversy (at least among most Western economists), the proper pace of privatization has become the most contested policy design issue in the transition economies. A closely related controversy has concerned the choice of privatization method. Skepticism is frequently voiced about the quality of corporate governance likely to result from employee buyouts and voucher programs, but the justification for these methods is usually couched in terms of their speed, with attention paid to design details that mitigate governance problems.

Given the difficulty of carrying out trade sales to large investors, the debate is over whether such methods of privatization, even if second best, should nevertheless be a priority for policy.

In this paper, we argue that the debate suffers from two problems. First, it has been conducted on the basis of very little empirical evidence, particularly firm-level information on the interaction between privatization competition. Second, it has overlooked an important interaction at the level of the firm’s product market. We argue that the degree of competition in a market is a function not only of market structure, concentration, or the extent of price and entry liberalization but depends as well on who the participants in the market are. We hypothesize that private firms may be more aggressive competitors than state firms and that a firm operating in a given market may face tougher competition if most competitors are private. Thus even if the effect of privatizing a firm is independent of or substitutable for exposing it to competitive markets, privatization of competitors may be complementary, raising the effective competition associated with a particular market structure. The indirect effects of privatization, working through market competition, may be as strong as or stronger than the direct effects, which work through the corporate governance of a particular firm.

We analyze a simple Cournot competition model that distinguishes two aspects of the interaction between competition and privatization: privatization of a firm and privatization of the firm’s competitors. Under plausible conditions, the model implies that privatizing a firm is a substitute for exposing it to competitive markets but privatizing its competitors is complementary.

We then test the model empirically. Our empirical work has several distinct advantages over earlier studies of competition and
firm performance in transition economies in terms of the size and coverage of the data set, the time span of observations on each firm, and the availability of a variety of measures of market structure and competition. The panel data set we use for estimation purposes is quite comprehensive, including 13,288 Russian manufacturing enterprises covering 83.3 percent of total employment in Russian industry in 1992, the year of the liberalization shock, and spanning eight years (1992–99). Since our data comprise nearly the entire population of medium-size and large industrial enterprises, including information on their exact locations and disaggregated five-digit industries, we can use much more precise measures of market structure than those available to other researchers.

We find that on average privatization improves efficiency while reduced market concentration does not. The privatization of a firm reduces the marginal impact on firm efficiency from reduced market concentration, but the privatization of its competitors increases this marginal effect. The marginal effect becomes positive when most of the firm's competitors are privatized. It is largest when the firm's competitors are foreign owned, although the marginal effect is still strong when the firm's competitors are domestic firms with either private or mixed private and state ownership. The results imply that an important indirect impact of private ownership is the intensification of market competition and thus that competition only among state-owned enterprises may be ineffectual in stimulating them to increase efficiency. Privatization improves firm efficiency whether or not the firm faces competition, while reducing market concentration improves firm efficiency only if the other firms in the market are private. This evidence suggests that liberalizing the economy without also privatizing it is likely to be ineffective, that it would be better not to wait until after demonopolizing an industry to privatize its firms.

Worker Training in a Restructuring Economy: Evidence from the Russian Transition
Mark C. Berger, Department of Economics and Center for Business and Economic Research, University of Kentucky; John S. Earle, SITE and Central European University; and Klara Z. Sabirianova, William Davidson Institute, University of Michigan and Urals State University

Using 1994–98 data from the Russian Longitudinal Monitoring Survey, we measure the incidence and determinants of several types of worker training and estimate the effects of training on workers' interindustry, interfirm, and occupational mobility; their labor force transitions; and wage growth in the Russian Federation relative to the United States. We hypothesize that the shock of economic liberalization in Russia may raise the benefits of training, particularly retraining for new jobs, but uncertainty concerning the revaluation of skills may raise the costs, with an overall ambiguous effect on the amount of training undertaken. The Russian Longitudinal Monitoring Survey indicates a lower rate of formal training than studies of the United States have found, suggesting that the second effect dominates. Previous schooling is estimated to affect the probability of training positively, but the relation is much stronger for additional training in the same field than for retraining for new fields. This result is consistent with the hypothesis that schooling and training are complementary but become more substitutable in a restructuring environment. Foreign ownership of the firm also positively affects the probability of undertaking training, providing evidence of active restructuring by foreign investors. Additional training in workers' current fields is estimated to reduce mobility and earnings, suggesting inertial programs from the pretransition era. Retraining in new fields increases all types of worker mobility and is associated with higher returns than those typically observed for training in the United States, but it also raises the variance of earnings and the probability of unemployment, consistent with a search view of such retraining. Given the large returns to retraining, the efforts of Russian workers to learn new skills may increase as uncertainty diminishes and restructuring proceeds.

Risk Factors and Predictability of Stock Returns in Central and Eastern Europe
Anete Pajuste, Stockholm School of Economics; Gatis Kepitis, Price Waterhouse; and Peter Högfeldt, Stockholm School of Economics

Using broad market indices instead of subindices of high-performing stocks selected ex post, this paper avoids the common survivorship bias problem that afflicts most other studies of risk and return in emerging markets. It analyzes risk factors influencing equity market returns in five Central and Eastern European emerging markets and the changing importance of European risk factors. Local risk factors—the exchange rate, foreign reserves, and trade—are shown to be the most important at explaining variance in returns, followed by information about emerging markets. European risk factors have not been very important so far, but their importance is growing. There is increasing correlation between the Central and Eastern European markets and Western European markets, especially since mid-1997. The potential for stock return predictability based on past information is found in Slovenia and to some extent in Poland; it is not evident in the Czech Republic or Hungary.
Fiscal Decentralization: Basic Policy Guidelines for Practitioners
by Kenneth Davey

Fiscal decentralization is the currently fashionable term used to describe the financial aspects of devolution of power to regional and local government. The term covers two interrelated issues: the division of spending responsibilities and revenue sources across levels of government (national, regional, local, and so forth) and the amount of discretion given to regional and local governments to determine their own expenditures and revenues (both in aggregate and in detail). These combined dimensions have a significant impact on the reality of decentralization in its broad political and administrative sense. How much power and responsibility regional and local governments actually exercise depends crucially on what range of public services they finance, whether their revenues are commensurate with their responsibilities, how much real choice they have in allocating their budget to individual services, and whether they can determine the rates of their taxes and charges (both allowing them to vary their level of spending and making them answerable to the payers).

Spending Responsibilities

There is wide diversity across states in terms of the scale of tasks devolved to local government. In most countries, local government is responsible for what are often called communal services: local roads and lighting, water supply and sanitation, waste management, parks and sports facilities, cemeteries, low-income housing. What varies greatly is the extent of local responsibility for the social sector, chiefly comprising education, health, and social assistance. In some cases, these services are funded by the state budget; in some, costs are split between levels of government, and, in others, local budgets meet all costs except central supervision. Cost splitting may be by function (the state pays for secondary education, hospitals, and social benefits, and local government pays for basic education, primary health care, and social services) or by cost factor (the state provides professional salaries, while local government pays all other operating costs).

Table 1. Local Expenditures as Percentage of GDP in Central Europe, 1990s–1998

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<td>Czech Republic</td>
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<td>Estonia</td>
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<td>Hungary</td>
<td>17.4</td>
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<td>Poland</td>
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<td>Slovakia</td>
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– Not available.
tergovernmental transfers (either grants or subsidies), or shares of state taxes.

Local Discretion

Clearly, the structure of local government responsibilities and resources affects the local government’s discretionary power—its ability to make decisions about the nature and levels of local services. If local government obtains a significant proportion of local taxes and charges, it is in a much better position to determine how it spends the money. Revenue shares and block grants should provide more freedom of allocation than targeted grants.

Table 2. Local Government Expenditure as Percentage of General Government Expenditure in Central Europe, 1994–98

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<td>Czech Republic</td>
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<td>Estonia</td>
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<td>Hungary</td>
<td>26.7</td>
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<td>Latvia</td>
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<td>Lithuania</td>
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<tr>
<td>Poland</td>
<td>19.0</td>
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<td>Slovakia</td>
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<td>Slovenia</td>
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– Not available.

Note: Figures exclude social insurance fund expenditures.


In practice, local discretion depends on a more complex set of factors. Sharing a well-established national tax may support more budgetary choice than dependence on a politically sensitive and administratively burdensome local tax. Targeted grants may simply release local government funds for other expenditures. Expenditure decisions may be largely determined by national regulations over service requirements.

The classic argument for maximizing local discretion is most associated with U.S. economist Wallace Oates. He argues that the greatest efficiency is achieved when budgetary choices are made by local officials elected by local people who have to meet the full cost of their decisions through local taxes. This view has been challenged by European writers, who consider the link between local government budget choices and popular preference somewhat tenuous. They argue that the efficiencies of local expenditure choice outweigh those of local taxation; many important fields of local expenditure, such as education or environmental services, combine legitimate national and local interests. Moreover, in recent years national macroeconomic policy has sought to restrict fiscal burdens; it has been common for governments in both Eastern and Western Europe to restrict local taxation, particularly on business, to stimulate investment and growth. The extent of local discretion is, therefore, a matter of balance between national and local interests: neither central control nor local autonomy has priority.

Dynamic Process

Fiscal decentralization determines the framework of expenditures, revenues, and legal discretion within which regional and local governments operate. It does not deal with issues of financial management, budgeting, accounting, delegation, procurement, auditing, or other similar processes through which local governments manage their financial affairs. These are equally important, but the subject of a separate body of law and practice.

Fiscal decentralization is inevitably a dynamic process. Although local governments’ responsibilities and resources may be fixed in law, demands on their services and the value of their revenues respond to social and economic changes over which lower levels of government have little control. It is essential to maintain channels of consultation between national government and local government associations so that adjustments can be made in a timely and equitable way, usually through the equalization formula.

This article is based on “Fiscal Decentralization,” published in the LGI quarterly, Local Government Brief in September 2000. It is available online, at lgi.osi.hu/newsletter/index.html.

From the UK magazine The Spectator

'I have here the results of your brain scan.'

From the UK magazine The Spectator
Enlarging the Database for Local Initiatives for Resolving Ethnic Conflict: Call for New Best-Practice Studies

Innovative local policymaking practices for preventing and solving ethnic conflicts as well as pursuing multicultural politics in Central and Eastern Europe and the former Soviet republics are in high demand. In early 1997 the Local Government and Public Service Reform Initiative (LGI) decided to initiate an in-house research project, "Managing Multiethnic Communities," in order to identify best practices and disseminate them to community leaders, local and regional governments, NGOs, and educational institutions.

A large database was built, containing more than 100 case studies describing methods for improving community relations in multiethnic environment and settling ethnic conflicts. The database allows researchers, activists, and public officials to share their experiences. The case studies—collected from 20 countries in Central and Eastern Europe, the former Soviet republics, and Southeast Europe—are available in Russian and English. They are searchable by country, minority group, and topic, including conflict resolution, participation and representation of minorities, the socioeconomic empowerment of minorities, minority education, and use of the mother tongue.

The Center for European Migration and Ethnic Studies (CEMES) recently decided to join LGI in updating and maintaining the database. Both CEMES and LGI invite public administration officials, civil society activists, and researchers, scholars, and other experts to share information on innovative practices in community relations in multiethnic environments and local initiatives for resolving ethnic conflict. Contact Andrea Krizsan, Email: andrea@cemes.org, or Petra Kovacs, Email: kovacsp@osi.hu. To view the online database or download a submission form, please visit the Web site, at: http://lgi.osi.hu/ethnic/csdb.

The Practice of Best Practices
by Mátýás Gáspár

The term "best practice"—long used in private sector feasibility studies and performance evaluation in Western countries—has recently become a buzzword in public administration reform in Central and Eastern Europe. The term is increasingly used to refer to successful, innovative solutions to public sector problems. Best practices are defined in many ways:

• Methods of achieving maximum impact performance.
• The optimal means, techniques, and procedures for solving problems, achieving goals, and fulfilling needs.
• Paths leading to organizational excellence.
• Solutions that have already been applied elsewhere.
• Solutions that can be sustained legally, politically, socially, financially, institutionally, and strategically.
• Solutions that can be shared with and used by others.

Systematically collecting and disseminating new solutions—products of individual and communal creativity that have proved effective in practice—is the basic innovation technique in social, community, and public service. Major international, national, and regional development programs are based on them. Policymakers have begun to recognize that by incorporating best practices of others, they can reduce the risk associated with research and pilot schemes, thereby speeding up the development process.

The range of stakeholders is broad. Primary user groups include citizens (the end-users of all services and benefits), voluntary organizations, politicians and community leaders, experts in public administration and public service, the business sector, research and development organizations, and central, regional, and local governments.

The collection and dissemination of already proven practices is less expensive and involves much less risk than experimenting with new practices. Best-practice information systems can be powerful tools for building capacity, analyzing current trends, networking and exchanging information, engaging in technical cooperation and forming partnerships, involving citizens, and making organizations more competitive and effective.

Monitoring press reports is an effective method of collecting information on best practices. It is generally applied as a preparatory technique, as the level of detail and accuracy of press reports varies. Supplementary research methods include organizing tar-
get-oriented research projects; issuing “calls for tenders” on creating good solutions, documenting existing innovations, and writing case studies; purchasing descriptions; studying the literature on benchmark analysis; and collecting information through innovation networks of associations, unions, and other organizations.

This article is based on “The Practice of Best Practices,” LGI Discussion Paper Series No. 14, published in 2000. The paper is the outcome of an LGI research program on best-practice information systems in Central and Eastern Europe launched in February 1998. It is available online, at lgi.osi.hu/publications.

Types of Subnational Governments in the Russian Federation

A wide variety of subfederal government structures exists in the Russian Federation. Indeed, “local government” can have a significantly different meaning from one oblast (region) to another. Models of local government vary, often according to local traditions and the priorities of regional leaders. Four (by no means comprehensive) basic models of subnational governments can be distinguished, each offering different degrees of budgetary autonomy.

Model I: Local Governments in Cities and Rayons (Districts)

Under this scheme, municipalities in larger cities and rayons report to the regional government (smaller cities could also be included in the rayon category). Financial dealings with federal government agencies (transferring funds, sharing taxes) are specified by branches of the regional governments. This pattern is typical of most Russian regions.

Model II: Local Governments at the Sub-Rayon Level

Many municipal governments in large and small cities and rural villages operate at levels below the rayon. Regional governments have been reluctant to recognize these governments as participants in intergovernmental fiscal relations (despite Article 1 of Russia’s Federal Law on General Principles of Organization of Local Self-Government, which asserts that the major criteria classifying a self-government are appointment of bodies of power by election, availability of municipal property, and an independent local budget). At this level, local governments usually set up divisions of sublocal executive bodies that “interpret” the decisions made by the higher elected government authority.

Model III: “Double-Layer Cake” of Local Government

Different regions have interpreted this model in different ways, but most have taken one of two approaches. In the first approach, regional bodies create an intermediate level of local rayon-level government in the rayons and cities—local self-government bodies that report back directly to the regional government. Local self-government bodies are also formed in all populated areas (small towns, rural districts, districts within cities), which also report back to the regional government. Financial relations between this second level of local government and the regional government work through the intermediate level created in this system.

Under the second approach, regional governments refuse to recognize all branches of local self-government as full-fledged participants in intergovernmental fiscal regulations. Instead, they delegate their intergovernmental fiscal powers to “traditionally” formed bodies of local self-government, disregarding any sub-rayon level municipal entities that may have spun off.

Model IV: Local Governments with No Budgetary Rights

Two common approaches actually eliminate the budgetary power of local government, even within elected representative and executive bodies.

• In the first approach, regional authorities unilaterally resume, or retain, their functions of levying local taxes and forming local budgets within territories under their jurisdiction. The municipal government bodies then execute budgetary functions assigned to them without assuming responsibility for the sources of the revenues or how they are spent.

• Under the second approach, regional authorities officially volunteer to perform functions delegated to them by local self-government bodies, including establishing local taxes and forming local budgets in territories within their jurisdictions.

Subfederal governments in the Russian Federation are highly diverse, with regions having two, three, and even four levels of government. Policy recommendations for regional and subregional government and budgetary reform must take into account this structural diversity if they are to be effective.

World Bank Institute and LGI Offer Urban and City Management Course

The World Bank Institute and the Local Government and Public Service Reform Initiative (LGI) of the Open Society Institute are currently cooperating to run an urban and city management course, in Budapest, Hungary. The aim of the two-week course is to improve urban governance in the Central and Eastern European region.

Most of the population of Central and Eastern Europe lives in cities, and the lion’s share of the region’s economic activities take place there. The newly established democracies and local governments in the region face multifaceted and complex urban challenges, including the ever-growing demand for better infrastructure; the need for fast, flexible, and efficient public and private services; and increasing expectations for better urban environments. At the same time, local governments must operate within the framework of a shrinking public sector.

These conditions call for new methods of urban governance. Cities throughout the region have adapted and implemented innovative solutions, with varying degrees of success. In several urban centers, participatory decisionmaking, new methods of municipal financing, privatization of public service delivery, and regulation of privatized services have been initiated. These best practices are introduced in the course, together with other tools city managers and policymakers need to plan, manage, and govern cities.

The course is appropriate for executives and mid-career decisionmakers and officials from Central and Eastern Europe holding either elected or appointed positions in local governments. Future trainers of similar courses, urban practitioners, and private consultants working for local governments are also welcome. The teaching staff of the course includes practitioners and academics from the World Bank and other international institutions and leading experts on Central and Eastern Europe. In addition to lectures, case study presentations, and discussions, the course allows participants to operationalize what they learn by applying it to a concrete situation involving Budapest.

LGI will publish the best case studies collected from the course as part of its working paper series. Together with the World Bank Institute, it will also publish a textbook on Central European Urban Policy and Management. For more information, see the course Web site, at www.aemnet.hu/urbancourse.

LGI/OSI Publications

To order: Local Government and Public Service Reform Initiative (LGI), P.O. Box 519, H-1357, Budapest, Hungary, email: lgprog@osi.hu or.


This study examines urban development in six Hungarian municipalities of different sizes, positions, and locations. It focuses on four types of local government activities: urban planning and regulations, local government property management, utilization of municipal service delivery rights and competencies, and local government capital investment.

Urban planning, regulations, and administrative powers may have an impact on local revenue-raising and should thus be regarded as assets. Similarly, municipal service delivery rights can be utilized in such a way that private partnership leads to improved infrastructure and better services. Local revenue policy measures are also assets. Urban development should be based on the harmonized use of these types of assets. Local governments with well-integrated assets management will be able to improve their services and their financial position.

Urban development is a complex activity that requires cooperation among various types of professionals (property and real estate managers, urban planners and regulators, local government and company finance experts). These experts do not communicate easily, and local government administrators often fail to support cooperation among them.


Information: Budapest 1051, Nador.u.11, email: lgprog@osi.hu, Web site: www.osi.hu/lg.
Meager Foreign Investment Delays Improvement in Russia’s Energy Sector
by Juhani Laurila

Foreign direct investment (FDI) inflows to the Russian Federation have been modest by any standard: according to the State Statistics Committee, the gross flow of financial capital to Russia’s corporate sector was $11 billion in 2000, about 40 percent of which (or $4.4 billion) was FDI. The accumulated stock of all financial capital in Russia between 1993 and 2000 amounted to $32 billion, about half of which was FDI. In per capita terms, the FDI stock in Russia is among the smallest in European transition economies. A hostile business climate and prohibitive controls efficiently bar access to Russia in general and to the energy sector in particular. In fact, only about 10 percent of last year’s FDI went to the energy sector.

Production-sharing agreements (PSAs) were designed to attract foreign investment in the energy and raw material sectors. These agreements also seek to ensure Russian control and at least 70 percent involvement in the exploitation of natural resources, with corresponding benefits. These rules and the prevailing business climate explain why only three, or possibly four, of the 28 PSA contracts approved since the introduction of the PSA regime in 1996 are operational.

Although the Ministries of Economy and Energy recently agreed on modification of the tedious authorization procedures, doubts have already arisen about the tax rules introduced in the draft of the new PSA law (that is, concerns over the possibility of double taxation). The PSA regime reflects the psychological or political ambivalence that Russian officials, policymakers (particularly at the regional and local level), and citizens feel toward FDI, which helps finance exploration but may exploit national assets and wealth to Russia’s disadvantage. The Russian government, however, acknowledges that foreign capital and technology are necessary to modernize the energy sector and calculates that friendlier treatment of foreign investors could bring in $60–$70 billion in foreign investments during the next 10–15 years.

Russia will need substantial amounts of financing to explore, extract, and transport oil, natural gas, and electricity to be able to meet expected Western European demand. IEA and Russian estimates indicate that investments of $5–7 billion a year will be needed in the next 20 years simply to sustain the current level of oil production. About $2 billion a year is needed just to maintain production in depleting gas fields. Estimates of investments needed in the power sector are in the range of $5–$9 billion a year. Thus during the coming 20 years about $15 billion a year will be needed to keep the Russian energy sector in business.

The scant FDI is bound to slow development of Russia’s energy sector. Low, regulated domestic energy prices and nonpayment of energy bills increase strain on the sector. Russian energy production and investments, burdened by high capital costs, must also compete with lower-cost energy from elsewhere.

Time is running out. Exploration and construction of production facilities, pipelines, and related infrastructures takes years. It takes even longer to create market institutions and behavior conducive to a healthy business climate. Perhaps a more liberal and permissive PSA regime would serve Russian interests better by attracting FDI to Russia’s energy and raw materials sectors.

Juhani Laurila is an economist at BOFIT. This is an abridged version of his article “FDI and the Russian Energy Sector: An Ill-Managed Partnership,” published in BOFIT’s Russian Economy: The Month in Review, April 6, 2001.

Continued Dollarization of the Lithuanian Economy
by Igor Vetlov

In an environment of high inflation and excessive exchange rate volatility, the ability of a domestic currency to provide the basic functions of money can be significantly distorted. Such conditions can motivate a country to substitute a more stable foreign currency for its domestic currency. This shift to a foreign currency as a store of value and unit of account is often referred to as dollarization. In the context of macroeconomic stabilization, the evolution of dollarization can serve as a direct indicator of the credibility of the domestic currency and the overall success of stabilization efforts.

In the earlier stages of transition, Lithuania, like other transition economies, experienced a flight from its domestic currency, triggered by near hyperinflationary levels of inflation and a substan...
The Russian crisis in the second half of 1998 again increased dollarization in Lithuania—although, given the circumstances, the increase was surprisingly small. The big surge in the ratio came in the second half of 1999, when dollarization reached its highest level since 1995, probably in response to the rise in interest rates paid on dollar-denominated assets abroad. The continuing rise in the dollarization ratio may be related to the approaching repegging of the litas to the Euro, due to take place in early 2002, according to the Bank of Lithuania.

Igor Vetlov is a senior economist at the Bank of Lithuania Economic Research Center. This is an abbreviated version of his article “Dollarization in Lithuania,” published in BOFIT’s Baltic Economies: The Quarter in Review, in January 2001. See also BOFIT Discussion Papers, 2001, o. 1. BOFIT address: P.O. Box 160 FIN-00101 Helsinki, Finland, tel.: 3589-183-2268, email: bofit@bof.fi, Web site: www.bof.fi/bofit.

World Bank/IMF Agenda

Global Development Finance 2001: Temporary Slump after Strong Recovery

Growth in the transition economies of Europe and Central Asia [plus Turkey, which is part of the Bank’s Europe and Central Asia Vice Presidency] is expected to slow to 2.3 percent in 2001, according to Global Development Finance 2001, a new World Bank report. The trend reflects a decline in external demand, the effects of stabilization and structural reform programs, the impact of policy tightening to avoid overheating (in Poland, for example), and the crisis in Turkey. Pressures on fiscal balances include large public sectors, overextended social security systems, significant off-budget expenditures, forthcoming general elections, and ongoing adjustment costs related to the EU accession process. (Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia, and Turkey are seeking EU membership.) Annual growth in the region is expected to stabilize around 4 percent in 2002 and 2003.

Average GDP in the region posted a strong recovery in 2000, growing 5.6 percent. The Central and Eastern European countries benefited from increased exports to the EU, which contributed to a 4.6 percent rate of growth—a marked improvement over 1999, when growth declined 0.3 percent. The CIS countries posted growth of 6.8 percent, up from 2.6 percent in 1999. In the Russian Federation and Central Asia, higher oil prices allowed for increased fiscal outlays and investment, especially the pay-down of arrears and a shift to cash payments.

Long-term external debt in the region declined slightly to $387 billion in 2000, down from $391 billion in 1999. The debt-to-export ratio improved markedly, falling from 144 percent in 1999 to 114 percent in 2000. The debt-service ratio also improved, falling from 18 percent in 1999 to 14.6 percent in 2000. Net long-term capital flows to the region increased slightly, from $52.5 billion in 1999 to $54.8 billion in 2000.

World Bank Plans New Loans to Russia

A total of six to seven projects for Russia amounting to $600 million in new loans are expected in fiscal year 2001, of which three totaling $280 million are still to be completed, said Johannes Linn, Vice President for Europe and Central Asia, after concluding a three-day visit to Moscow in early April. The largest of the three credits likely to be put before the Bank’s board by June is a $150 million loan to kick-start treatment and prevention programs for HIV/AIDS and tuberculosis. Eighty million dollars will be lent in a pilot program to relocate people from high-maintenance cities above the Arctic Circle to warmer climates within Russia. A $50 million program will finance education reform in three regions of Russia. Off the agenda is the fourth structural adjustment loan, aimed at financing fundamental economic reforms.

“At this point, when the federal budget and the balance of payments are looking good, Russia doesn’t need such loans," Linn explained. However, the Russian government has requested the World Bank develop a monitoring system which can track the reform efforts. Russia is one of the World Bank’s largest borrowers, with $9.5 billion in loan commitments, $7 billion of which has already been disbursed.

Russia Turns Down IMF Stand-By

In March the Russian Federation turned down a one-year stand-by arrangement proposed by the IMF. While the deal would
not have provided Moscow with fresh infusions of cash, it might have helped the government reschedule about $40 billion (45 billion Euros) in debt with the Paris Club group of creditor nations. Russian Finance Minister Alexei Kudrin said Russia decided against signing the agreement "after assessing its capabilities." The IMF’s offer involved no money, unless the Russian economy took a sharp turn for the worse, but the accord would have required the Russian government to charge market rates on central bank loans to the government and release more information about the operations of the Russian central bank and the state-run savings bank, Sberbank.

IMF and World Bank economists have noted that Russia has done little to reform its banking sector since the country’s 1998 financial blowout and warned that another crisis is looming if nothing is done.

The IMF last lent money to Russia in the summer of 1999, when it disbursed $640 million as the first part of a $4.5 billion package. That aid program was put on hold amid complaints that Russia failed to meet various reform promises and stashed some central bank funds to offshore banks.

(Background report of Alan Cullison of the Wall Street Journal)

No Misappropriation of Ukraine Funds

"No instances of misappropriation of funds were uncovered," wrote Thomas C. Dawson, Director of IMF External Relations Department in his letter to the editor of the Financial Times (April 12, 2001). Dawson was responding to an article in the Financial Times that stated that foreign reserves of the National Bank of Ukraine were misused during 1997-98. "It is not unclear where most of the $700 million in central bank reserves went. In fact, as detailed in the audits the National Bank of Ukraine received all the income streams it was due," wrote Dawson.

According to the article in question, in 1997-98 Volodymyr Bondar, the former first deputy chairman of Ukraine's central bank, funneled some $700 million in central bank reserves on loan from the IMF through the Cyprus affiliate of Credit Suisse First Boston, the Swiss-U.S. investment bank. Bondar was arrested in March. The investigation into his activities has wide political implications. Those opposing the reform policy of Ukraine’s popular prime minister Viktor Yushchenko hope to use the case to weaken his position as he headed the central bank from 1993 to 1999.

Bosnia-Herzegovina Has Lowest Level of Foreign Investment in Eastern Europe

Between 1996 and 1999 foreign direct investment (FDI) in Bosnia-Herzegovina was just $4.7 million a year. During the same period, annual FDI was $56 million in Albania, $54 million in Moldavia, and $43 million in Macedonia.

The World Bank is ready to help the authorities create a better business climate, according to World Bank Executive Director Pieter Stek. Toward that end, the Bank has prepared a report recommending how to remove obstacles to private investment and improve the business environment. The Bank has also compiled a report on corruption, seen as a major obstacle to economic development in Bosnia-Herzegovina.

IMF Approves $368 Million Loan for Vietnam

In early April the IMF Executive Board approved in principle a three-year $368 million "arrangement" to Vietnam under the Poverty Reduction and Growth Facility (PRGF). The loan is intended to boost growth and reduce poverty. The Board also approved the release of a $53 million loan under the arrangement. Under the program, Vietnam’s GDP growth is projected to rise to 7 percent in 2003 (up from a projected rate of growth of 5 percent this year), with inflation held to less than 5 percent. Per capita income should rise by an average annual rate of 4.5 percent. Vietnam is to accelerate liberalization of its relatively restrictive trade regime. Private sector development and foreign direct investment will be promoted by easing barriers to entry and liberalizing the business environment for both domestic and foreign investors. Policy transparency will also be improved.

IMF Conditionality: Reduced but Not Dispensable

Discussions on how the IMF uses conditionality have moved forward, and the Fund is seeking external comments before a Board meeting in June. On March 7 the IMF Board agreed to reduce the use of structural conditionality, applying it only when critical to achieve macroeconomic stability. The need for conditionality will be assessed on a case-by-case basis and applied narrowly. Structural benchmarks, which have tended to be applied much like conditions, will be used more sparingly and only to monitor policy outcomes. Letters of Intent should make a clearer distinction between a government’s overall policy program and that part that is subject to Fund conditionality. Stressing that conditionality cannot compensate for lack of country ownership of the reform process, the Board advised staff to reduce financing where support is lacking. More will be done to test prior commitment and intent through “prior actions.” The streamlined approach will be applied immediately.

Since Horst Koehler’s “Streamlining Structural Conditionality” guidance note was issued last September, the average number of structural conditions in Poverty Reduction Growth Facility (PRGF) programs has been reduced by about a third. In some cases they have increased, however, with the addition of new governance conditionality. The IMF has not yet published its paper on governance conditionality—a new priority in its PRGF programs.

IFC Plans Governance Clauses

The International Finance Corporation (IFC), a private sector arm of the World Bank Group, plans to include corporate
governance clauses in loan agreements. IFC Executive Vice President Peter Woicke told the Financial Times that projects supported by the IFC already must meet strict environmental and social requirements. "We want to push for corporate governance, transparency, and minority shareholder protection in our loan agreements," he said.

New Initiative Launched in Bratislava to Clean Urban Air

The ways and means to clean the polluted air in the cities of Central and Eastern Europe and Central Asia were discussed during a three-day workshop, "Clean Air Initiative," held in Bratislava, Slovakia, in mid-April. The workshop was organized by the World Bank Institute and the Europe and Central Asia Region and supported by the Dutch and Japanese governments and the host city. The workshop provided a forum for discussion of various air quality themes, including health, environment, governance, transport, energy, public awareness, capacity building, and project financing.

World Bank Opens Regional Office in Croatia

The World Bank will open a regional office in Zagreb in the fall, in a bid to increase the impact of its assistance in Bulgaria, Croatia, and Romania. "This decentralized structure allows us to be closer to our client countries, other development partners, and stakeholders; to be more effective in our support for economic reforms and development; and to be more cost effective in our operations," said the head of the new office, Andrew Vorkink, Director of the South Central Europe Country Unit, which is responsible for the Bank’s assistance programs in the three countries. According to Vorkink, the move is expected to help the Bank respond better to the needs and challenges of the Stability Pact—launched in 1999 by major Western powers to help overhaul security, infrastructure, and economy in the Balkans—and help integrate the three countries with the European Union. The Bank will continue to maintain its country offices in Bucharest, Sofia, and Zagreb.

World Bank Consults on Belarus’ Country Assistance Strategy

The World Bank Group has begun a series of consultations with various social groups in Belarus to gather ideas and feedback that will help design its strategy of assistance to the country (CAS) for the next three years. The CAS, which is expected to be finalized by the end of the year, will contain all the Bank’s planned operations, including lending, analytical work, and technical assistance programs. It will be designed with the government of Belarus, in consultation with a range of representatives from civil society, including NGOs, community groups, the media, professional associations, and religious groups. So far the strategy of assistance covers targeted social protection activities, the impact of the Chernobyl disaster, the HIV/AIDS epidemic, and protection of the environment.

Global Partnership for Investment in Small and Medium-Size Enterprises Launched

To help small and medium-size enterprises gain access to financing and consulting services, the International Finance Corporation and the Small Enterprise Assistance Funds (SEAF) have launched a $2.5 million global partnership initiative. SEAF, an NGO based in the Netherlands and the United States, operates a network of 14 commercially driven investment funds around the world. With $140 million under its management, it invests in small and medium-size enterprises (firms with 10–100 employees and annual revenues of $200,000–$2 million) with high growth potential. After taking a minority equity position, SEAF provides a combination of fee-based and donor-funded customized consulting services in key areas, such as marketing, finance, and management, before eventually selling its stake. In 12 years of operation it has helped create 7,000 jobs and boosted the competitiveness of more than 160 small and medium-size enterprises.

Joint IMF–World Bank Study to Rebuild North Korea’s Economy?

IMF Managing Director Horst Köhler has proposed a joint survey by South Korea and the World Bank to help rebuild North Korea’s devastated economy. Following a survey of the economic situation, workshops would be organized with the participation of the two Koreas and the two international agencies. President Kim Dae-Jung has responded favorably to the suggestion, agreeing that a special analytical model is needed to rebuild the North’s economy.

North Korea’s economy is in a shambles after it collapsed because of mismanagement and the halt of major subsidies following the break-up of the former Soviet Union. As result, factories are at a standstill, hunger is widespread, and people are freezing in their unheated homes. Kim Jong-II, has made a call for “new thinking,” which officials in the South Korea say could lead to the opening up of the socialist economy to outside investment and technology.

IMF, World Bank: How Poor Countries Should Manage Debt

A decade after the break-up of the Soviet Union, some of its former republics are still desperate for investment. Armenia, Georgia, the Kyrgyz Republic, Moldova, and Tajikistan, which are among the poorest countries in the world, need foreign assistance and reform, according to a joint report by the IMF and the World Bank released in March. (The report, “Armenia, Georgia, the Kyrgyz Republic, Moldova, and Tajikistan: External Debt and Fiscal Sustainability,” is available on the Web, at http://www.imf.org/external/np/eur2/2001/edebt/eng/main.pdf.)
Having suffered severe financial strains after the break-up of the Soviet Union in 1991, the combined external debts of these countries—debt-free a decade ago—have ballooned to more than $5.7 billion. That sum represents a staggering debt load, averaging 422 percent of their annual government revenues and 122 percent of their annual exports, according to the report.

The two principal authors of the study, Mohammad Shadman-Valavi, IMF Assistant Director, and Samuel Otoo, World Bank Sector Manager, confirmed that this debt burden creates serious fiscal difficulties and will adversely affect poverty reduction efforts in the coming years. The report finds that the key to improving matters is gaining the confidence of foreign investors, which requires significant progress toward curbing corruption, increasing transparency, and improving the judicial process so that investors have some protection under the law.

Newly Approved World Bank Loans in Brief

China: $105.5 million project loan (5-year grace period, 20-year maturity) for environmental recovery of the Huai River and its tributaries. The loan will provide facilities for collecting and treating wastewater and establishing municipal wastewater utilities.


Georgia: $25.9 million, three-phase adaptable program credit (10-year grace period, 40-year maturity) to support the development of primary and general secondary education over the next 12 years. Phase 1 will develop a national curriculum for primary and general secondary education, train teachers and principals, and provide basic learning materials.

Web site: http://www4.worldbank.org/sprojects/Project.asp?pid=P055173. For more information, contact Bart Stevens (tel.: 202-458-2563, Email: Bstevens@worldbank.org).

Mongolia: $34 million IDA credit (10-year grace period, 40-year maturity) to reconstruct and upgrade roads in Mongolia’s central and western regions, implement a financial accounting system for the railways, and initiate a system of annual vehicle inspections.


Romania: $80 million adaptable program loan (5-year grace period, 17-year maturity) for the development of rural finance services, providing access to investment capital and safe banking services to individual farmers, rural microentrepreneurs, and small and medium-size businesses.


Russia: $85 million project loan (5-year grace period, 17-year maturity) to improve efficiency of district (municipal) heating systems and promote sound cost-recovery policies and commercial practices. Project funds will initially go to 9–10 Russian cities, including Syzran, Nerungri, Mytishi, and Dubna. Kostroma, Krasnoyarsk, Volgograd, Kazan, and Tambov could join the project later.

Ukraine: $28.2 million project loan (5-year grace period, 20-year maturity) to improve Sevastopol’s heating supply by introducing decentralized gas-fired mini-boilers. Sevteploservis, a new enterprise, will improve heating services in this major city on the Black Sea on a commercial basis.


Conference Diary

For the Record

“Two New Leaders: Will It Make a Difference?” Harvard-Columbia Arden House Conference on American-Russian Relations

March 16–18 2001, Arden House Conference Center, Harriman, New York, United States


Information: Harvard-Columbia Arden House Conference Center, Davis Center for Russian Studies, Harvard University, 1737 Cambridge Street, Cambridge, Massachusetts, United States, 02138, tel.: 914-351-2171 or 617-495-8900, fax: 617-495-8319, Email: dgurvich@fas.harvard.edu.

EBRD Annual Meeting and Business Forum 2001

April 22–24, 2001, Hilton London Metropole Hotel and Conference Centre, London, United Kingdom

The European Bank for Reconstruction and Development (EBRD) held its 10th annual meeting in London April 22–24, 2001. The occasion marked the 10th anniversary of the start of the bank’s operations. The theme of this year’s conference was “Ten Years of Investing for Economic Growth and Transition.” The EBRD Business Forum, held alongside the annual meeting, comprises a series of seminars, roundtables, and debates on the countries in which the EBRD invests.

Information: http://www.ebrd.com/annualmeeting, Office of the Secretary General, Annual Meetings Unit, European Bank for Reconstruction and Development.
Forthcoming

World Bank's Thirteenth Annual Bank Conference on Development Economics
May 1–2, 2001, Washington, D.C., United States

Opening address by World Bank President James D. Wolfensohn, keynote address by World Bank Senior Vice President and Chief Economist Nicholas H. Stern.

Session One: Globalization and Inequality
Kevin O'Rourke, Trinity College, Dublin; Daniel Cohen, Ecole Normale Superieure, Paris; Richard N. Cooper, Harvard University; and Anthony Venables, London School of Economics.

Session Two: Health and Development
Morten Rostrup, Medecins sans Frontieres; Jean O. Lanjouw, Yale University; Anne Case, Princeton University; and Tomas J. Philipson, University of Chicago.

Four parallel workshop sessions will be held each afternoon. Participation by non-Bank and non-IMF staff by invitation only.

Restructuring Stability and Development in Southeastern Europe
June 1–3, 2001, Volos, Greece

Organizer: South and East European Development Center of the University of Thessaly, Greece (SEED).

Participants in this international conference will discuss the situation in the Balkan region and try to answer several open questions: Will Western-type growth and prosperity levels eventually be reached in Eastern and Southern Europe, or are old divisions simply being replaced by new ones with respect to levels of development and economic structure? Why has performance in the Balkan countries been so different from performance in Central Europe? Why did the Balkans fail in many respects in their transition from plan to market? Are domestic policy failures or unfavorable initial conditions and geography responsible for their poor performance? What has been the policy response of the European Union and other international organizations? Is this policy response adequately designed and implemented? What are the goals, composition, impact, and future of the Stability Pact? The conference will attract development experts, policymakers, and leading academics.

Information: Pedion Areos, 38334 GR-Volos, tel.: 30 421 74467-8; fax: 30 421 74385. Email: pettrakos@uth.gr or mt siapa@uth.gr, http://www.uth.gr/main/research/synedria/anakoinseis/se_dev_conf.htm

The Sixth Annual International Conference on Transition Economics,
June 23–26, 2001, Portoroz, Slovenia

Sponsored by the Centre for Economic Policy Research (CEPR) and the William Davidson Institute, this conference will create a forum in which leading transition economists from different universities and countries can present new research, meet and develop long-term collaborative relationships, and complete ongoing research.

Information: www.wdi.bus.umich.edu.

Transition Economics Workshop for Young Academics
June 27–July 5, 2001, Portoroz, Slovenia

Sponsored by the Centre for Economic Policy Research (CEPR), this workshop, a follow-up to the international conference, will promote the research activities of Ph.D. students and recent Ph.D.s from both the EU and Phare countries of Central and Eastern Europe. Young academics will receive feedback on their work in progress from established academics in the field and from one another. The workshop is organized by Mark Schaffer, Centre for Economic Reform and Transformation, Heriot-Watt University; Janez Prasnikar, Research Center of the Faculty of Economics, University of Ljubljana; and Gérard Roland, ECARES.

Information: www.cepr.org.

Sustainable Agriculture in Central and Eastern European Countries: The Environmental Effects of Transition and Need for Change
September 10–16, 2001, Nitra, Slovakia

Organizers: Consortium of Chair of Resource Economics, Germany; Agricultural University of Nitra, Slovakia; and the Food and Agriculture Organization Subregional Office for Central and Eastern Europe in Budapest, Hungary.

Call for papers: Papers should address the following questions:

- What are the causes and effects of institutional changes on water, soil, and biodiversity/landscape?
- What are the determinants of current agri-environmental policies and their effects on water, soil, and biodiversity/landscape, and what are the opportunities for policy changes?
- What are the natural, economic, and political determinants of farming systems in Central and Eastern European countries during transition, and what impact do they have on the environment? Which indicators are useful for capturing the environmental effects of farming systems?

Deadline: May 15, 2001. Abstract must be written in English and sent electronically in Microsoft Word format to the Seminar Secretariat in Berlin. Abstract should include the names of all authors, with the surname of the paper presenter typed in capitals; the Email addresses of all authors; and the institutional affiliations and mailing addresses of all authors. Abstracts should contain no symbols, references, or equations.
New Books and Working Papers

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

World Bank Publications

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Recent Titles


In its fifth edition, this World Bank statistical reference provides a comprehensive view of the world economy. The print edition contains more than 80 tables and 600 indicators for 148 economies and 14 country groups, with basic indicators for another 59 economies. The six sections cover world view, people, environment, economy, states and markets, and global links. The volume includes the most recent data on poverty, education, health, and the environment from around the world, as well as new data on the digital divide and how information communication technology is changing the process of development.


This volume provides easy-to-read colorful world maps, tables, and graphs highlighting key social, economic, and environmental data for 206 countries. The atlas parallels the six thematic sections of the World Development Indicators (world view, people, economy, environment, states and markets, and global links). It contains new estimates of purchasing power parities and gross national income, as well as, share of exports, agriculture, and investment in GDP.


This toolkit describes international best practices in investment promotion, gained during MIGA’s 12 years of investment experience in more than 150 emerging economies and developing countries. It is a useful guide to national and local investment intermediaries for attracting and retaining foreign direct investment. Its nine modules cover all basic functions of investment promotion: understanding foreign direct investment, developing an investment promotion agency, creating an investment promotion strategy, building effective partnerships, strengthening the location’s image, targeting and generating investment opportunities, servicing investors, monitoring and evaluating activities and results, and utilizing information technology.

Technical Papers


Pietro Garibaldi, Mattia Makovec, and Gabriella Stoyanova, From Transition to EU Accession: The Bulgarian Labor Market During the 1990s, TP 494, 2001, 80 pp.

Working Papers

www.worldbank.org/research/workingpapers

Michael Lokshin and Martin Ravallion, Short-Lived Shocks with Long-Lived...

In theory it is possible that a vulnerable household will never recover from a sufficiently large but short-lived shock to its income. Such shocks could explain the persistent poverty that has emerged in many transition economies. In general, however, households bounce back from transient shocks, albeit not rapidly, as this study, based on statistics from Hungary, shows.

To order: Patricia Sader, Room MC3-556, tel.: 202-473-3902, fax: 202-522-1153, Email: psader@worldbank.org.


To order: Agnes Yaptenco, Room MC3-444, tel. 202-473-1823, fax: 202-522-1155, Email: ayaptenco@worldbank.org.

Carlos B. Cavalcanti and Zhicheng Li, Reforming Tax Expenditure Programs in Poland, WPS 2465, October 2000, 23 pp.

Various “tax expenditure programs”—tax deductions, exemptions, credits, deferrals, preferential tax rates, and exclusions from taxation—that Poland introduced in 1992 to compensate lower-income taxpayers for the withdrawal of subsidies have proliferated, making the normative tax system difficult for the average taxpayer to understand, reducing the tax base, and benefiting higher-income taxpayers more than the taxpayers they were originally designed to help. The authors suggest that strengthening the administration of Poland’s tax expenditure programs is the first step toward making these programs effective and equitable, limiting their costs, and preventing the tax base from shrinking.

To order: Anita Correa, Room H4-318, tel.: 202-473-8949, fax: 202-522-2755, Email: acorrea@worldbank.org.


The claim has been made that government corruption is less severe in small countries than in large countries. The authors show that this relation is a result of sample selection. Most corruption indicators provide ratings only for countries in which multinational investors have the greatest interest. These tend to include almost all large nations but only those small nations that are well governed.

To order: Paulina Sintim-Aboagye, Room MC3-422, tel.: 202-473-8526, fax: 202-522-1155, Email: psintimaboagye@worldbank.org.


Despite a common parentage for most of the twentieth century, Uzbekistan and Kazakhstan followed seemingly different paths in the transition to a market economy. Uzbekistan adopted a cautious, gradual approach to market reform, while Kazakhstan followed a more aggressive strategy. Kazakhstan may have achieved a better policy environment, but its economic performance has not been better than Uzbekistan’s. Missing pieces of reform—especially deficiencies in the competitive environment—combined with a rapidly diminishing role for the state may have limited the gains from policy reforms in Kazakhstan.

To order: Lorie Henson, Room H4-347, tel.: 202-458-4026, fax: 202-522-2751, Email: lhenson@worldbank.org.


Developing the legal and regulatory framework, improving contract enforcement, and reducing administrative barriers in the business environment encourage investment and improve the efficiency of resource allocation. Policymakers in transition economies should complement privatization with institution building and promote foreign direct investment and public and private investment in education and research and development.

To order: Anne Nelson, Room H6-393, tel.: 202-473-7117, fax: 202-522-0073, Email:anelson@worldbank.org.


Banking efficiency in Turkey was expected to improve after liberalization. Instead, it declined, because of the worsening macroeconomic situation.

To order: Mustafa Dinç, Room MC2-814, tel.: 202-473-6233, fax: 202-522-3669, Email: mdinc@worldbank.org.


High-quality institutions—reflected in the rule of law, bureaucratic quality, freedom from government expropriation, and freedom from government repudiation of contracts—mitigate the adverse economic effects of ethnic fractionalization. Ethnic diversity has a more adverse effect on economic policy and growth when a government’s institutions are poor. But poor institutions have an even more adverse effect on growth and policy when ethnic diversity is high. In countries in which institutions are good enough, however, ethnic diversity does not weaken growth or worsen economic policies. Good institutions also reduce the risk of wars and genocide that might otherwise result from ethnic fractionalization.

To order: Kari Labrie, Room MC3-456, tel.: 202-473-1001, fax: 202-522-3518, Email: klabrie@worldbank.org.

The authors examine strategies for dealing with banking crises in 12 transition economies—five from Central and Eastern Europe (Bulgaria, the Czech Republic, Hungary, Macedonia, and Poland); the three Baltic states (Estonia, Latvia, and Lithuania); and four CIS countries (Georgia, Kazakhstan, the Kyrgyz Republic, and Ukraine). The Central and Eastern European countries extensively restructured and recapitalized their banks, most CIS countries pursued large-scale liquidation, and the Baltic states generally adopted a combination of liquidation and restructuring. The various strategies reflected the macroeconomic conditions and the level of development in each country's banking sector.

The Central and Eastern European countries generally incurred higher fiscal costs than the CIS countries but ended up with sounder, more efficient banking systems, with many of the recapitalized banks privatized to strategic foreign investors. The approach of the CIS countries was less fiscally costly but has left them with weak banking systems and low levels of intermediation. The Baltic states appear to have struck a good balance, incurring modest fiscal costs while making their systems sounder and more efficient.

Policy implications of the study include the following:

- Operational, financial, and institutional restructuring should be undertaken in parallel.
- Financial restructuring should involve adequate recapitalization to deter moral hazard and repeated recapitalization.
- Operational restructuring should entail privatization to core investors (particularly to reputable foreign banks) The enterprise problems underlying banking problems must also be addressed.
- Fiscal costs were reduced when governments dealt only with bad debt inherited from the socialist period; when small banks that held few deposits were allowed to fail, where the social costs of such failure were low; and when only banks that got into trouble because of external shocks were rescued while those suffering from poor management were liquidated.
- The government, not the central bank, should undertake bank restructuring. Central bank refinancing is not transparent and can lead to hyperinflation.

To order: Armanda Carcani, Room H4-326, tel.: 202-473-0241, fax: 202-522-2751, Email: acarcani@worldbank.org.


State policies can have an enormous affect on gender equity. They can mitigate cultural constraints on women's autonomy (as they have in China and India) or slow the pace of change in gender equity (as they have in the Republic of Korea). Policies to provide opportunities for women's empowerment should be accompanied by communications efforts to alter cultural values that limit women's access to those opportunities. China has achieved the most gender equality, the Republic of Korea the least.

To order: Monica Das Gupta, Room MC3-633, tel.: 202-473-1983, fax: 202-522-1153, Email: mdasgupta@worldbank.org.


With the notable exception of China, in most countries with below-median per capita income the population has grown faster than total wealth. This trend is ultimately unsustainable. For many of these countries, policies for sustainability will require both boosting savings and slowing population growth.

To order: Luz Rivera, Room MC5-206, tel.: 022-458-2819, fax: 022-522-1735, Email: trivera@worldbank.org.


During the reintegration of the Central European countries into the world economy, their proximity and access to the European Union greatly affected first the flow of capital and then the flow of goods. Countries that adopted radical liberal reform and had preferential access to EU markets have benefited most, attracting foreign direct investment and convincing multinational corporations to locate production sites there.

Author's Email: bkaminski@worldbank.org.

Other World Bank Publications


In this theoretical and empirical analysis of the relation between barter and indebtedness of Russian firms, the authors build a
The model in which a firm uses barter to protect its working capital against outside creditors, even when barter involves high transaction costs. During renegotiation, rational creditors agree to postpone debt payments rather than destroy the firm's working capital. Debt restructuring reduces barter but does not eliminate it completely. Firm-level evidence from two independent surveys is consistent with the model's predictions.

Pietro Garibaldi, Mattia Makovec, and Gabriella Stoyanova, From Transition to EU Accession: The Bulgarian Labor Market During the 1990s, March 2001, 80 pp.


**International Monetary Fund Publications**


**Occasional Papers**


The Baltic countries have taken important steps to shore up the long-term financial health of their pension funds by preparing to implement a three-pillar scheme. But fundamental questions about the design of the fully funded scheme remain. For example, a tax-financed move from a pay-as-you-go pension system toward a fully funded plan would tend to increase aggregate savings, while a debt-financed reform would reduce aggregate savings. A move to a fully funded pension scheme imposes important costs, in particular on the current generation and the budget. Introduction of a mandatory fully funded scheme does not in itself solve the problems associated with aging societies.

Barry H. Potter and Jack Diamond, Setting Up Treasuries in the Baltics, Russia, and other Countries of the Former Soviet Union, OP No. 198, 42 pp.

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**New Europe Barometer Omnibus Survey**

This survey, forthcoming this fall, covers 10 European Union accession countries (Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia) plus Belarus, the Russian Federation, and Ukraine as well as Croatia, Serbia and neighboring Balkan countries as appropriate. Topics include earning money in unofficial economies, corruption and crime, destitution and prosperity, migration in search of work, health, support for democratic and undemocratic forms of government, and the European Union and NATO. Richard Rose and Christian Haerpfer directed the project. Information: i.m.rogerson@strath.ac.uk.

The first major social science survey in Moldova incorporates all the standard Barometer questions on politics, economics, and social conditions, facilitating comparison with other former Soviet republics and Romania.


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combined impact of low social spending and low household income is beginning to take its toll, however. Children whose families are not able to contribute toward their education or health care face the risk of being excluded from access to these vital services. Families are unable to protect children from the negative outcomes associated with transition. Governments need to intervene, both to protect the future human capital of their countries and to minimize the multiple risks children face during transition.


This paper compares child poverty dynamics using panel data from Germany, Hungary, Ireland, the Russian Federation, Spain, the United Kingdom, and the United States. It examines how into and out of the poorest quintile of the children's income distribution. There is significant uniformity in patterns of income mobility and poverty dynamics across the seven countries, except for Russia, where children in the mid-1990s were much more likely to move into or out of the poorest quintile than were children in the other countries studied. This trend will probably subside once the Russian economy stabilizes.

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