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Aftermath of the September Terrorist Attacks—A Slowdown in Transition Economies Too?

In the wake of the terrorist attacks on September 11, the economic fallout for Europe's transition economies depends on developments in the United States. Since the countries of the European Union are the major trade partners of these economies, the key will be how much Western European growth slows in response to the weakening of the U.S. economy.

The global economy will suffer in the aftermath of the terrorist attacks on the United States, but it is too early to have a complete sense of the impact, said World Bank President James Wolfensohn in a recent interview with the *Canadian National Post*. A slowdown in global trade and tourism as a result of fear of war will have a major effect on developing countries and their people.

The recent events were caused not by poverty, but by fanatics, the president emphasized. Nevertheless, he said, if people are poor and disadvantaged, risk of conflict is increased. That makes the World Bank's efforts to alleviate poverty and help countries improve their economies even more crucial. "There are 6 billion people on the planet, and 4.8 billion live in developing countries; that is 80 percent of the world," he said.

In the wake of the attacks on the United States, the World Bank and its sister institution, the International Monetary Fund, canceled their annual meetings, usually held in September. No decision has been made on meeting later or in another location. Wolfensohn voiced hope that other international initiatives—such as an attempt to launch a new round of global trade talks—would not be deferred because of the events in the United States. (A meeting of the World Trade Organization is planned for later this year in Qatar to discuss a new round of trade negotiations.)

Global Sluggishness

Economists predict that the blow to U.S. consumer confidence will lead to a more pronounced global deflation. The terrorist attacks came at a time of significant weakness in global growth, linked to the bursting of the U.S. information technology bubble and the end of a 10-year period of rapid U.S. expansion. With Japan in a long-term stagnation and euro-area growth disappointing, the outlook for global growth has hinged on the outlook for the U.S. economy, which accounts for 30 percent of global output. Reduced U.S. consumer spending would further dampen growth in U.S. imports. Countries depending on sales in the U.S. market will feel the pinch of the American slowdown. Moreover, uncertainty raises the risk premium on emerging market borrowing, an effect that will hit hardest in economies with the greatest external financing needs. Brazil and Argentina stand out among these economies, but the Philippines is also on the list. Central European external deficits are generally well financed by long-term investment inflows.

In 2001, even before the September 11 terrorist attacks on the United States, the global economy was set to experience its most severe slowdown since the 1974 oil price shock. In 2000 world growth averaged 4.7 percent, the fastest pace since 1988. But the Economist Intelligence Unit estimates that in 2001 global economic growth will slow to only 2.4 percent, similar to the rate in 1993, when Western Europe was in recession.

The economic impact of the attacks will be felt mainly during the fourth quarter of 2001, when consumer and capital spending will be more subdued than previously expected. Although risks have increased, a recession can be avoided. Economic recovery next year will be sluggish, however, with growth averaging only 2.3 percent.

Weakening Growth in Eastern Europe

Data for the first half of 2001 confirm a long-predicted slowdown in growth in the transition region, although some econo-

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mies continue to grow faster than expected. This follows good performance in 2000, the most successful year of the transition. Real GDP growth for the region (weighted by GDP at purchasing power parity exchange rates) averaged 6 percent, more than twice the rate in 1999. Reforms enacted during the 1990s in many countries seem to have helped fuel the growth. Average growth in the region is expected to weaken in 2001, to 4.5 percent. Eastern European countries may gain from the crisis, however, if portfolio investors, seeing Latin America's emerging markets as too dependent on trends in the U.S. economy, seek diversification.

Predictions about economic developments over the next year vary, but some tendencies emerge from forecasts for selected economies in Central and Eastern Europe and for China:

In **the Russian Federation,** the negative impact from the terrorist attacks against the United States is expected to be limited. Inadequate structural reforms, continuing appreciation of the ruble, and lower oil prices will be the main constraints on economic growth. (The United States accounts for a mere 8 percent of Russia's exports.) As a major exporter of primary materials, minerals, and oil and gas, Russia will benefit if the prices for these commodities rise as a result of protracted military action. Oil and petrochemicals account for more than 80 percent of Russia's exports, and metals for another 10 percent. (More details on page 18.)

In **Poland,** some rebound is likely in the second half of 2001, but for the year as a whole growth is expected to reach only 2.5 percent—the slowest rate of expansion since the early 1990s. Exporters losing markets in the European Union may trim their workforces, which could further increase unemployment (currently 15.9 percent). (See also page 46.)

In **Hungary,** growth is expected to slow to 4.2 percent in 2001 as a result of a slowdown in EU imports, real appreciation of the forint (which will accelerate following the recent widening of the exchange rate band), and a predicted monetary tightening (to compensate for fiscal slippage and nominal wage growth). Foreign direct investment from the United States is likely to slow as a result of the terrorist attacks. More than a third of Hungary's $22 billion in foreign direct investment has come from the United States in the past 10 years, and there were $200 million in U.S. investments in Hungary last year alone. Still, the effects of the slowdown in U.S. investment will not be significant.

In the **Czech Republic,** in contrast to the general trend, growth is expected to pick up. GDP growth of 3.5 percent is predicted for 2001, as long as the international environment remains calm. The wild movements in U.S. security markets could hurt the Czech capital market, however, as many local financial companies have invested in U.S. bonds.

Most of the Balkan countries will share in the dominant regional trend of slowdown in 2001. **The Federal Republic of Yugoslavia** has not yet fully reentered the international economy after a decade of isolation, and the attacks on the United States are expected to have only limited effects. But no GDP growth can be expected if foreign direct investment fails to flow into the country. In **Croatia**, the tourist industry, among the main generators of growth in 2000 and 2001, will probably suffer next year. In **Bulgaria,** inflows of foreign direct investment are likely to slow. **Romania** is expected to record significantly higher growth this year than last—4.5–5 percent, up from 1.6 percent. Depending on recovery in Western Europe, the export-led economic growth could hold on next year, but strong financial inflows are needed to balance the widening trade deficit. So far, the government has failed to attract large foreign investors.

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China's growth next year is not expected to dip below 8 percent. Fiscal expansion will continue to boost domestic demand, and the extremely competitive export sector (focusing on low-cost consumer goods) will thrive in a deflationary global economy, even if the U.S. market becomes more difficult.

Based on reports of the U.K.-based Economist Intelligence Unit and Oxford Analytica, as well as news agency reports.

An Economist's View: Poverty Did Not Cause the Terror Attacks

by Keith Marsden

If the United States and its allies are to win the fight against terrorism, they must not only employ their military might discriminately and effectively against the perpetrators. They must also answer apologists who try to explain, and even justify, terrorist actions by talking about the "basic roots" of the conflict. When examined against factual evidence, their arguments turn out to be false or grossly exaggerated.

• **Poverty.** Islamic terrorists are said to be revolting against the poverty imposed on Arab and other Muslim states by capitalism and its trading system. But information provided by their statistical authorities indicates that these states and their peoples have benefited greatly from participation in the global economy. Data for 13 Arab countries show that their gross national product rose at an average annual rate of 3.5 percent during 1965–98, a more than threefold increase. Growth rates for Egypt, Saudi Arabia, Syria, and Tunisia topped 5 percent, a fivefold increase since 1965. The average per capita income of an Arab nation (a term often employed by Arab leaders) was $4,000 in purchasing power parity dollars in 1998, above that of East Asia, at $3,280. It would have been substantially higher but for the civil wars in Algeria, Lebanon, Sudan, and the Republic of Yemen and the Iraqi attacks on Iran and Kuwait. Economic growth in non-Arab Muslim states averaged 4.5 percent annually during 1965–98, reaching as high as 6.8 percent in Indonesia and Malaysia. By comparison, growth averaged just 2.6 percent for the United States and 3.0 percent for all high-income countries over this period.

• **Trade.** World Trade Organization rules, it is claimed, are heavily weighted against Muslim states, and their access to U.S. markets has been largely restricted to oil. In fact, total exports of manufactures from the Middle East rose at an annual rate of 9 percent during the 1990s, and exports to North America rose by an even higher 14 percent. Total merchandise exports increased 13.5 percent annually from Malaysia, 8.5 percent from Indonesia, and 6 percent from Morocco and Tunisia, all topping the world rate of 5 percent. The United States offered the most dynamic major market during the 1990s. Its total merchandise imports increased 8.5 percent annually, compared with 4 percent for the European Union and 3 percent for Japan. And exports from Muslim states have been buoyant in both labor-intensive and new technology products. For example, exports of clothing from Bangladesh rose at a 25 percent annual rate during the 1990s, and Indonesia's by 10 percent. Exports of office machines and telecommunications equipment from Malaysia jumped 21 percent annually. Clearly, if the right policies are applied, the existing trading system provides rapidly expanding market opportunities that benefit both Muslim exporters and global consumers.

• **Aid.** Muslim countries received net official development assistance totaling nearly $29 billion from 1993 to 1998 (the latest year available). Over that period Bangladesh received $6.5 billion in official aid, Indonesia $5.4 billion, and Pakistan $4.9 billion. In 1998 aid inflow as a share of recipients' GNP reached 13.8 percent in the West Bank and Gaza, 7.9 percent in Yemen, 7.1 percent in Jordan, and 2.2 percent in Egypt—and just 1.1 percent in Israel.

In short, none of the arguments provides a convincing explanation or justification for Islamic terrorism. Schools and mosques inculcate a doctrine that combines religious zeal, anger over perceived injustices, and glorification of self-sacrifice—a sacrifice that will be rewarded in an afterlife and win the respect of families and a wider public. This dogma is reinforced by state- and clergy-dominated media and by the relative neglect of secular education. On average 43 percent of adult females (15 years and older) and 23 percent of the men are still illiterate in Arab countries. Government spending on education averages just 4.5 percent of GDP, compared with military spending of 7.4 percent.

The international development community and civil society organizations could play an important role in changing these attitudes and priorities.

Based on a recent article in the Wall Street Journal Europe. *The author is an economist living in Geneva.*

Integration Spurs Growth, Poverty Reduction

by Paul Collier and David Dollar

Globalization—the growing integration of economies and societies that results from international flows of goods, services, capital, people, and ideas—has increased growth and reduced poverty in a diverse group of countries, including China, India, Uganda, and Vietnam. Integration accelerates development. Workers with the same skills—whether farmers, factory workers, or pharmacists—are less productive and earn less in developing economies than in advanced ones. Integration through trade, migration, foreign investment, and international telecommunications narrows these gaps by raising productivity in the developing world.

The first great wave of modern globalization occurred between 1870 and 1910. Transport costs fell while flows of trade, capital, and labor increased. Between 1870 and 1914 trade roughly doubled as a share of global income. International capital flows were also extensive. A century ago globalization seemed as inevitable as it does today.

But incompetent economic policies, widespread unemployment, and growing nationalism quickly drove governments into beggar-thy-neighbor protectionism. By the late 1940s trade as a share of global income was back to its level in 1870—protectionism had offset 80 years of progress in transportation. During this period of autarky, global growth slowed: growth in per capita incomes fell by about a third and the number of poor people continued to rise. Moreover, world inequality continued to rise—protectionism was not equalizing.

The second wave of globalization, from 1950 to the late 1970s, saw unprecedented integration among rich countries, which trade relationships restored through a series of multilateral trade liberalizations under the General Agreement on Tariffs and Trade (GATT). Most developing economies, in contrast, restricted their involvement in foreign trade and investment, remained stuck in primary commodity exports, and were isolated from capital flows. But there were notable exceptions, and success stories like the Republic of Korea and Taiwan (China) encouraged others to open up to trade and investment.

During the third wave of globalization, which began in the late 1970s, developing countries with large populations (including China and India) began for the first time to open up to foreign trade and investment. (Openness can be measured through tariff rates, the extent of nontariff barriers, the share of trade in GDP, or the degree of distortion in the foreign exchange market—that is, the size of black market premiums.) Growth rates in these countries have accelerated as they have integrated with the global economy. Their experience is consistent with growth models in which technological advance plays a key role in growth, and integration of backward with more advanced regions accelerates technological learning. "Globalizers" have not just liberalized trade and investment, they have also implemented sound institutions and policies for productive investment and growth.

The expansion of China's participation in international trade since it initiated reforms in 1978 has been one of the most remarkable features of its transformation. While gross national product (GNP) grew by 9 percent a year in 1978-94, exports grew by about 14 percent and imports by 13 percent. In India, where an inward-oriented strategy brought disappointing results in terms of growth and poverty reduction, the government in 1991 started a series of far-reaching reforms that liberalized the domestic economy and

Demographic and Economic Indicators for Globalizing and Non-Globalizing Developing Countries, 1980 and 1997
(population-weighted averages)

Indicators	*24 globalizers*	*49 non-globalizers*
Population, 1997	2.9 billion	1.1 billion
Per capita GDP, 1980 [a]	$1,488	$1,947
Per capita GDP, 1997 [a]	$2,485	$2,133
Inflation, 1980	16%	17%
Inflation, 1997	6%	9%
Rule of law index, 1997 (world average = 0)	-0.04	-0.48
Average years of primary schooling, 1980	2.4	2.5
Average years of primary schooling, 1997	3.8	3.1
Average years of secondary schooling, 1980	0.8	0.7
Average years of secondary schooling, 1997	1.3	1.9
Average years of tertiary schooling, 1980	0.08	0.09
Average years of tertiary schooling, 1997	0.18	0.22

a. Measured in terms of purchasing power parity.
Source: Author and World Bank data.

opened it to foreign trade and investment. As a result per capita income rose more than 4 percent a year in the 1990s. Vietnam has also made a remarkable turnaround, and now has a far more open economy than it did 10 years ago.

These examples provide persuasive evidence that openness to foreign trade and investment—coupled with complementary reforms—can boost growth in developing countries. During the most recent wave of globalization some countries have seen their share of trade in GDP jump 50 percent or more. Other developing countries, by contrast, actually trade less today than they did 20 years ago. Many of the countries that have seen large increases in trade are the same ones that have received the bulk of increased foreign investment in the developing world.

By 1995 foreign ownership of assets was equal to 57 percent of global income, up from 18 percent in 1980. The nature of capital flows has also changed. In the early 1900s such flows typically financed public infrastructure projects (canals, railroads) or direct investments related to natural resources. Today most capital flows to developing countries are direct investments, and a large share goes to manufacturing and services.

These changes are related to lower transport costs, shorter transport times for both people and goods, and the revolutionary progress in telecommunications—from surface telephones to fax machines to cellular phones to the Internet. Since 1920 seagoing freight charges have dropped by about two-thirds, air travel costs by 84 percent, and the cost of a three-minute telephone call from New York to London by 99 percent. Thus production in widely differing locations can now be integrated in ways that were simply impossible before.

As integration increased, the annual growth rate of the world economy shot from 1.0 percent in the mid-19th century to 3.5 percent in the last 40 years of the 20th century. Higher growth sustained over several decades makes a huge difference in real living standards. Today it takes just two or three years for the world economy to produce all the value it produced in the entire 19th century.

Convergence and Divergence in the Distribution of Wealth

The tremendous increase in human wealth through about 1975 was very unequally distributed among countries. In 1913 the per capita income of rich countries was 16 times that of the poorest. Since then rich countries have grown faster—so today their per capita income is 64 times that of the poorest countries.

But at the same time, there has been convergence among and within nations that have integrated with the global economy. Many of today's industrial countries that were relatively poor in 1820 have seen the fastest growth in per capita income, so among this group inequality has declined. Similarly, per capita incomes have converged within countries and regions. Evidence suggests that when economically backward regions integrate with more advanced ones, their growth rates accelerate and their income levels gradually converge.

During the 1990s globalizing developing countries—including Brazil, China, Hungary, India, and Mexico—saw annual growth rates accelerate to 5 percent, while growth in industrial countries slowed to 2 percent. Among non-globalizing developing countries, average growth was negative in the 1990s. Thus in the 1990s the globalizers were catching up with rich countries, while non-globalizers continued to fall further behind.

In 1980 the globalizers were poorer (with per capita GDP averaging $1,488, measured in terms of purchasing power parity) than other developing countries ($1,947); by 1997 they were richer (see table). Among the globalizers average inflation was 16 percent in 1980, but by 1997 it had fallen to single digits. In 1980 the two groups of countries had similar educational attainments. But since then the globalizers have seen a much bigger increase in the average years of primary schooling among the adult population. Finally, in 1997 globalizers scored better on an index measuring property rights and the rule of law. The same index is not available for 1980, but countries such as China and Hungary have clearly strengthened property rights as a part of overall reforms. Globalizing transition and developing countries have moved forward on a broad range of reforms, and their experience shows how openness—coupled with other good economic and social policies—can contribute to development.

Contrary to views that globalization is increasing inequality within countries, there is no systematic relationship between measures of globalization and changes in household inequality. Some countries open up and see inequality rise; in others the income gap between rich and poor people narrows. In fact, the only countries that achieved a large-scale reduction in poverty in the 1990s are those that have become more open to foreign trade and investment. Consider Vietnam. As it has opened up, it has seen a large increase in per capita GDP and no significant change in inequality. Poor people's income has risen dramatically, and in just 10 years absolute poverty dropped by half, from 75 percent of the population in 1988 to 37 percent in 1998. China, India, and Uganda also experienced rapid poverty reduction as they integrated with the global economy. Among globalizers the number of people living in absolute poverty (less than $1 a day) fell by 120 million between 1993 and 1998—while in the rest of the developing world the number of poor people increased by 20 million.

It is, however, important to complement open trade policies with effective social protection measures such as unemployment insurance and food-for-work schemes. (Closed economies obviously need safety nets as well since households are subject to shocks from business cycles, technological changes, natural disasters, and disease.) To the extent that openness to trade raises national income, it strengthens a society's fiscal ability to provide these safety nets.

Lessons of Globalization

Globalization raises important issues that influence the extent to which poor countries will be able to deepen their integration with rich ones and to which poor people will share in the benefits. ***First, globalization is not inevitable.*** It can be stopped and reversed—with dire consequences. Hence international cooperation is crucial for maintaining and extending an open system for trade and investment. Growing integration is controversial, as evidenced by demonstrators determined to prevent trade agreements and other forms of international cooperation. We have seen retreats from global integration before, and the results were not pretty. Anytime there is a global slowdown, as has been occurring in 2001, there is a danger of a return of protectionism. Thus it is important to move ahead with a new round of trade liberalization and with efforts to improve the architecture for international financial integration.

Second, the successes of the 1990s show that integration requires not just open trade policies, but also sound institutions and policies in a range of other areas (including firmly established rule of law and vigilance against corruption). But weak institutions should not be an excuse to remain closed. Countries can use the international market to improve economic governance and to provide needed infrastructure (such as for ports, power, and telecommunications).

Third, global production is remarkably concentrated. Most of the world's GDP is produced in temperate regions within 100 kilometers of an ocean or a major navigable river. Thus many parts of the world are not participating in

Addressing the Risks of Globalization

A recent poll of 20,000 people in 20 countries—including developing countries such as Brazil, China, India, and Nigeria—found that by a margin of two to one people thought that globalization would materially benefit their families. But more than half of those polled are convinced that globalization threatens their country's unique culture.

As societies integrate culturally, in many ways they become more diverse: IKEA has brought Swedish design to Russians, coexisting with Russian design. Indian immigrants and McDonalds have brought chicken tikka and hamburgers to the United Kingdom, coexisting with fish and chips. But without policies to foster local and other cultural traditions, globalization may lead to dominance by U.S. culture.

Globalization will usually weaken monopolies. As countries open their markets, national monopoly producers face competition from foreign firms. But occasionally one firm will get a large enough global technological advantage that it acquires a temporary global monopoly. More commonly, oligopolies exert global market power. Such cases pose severe challenges to national antitrust regulators.

As global trade becomes more firmly based on a legal framework, the power of developing countries could increase: the weak need rules more than the strong. But there is a danger that the rules will favor the strong—for example, rich and poor countries have different interests when it comes to intellectual property rights and global warming. Poor countries want to keep some knowledge as a public good, while rich countries want to turn it into a private good to reward innovation. Poor countries will suffer the most from global warming, while rich countries are generating most of the carbon dioxide that is causing the problem. In bargaining to achieve fair rules on such issues, poor countries are handicapped by their poverty and fragmentation.

Still, despite widespread fears, there is no evidence that environmental standards are falling. In fact, a recent study of air quality in major industrial centers of the new globalizers found that air quality has improved significantly in all of them. Increased integration can help in this regard—for example, communities can exchange successful strategies for controlling pollution. As with core labor standards, some groups in rich countries are proposing that environmental regulations be policed through World Trade Organization sanctions. But such sanctions would risk being hijacked by protectionist lobbies in rich countries, restricting the opportunities of poor ones.

This box is drawn from recent World Bank research on globalization (http://www.worldbank.org/research/growth).

globalization. Some countries have been handicapped by unfavorable geography, such as being landlocked and prone to disease. Others have suffered from weak policies, institutions, and governance (including unstable property rights and rule of law). Still others have been hurt by civil wars. Reducing poverty in these locations will require a combination of policy reforms to improve the investment climate, development assistance to address education and health problems, and migration to more favorable locations.

Finally, much of the controversy about global economic integration has to do with its effects on politics, culture, society, and the environment. Thus poverty is just one issue—but it is an important one. Anyone concerned about poverty should think twice about restricting trade. Doing so would impose further hardships on poor people in developing countries. Important environmental and social issues need to be addressed, but not by restricting trading opportunities of poor countries.

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Globalization and Migration

During the 1870-1910 wave of globalization, 60 million people migrated from Europe—primarily from less developed regions—to the United States and other parts of the new world. These flows were a powerful force for wage convergence. Emigration is estimated to have raised Irish wages by 32 percent, Italian by 28 percent, and Norwegian by 10 percent. Meanwhile, immigration lowered Argentine wages by 22 percent, Australian by 15 percent, Canadian by 16 percent, and U.S. by 8 percent. Labor flows between developing countries were also extensive in the early periods of globalization, though they are less well documented. About 10 percent of the world's population moved permanently to a new country, and even more migrated from rural to urban areas within countries.

The same forces operate today. A study following individual, legal migrants from Mexico to the United States found that on average they left jobs paying $31 a week and on arrival in the United States could immediately earn $278 a week—nine times as much. Similarly, Indonesian workers earn 28 cents a day at home, compared with $2 a day or more in neighboring Malaysia. Thus there are huge real gains to workers who migrate to more developed economies.

Although there are strong economic pressures for migration, legal migration is highly restricted. Thus when it comes to labor flows, today's world is much less globalized than it was a hundred years ago. Only about 2 percent of the world's population consists of migrants living in countries not of their citizenship. At the same time, pressures for migration are mounting. The labor force in OECD countries is aging, while the labor force in the developing world is surging because of high birth rates. Each year 83 million people are added to the world's population—82 million of them in developing countries. Without more migration, the ratio of workers to retirees in Japan and the European Union will fall from five to one today to three to one in 2015, straining social security systems.

Combining OECD capital and technology with developing country labor has the potential to generate mutual economic benefits. Some of those benefits can come through the flow of capital and production to developing countries. But geographic factors make it unlikely that capital flows and trade will eliminate the economic rationale for migration. Too many parts of the developing world have poor institutions and weak infrastructure that will not attract production. Moreover, some production networks in industrial countries are too deeply rooted to move. Institutional and policy reforms and infrastructure investments in lagging developing countries could address the first concern and reduce—though not eliminate—economic pressures for migration.

The experiences of Mexico and the United States illustrate how migration can benefit both economies. About 7 million Mexican citizens live legally in the United States, along with another 3 million undocumented Mexican workers. These workers represent about 10 percent of Mexico's population and an even larger share of its labor force. Their work in the United States takes pressure off Mexico's labor market (raising wages there) and generates a significant flow of remittances to relatives back home. In the United States this labor inflow was a key factor in the sustained growth with low inflation of the 1990s. Still, migration is estimated to have reduced the relative wages of unskilled U.S. workers by 5 percent—highlighting again that globalization typically produces winners and losers.

OECD countries not only tend to be highly restrictive about migration, they also tend to discriminate in favor of educated workers (causing a "brain drain" from developing countries). Labor flows would do more to reduce poverty in developing countries if immigration policies in industrial countries were more neutral and allowed more unskilled workers to immigrate.

Globalization Is No Shortcut to Development

by Dani Rodrik

"Global integration shouldn't become a substitute for a development strategy," warns Dani Rodrik, professor of international political economy at the John F. Kennedy School of Government at Harvard University, in a recent article ("Trading in Illusions," Foreign Policy, *March/April 2001). In his view, by focusing on international integration, governments in poor nations might divert human resources, administrative capabilities, and political capital away from more urgent development priorities such as education, public health, industrial capacity, and social cohesion.*

Dismantling barriers to trade and investment will not solve the challenges of development. Integrating countries must also comply with a long list of admission requirements, including new patent rules and more rigorous banking standards. Successful trade liberalization should involve tax reform to make up for lost tariff revenues, social safety nets to compensate displaced workers, administrative reform to bring trade practices into compliance with World Trade Organization (WTO) rules, labor market reform to enhance worker mobility across industries, technological assistance to upgrade firms hurt by competition from imports, and training programs to ensure that export-oriented firms and investors have access to skilled workers.

The Group of Seven industrial countries (G-7) has established international codes and standards for fiscal transparency, monetary and financial policy, bank supervision, data dissemination, corporate governance, and accounting. The Financial Stability Forum, a G-7 organization, considers 12 of these standards essential for creating sound financial systems in developing countries. Another 59 standards are considered relevant for sound financial systems. The prescribed comprehensive institutional reforms took industrial countries generations to accomplish.

Most of the institutional reforms on the integration agenda are perfectly sensible, and in a world without financial, administrative, or political constraints there would be little argument about the need to adopt them. But setting institutional priorities to maximize integration with the global economy has real opportunity costs. World Bank trade economist Michael Finger estimates that a typical developing country must spend $150 million to implement requirements under just three WTO agreements—those on customs valuation, sanitary and phytosanitary measures, and trade-related intellectual property rights. As Finger notes, this sum equals a year's development budget for many of the world's least developed countries.

Should governments in developing countries train more bank auditors and accountants, even if those investments mean fewer secondary school teachers or reduced spending on primary education for girls? When it comes to legal reform, should governments focus on importing legal codes and standards or on improving domestic legal institutions? In public health, should governments promote the reverse engineering of patented basic medicines and the importation of low-cost generic drugs from unauthorized suppliers—even if doing so means violating WTO rules against such practices? (Consider Brazil's recent confrontation with Roche, the Swiss pharmaceutical company, over distributing a generic version of a patented AIDS drug.) How should governments choose their exchange rate regimes? Since the early 1960s nearly every growth boom in the developing world has been accompanied by a controlled depreciation of the domestic currency. Yet financial openness makes it

From Montreal Canada, *Aislin The Gazette*

all but impossible to manage the exchange rate.

World markets are a source of technology and capital; it would be silly for the developing world not to exploit such opportunities. But globalization is not a shortcut to development. Successful strategies for economic growth require a judicious blend of imported practices and domestic institutional innovations. Policymakers should forge a domestic growth strategy by relying on domestic investors and institutions.

The fastest-growing countries—China, India, and others in East and Southeast Asia—have liberalized trade and investment. But they have done so in an unorthodox manner—gradually, sequentially, and only after an initial period of high growth—and as part of a broader policy package with many unconventional features. Significant import liberalization did not occur until a transition was made to high economic growth. And all these countries managed to eke growth out of existing institutions, imperfect as they may have been. (China followed a highly unorthodox two-track strategy, violating almost every rule in the guidebook—including, most notably, the requirement of private property rights.)

Asia's experience highlights a deeper point. A sound overall development strategy that produces high economic growth is far more effective in achieving integration with the world economy than a purely integrationist strategy that relies on openness to work its magic. A relatively protected economy like Vietnam is integrating with the world economy much more rapidly than an open economy like Haiti because Vietnam, unlike Haiti, has a reasonably functional economy and polity.

Policymakers need to know which strategies will produce the desired results and whether the prescriptions of the current orthodoxy are up to the task. Countries that have achieved long-term economic growth have usually combined the opportunities offered by world markets with a growth strategy that mobilizes the capabilities of domestic institutions and investors. Public enterprises during the Meiji restoration in Japan, township and village enterprises in China, an export processing zone in Mauritius, extensive credit subsidies in the Republic of Korea, infant industry protection in Brazil in the 1960s and 1970s—these are among the innovations that have been instrumental in kick-starting investment and growth in the past. Few of these experiments have worked as well when transplanted to other settings, underscoring the decisive importance of local conditions. To be effective, development strategies need to be tailored to domestic institutional strengths. There is simply no alternative to a homegrown business plan.

The author is professor of economics and international affairs at Columbia University.

Measuring Globalization

According to a recent study by A.T. Kearney Consulting (published in *Foreign Policy*, January/February 2001), Singapore is the world's most global country, leading a group of nations that have become integrated through cross-border flows of goods, services, capital, people, and communications. These countries display more equitable patterns of income distribution and lower levels of corruption than countries that are less global. The study also found that the sharp rise in Internet access among advanced economies more than offset the slow growth in traditional economic measures of integration, such as cross-border trade. This situation has produced a growing "globalization gap" between industrial and developing nations, because overall integration levels among emerging markets have barely increased.

The globalization index is based on data from 50 industrial countries and key emerging markets representing nearly 80 percent of the world's population and more than 95 percent of global economic output. The index encompasses the following key indicators of global integration:

- *Globalization in goods and services* is measured by the share of international trade (exports and imports of goods and services) in GDP, as well as the convergence of domestic and world prices.
- *Financial globalization* is measured by income payments and receipts, inflows and outflows of foreign direct investment, and inflows and outflows of portfolio capital, all measured as a share of GDP.
- *Globalization of personal contact* is measured by international tourists and travelers as a share of population, minutes of incoming and outgoing international telephone calls per capita, and transfer payments and receipts as a share of GDP.
- *Internet connectivity* is measured by the number of Internet users, the number of Internet hosts, and the number of secure servers, all measured on a per capita basis.

According to the index, the 20 most global countries (in descending order) are Singapore, the Netherlands, Sweden, Switzerland, Finland, Ireland, Austria, the United Kingdom, Norway, Canada, Denmark, the United States, Italy, Germany, Portugal, France, Hungary, Spain, Israel, and Malaysia.

WTO Accession Will Accelerate Reforms in China

An Action Plan to Address the Most Pressing Issues

by Chi Fulin

China's accession to the World Trade Organization (WTO) will accelerate its market-oriented reforms, integrating it with the international trade system. Initially, China was to complete the transformation of its economic system by 2010. Now, to compete effectively in global markets, China must shorten that transition period to three to five years. Reforms will focus on transforming state-owned enterprises, redressing the ownership structure, improving the financial system, modernizing the tax regime, and streamlining public administration. China will also further open its markets. The presence of foreign enterprises—especially in services—will bring major changes, such as competition for state enterprises that until now have held a monopoly position. The main areas of reform are described below.

Governance, Transparency, and the Private Sector

• ***Moving ahead with public administration reform.*** Bureaucratic intervention in solving disputes between businesses should give way—in line with WTO regulations—to the rule of law, including arbitration courts. Market prices, taxes, and exchange rates will connect China with global markets. The government's approach will be more service-oriented.

• ***Increasing transparency to enhance public understanding of and support for reform.*** The public should be kept informed about China's commitments to the international community and the expected reforms, to help them prepare for the consequences of the WTO accession. People should be informed of both the obligations and the rights involved, as well as the new opportunities for the country.

•***Improving the efficiency and transparency of the public administration will also strengthen law enforcement.*** The central government is required to guarantee uniform countrywide implementation of WTO regulations on intellectual property rights and foreign trade and investment. Regulations must be made accessible to the public. Institutions responsible for implementation must guarantee faithful enforcement of these laws and policies.

•***Strengthening corporate governance by accelerating the transformation of state-owned enterprises (SOEs) to joint stock companies***. The state's shareholding in many enterprises should be reduced to a reasonable level, a move facilitated by earlier successes of state enterprise restructuring through the introduction of the shareholding system. Private enterprises should ensure modern corporate governance by striking a proper balance among boards of directors, supervisory boards, and general managers.

•***Supporting the development of nonstate enterprises***. Reforms should fundamentally improve the environment in which private enterprises operate, treating them as equals in areas such as financing—through market access, property rights, and subsidized loans or the establishment of an investment insurance fund.

Infrastructure and Public Utilities

•***Separating the government from enterprises is the key to reform for infrastructure and public utilities.*** Though infrastructure management has changed tremendously in recent years, the state still holds a monopoly in sectors such as telecommunications, civil aviation, railways, and power. In its Tenth Five-Year Plan the government pledged to reform the management of these industries along with related government departments, to introduce competition and streamline administrative processes. These moves should be made according to the principle of separating government from enterprises so that the relationship between government, enterprises, and the market truly meets the requirements of a socialist market economy. Direct state ownership should be replaced by effective regulations, as in mature market economies.

Monopolies waste resources, constrain efficiency, inhibit innovation, and place a heavy burden on consumers. Thus establishing an environment that stimulates fair competition is of utmost importance. Institutional barriers that prevent private enterprises from competing as equals should be eliminated. As envisaged, the laws and regulations governing telecommunications, civil aviation, railways, and power will soon be modified and clarified to provide nondiscriminatory market access to nonstate domestic and foreign companies involved in infrastructure and public utilities.

Commercial Banks, Bad Debts, and the Financial Sector

•***Transforming state-owned commercial banks to joint stock ownership*** while spinning off their bad assets that accumulated from the debt of state enterprises. Instead of receiving state sup-

port, banks should raise money in capital markets. But before this transformation occurs, their huge stock of bad debts should be resolved. In 1999 four asset management companies—Huarong, Changcheng, Dongfang, and Xinda—were created to deal with the bad loans of state-owned commercial banks. But more radical methods are needed: temporarily, so an authoritative debt trust company should be set up by the central and local governments to operate, manage, and dissolve bad assets. This company would oversee the four asset management companies, which could

China's Local Trade Barriers: A Hard Nut to Crack

"Building a unified, fair, and regulated market is important for [China's] entry into the World Trade Organization," said Shi Liwen, chairman of China's biggest construction company, Shanghai Construction Group, in a recent interview with Bruce Gilley of the *Wall Street Journal*. Shi complained at the March 2001 annual meeting of the National People's Congress that his company often found it impossible to operate outside Shanghai because of local protectionism. He told the meeting, "We have to break down sector monopolies, break through departmental blockades, and get rid of local protectionism."

China contains 1.3 billion people in 27 provinces and 4 vast province-level cities. And as Gilley points out in his article, internal trade barriers are extensive. Henan and Anhui provinces, for example, ban imports of tobacco products from Guizhou, while a bottle of Beijing's Yanjing beer that costs the equivalent of 18 cents in the capital costs $1 in Sichuan province because of provincial fees and taxes. Internal trade of agricultural products like grain, flour, and soybeans is impeded, while the marketing of bottled water and medicine is heavily restricted by local standards.

Small provincial banks are impeded from opening branches outside their home regions in order to shield the four main state banks from competition. Companies can hardly open subsidiaries or buy other companies outside their home bases. Interprovincial investment is also deterred by the judiciary: local courts usually rule in favor of local companies. "Local courts have become the courts of localities. They protect local interests," said Xiao Yang, China's top judge, in a 2000 speech.

These local barriers blocking the free flow of goods and capital result in higher prices, less efficient investment, and excess capacity in many sectors. Nearly every province has a maker of washing machines, color televisions, and refrigerators. China also has 120 car manufacturers—most of them surviving on various forms of local protection. The central government wants to cut the number to half a dozen, but 22 provinces and cities have declared the sector to be a core industry for the coming decade. "If we don't overcome local protectionism, the world's large car-makers will lose faith in our investment environment and stop investing in China," pointed out a recent report by the State Planning Commission. "This will further undermine the attempts by domestic makers to attract investment and advanced technology."

Double-digit export growth, economists say, partly reflects the inability to sell domestically, just as China's absorption of huge foreign investment partly reflects the diversion of much of the country's savings into inefficient state enterprises. Interprovincial trade has fallen from 37 percent of national retail trade in 1985 to about 25 percent today. Despite a huge expansion of national highways, ports, and air cargo facilities, the average distance traveled by a freight shipment fell to 310 kilometers in 2000 from 395 kilometers in 1978.

The State Planning Commission has suggested revamping the fiscal system so that local officials do not collect tax payments directly from local state enterprises. This move would weaken incentives to protect firms, though the firms' provision of jobs and social services would remain a key local concern. Another idea is to stop linking the promotion of local cadres to the economic growth of their localities. That move would reduce incentives for cadres to rely on market barriers to boost local output. "Local authorities are obsessed with local GDP growth rates—the leading criteria for evaluating cadre performance—and so make full use of their administrative powers to assist local enterprises," says Lin Jiabin of the Development Research Council, the cabinet's think tank.

While those ideas remain on the drawing board, the central government has made more general efforts to reduce local government control over economic activities. State enterprise privatization, regulatory streamlining, and the creation of autonomous economic bodies—handling things like technical standards and stock exchange listings—are meant to limit local governments' ability to meddle in the economy. Legal reforms could also play a role. One change proposed by legal scholars is the passage of an interstate commerce clause like that in the U.S. Constitution. That clause allows the federal government to override state attempts to erect protectionist barriers.

raise capital from the public. State-owned commercial banks would then be able to sell bad debt to these asset management companies, which would be granted broad scope—strictly supervised—over business activities.

•***Accelerating the development of nonstate financial institutions***. The financial sector has always been a state monopoly. China's prospective WTO membership has increased pressure for developing private financial institutions, which would promote competition and make domestic banks more competitive with foreign financial institutions. Accordingly, laws regulating commercial banks and insurance companies should be updated to permit state-owned and private enterprises to operate in the financial sector and establish banks, insurance companies, and investment funds.

•***Strengthening the management and supervision of banks, investment companies, and securities markets*** by enacting new laws in accordance with international standards. In this way financial institutions' market access, asset evaluations, reserve requirements, internal controls, and information disclosure can be regulated. But China should exercise caution, opening its financial market step by step to foreign investors to protect itself from destabilizing speculation.

Agriculture and Rural Development

•***Liberalizing trade of farm products***. Although prices have been liberalized for most agricultural products, the state still dominates the purchase, sale, and import and export of staple agricultural products such as foodstuffs, cotton, and vegetable oil. This setup places a heavy burden on public finances and is hindering WTO accession. Thus trade in foodstuffs, cotton, and vegetable oil should be diversified, allowing the entry of nonstate companies. At the same time, prices should be further deregulated to allow farmers to adjust their product mix to market demand. Large nonstate companies should be allowed to compete in the foreign trade of agricultural products. Reforming the distribution of agricultural products will eliminate regional monopolies and lower costs. This move assumes the establishment of an agricultural information system providing data on distribution, transportation, storage facilities, bidding, and marketing. With wholesale markets playing a leading role, agricultural production can once again surge.

•***Introducing rural land reform and a market for land use rights.*** Fragmented farming operations have prevented the application of advanced production technologies, the improvement of product quality, and the establishment of modern farming organization. Chinese producers are not competitive with large-scale farms in industrial countries; thus renewing the rural land system is imperative. Farmers' long-term land use rights should be made transferable and should be allowed to be used as mortgage or investment. Long-term land use rights are a precondition for capitalization, which will enable farmers to purchase rural land and get involved in larger-scale farming. Better land use rights will also accelerate agricultural modernization. The government should help develop the market for rural land use rights, specifying rules for market access and transactions processes as well as stipulating the contract rights and obligations of sellers and buyers. Farmers' land use rights should be guaranteed by law.

Human Resources

•***Reforming the mechanism for human resource selection***. The rigid traditional practice of leaders selecting managers from a narrow circle of candidates should be changed by creating a competitive, dynamic environment for promoting talented managers. The emergence of a knowledge economy in the United States is linked with the spread of the concept of human capital in economics—a concept which recognizes that knowledge and skills are more important than material and financial capital. Performance can be linked to compensation not only through salaries and bonuses but also through stock options. In China egalitarianism in the income distribution system should be reformed to give priority to efficiency without sacrificing equity. Innovative technical and research staff and well-performing managers can be strongly encouraged by stock options. In general, stock ownership by employees can promote corporate unity. At the same time, a sound social security system should be set up to ensure the basic livelihoods of unemployed and low-income workers.

•***Reforming the residential registration system,*** which restricts the movement of rural residents into cities. A new, more flexible residential registration system should be created, dismantling the segmentation between rural and urban administration. An integrated labor market should be established by connecting local labor markets, thereby ensuring the market-driven allocation of human resources.

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Discussion Forum

Ten Years That Have Shaken Russia—Conflicting Assessments of the Results

To commemorate the 10th anniversary of the misfired Moscow coup that buried the Soviet Union, a series of studies have analyzed Russia's economic and social progress over the past decade. Here we offer two very different views. The first is from Anders Åslund, the well-known Swedish scholar who has long been an adviser to the Russian government. The second is from the equally distinguished Peter Reddaway, a professor of political science at the George Washington University. We also provide a snapshot of the current state of the Russian economy.

Think Again—Some Common Misconceptions about Russia

by Anders Åslund

"The Russian Economy Has Collapsed"—according to official Russian statistics, gross domestic product (GDP) plummeted 44 percent between 1989 and 1998.

But this figure is grossly exaggerated. Under communism everyone padded output to reach the targets of the planned economy, but no one cared about the quality or even the usefulness of the items produced. For instance, the Soviet Union manufactured more than six times as many tractors as the United States, yet its agricultural output lagged far behind because production was so wasteful. Much of Soviet manufacturing was unfit for consumption, so Russians flocked to the imported goods that flooded the market following the liberalization of foreign trade. Thus the subsequent decline in the production of useless goods and unneeded inputs was not a tragedy but a desirable change. At least one-fifth of Soviet output fell into one of these categories, and the estimated GDP of the Soviet era should be reduced accordingly.

After communism the statistical measure of output shrank far more than its actual level. The underground economy accounts for at least one-quarter of this purported contraction. Thus the Russian economy has not collapsed. Rather, until 1998 it stagnated because of sluggish, incomplete reforms. Russia's level of economic development remains where it was during the Soviet era, roughly on par with Brazil's.

Moreover, Russia has not developed a new "virtual economy" based on barter rather than money. The share of barter transactions in Russian industry peaked at 54 percent in August 1998, but the financial crash curtailed this system of hidden subsidies that had been the norm for Russian enterprises. Nonmonetary transactions fell like a stone once Russian industry realized that it could no longer depend on the state and would have to earn real money in the marketplace. Today the virtual economy is marginal.

According to the latest official data, Russia achieved GDP growth of 5.4 percent in 1999 and 8.3 percent in 2000—and growth continues today. While many systemic problems remain, Russia appears to have attained a critical mass of market reforms and privatization. (Several other countries in the region, such as Kazakhstan, have made similar achievements and are also booming.) Considering the enormous distortions left behind by communism, that is a splendid feat.

"Shock Therapy Was a Failure"—Russia's economic and social troubles are the result of radical economic reforms, such as privatization and price liberalization, that were launched too fast and too soon.

The economic mayhem that preceded the collapse of the Soviet Union—the legacy of years of gradual, inadequate reforms—left former President Boris Yeltsin with few choices but to move.

Russia toward a market economy. But this situation was not unique to Russia, which is why more than 20 other former communist countries also pursued market reforms. The most successful of these countries, with high growth and contained corruption (notably Estonia and Poland), undertook far more radical reforms. Nearly all of Russia's current problems—widespread corruption, excessive state intervention, high tax rates, lingering inflation, limited rule of law—reflect insufficient reform efforts.

Russia has experienced rapid economic growth and considerable structural improvements in the wake of the financial crash that shook the world in August 1998. That crisis reduced the wealth and political power of two of Russia's most corrupt groups: oligarchic tycoons and regional governors. More surprisingly, the crash convinced both the communists and the general public that there was no alternative to a real market economy. Until fairly recently Russia's real prob-

lem was too little shock and too much corrupt state therapy in the form of subsidies to the country's elite.

"Privatization Has Generated Only Corruption"

Instead of saying that privatization has generated corruption, it would be more accurate to say that it has generated national wealth. Since 1997 Russia's private sector has accounted for 70 percent of GDP.

Corruption is usually defined as the misuse of public power for private gain. But privatization permanently deprives public servants of public property, so they can no longer charge money for the privilege of using it. The bribery that plagues Russia today is not related to privatization. Rather, it is overwhelmingly tied to law enforcement, tax collection, and state intervention.

In general, the higher is the level of privatization that a former communist country has attained, the higher is the economic growth that it has achieved. Russia is atypical in having been more successful with privatization than with other market reforms, such as price liberalization. As a result people tend to blame privatization for Russia's shortcomings, while it would be more logical to complain about the dearth of other reforms. Russian enterprises are hounded by scores of state inspectorates that regularly extort money from businesspeople.

Strangely, the standard comparison is between privatization in Russia and in Poland, with the allegation that Poland privatized more slowly. In fact, Poland started off with a bigger private sector than did Russia. But Poland undertook more reforms in nearly all spheres—suggesting that, had Russia not privatized so fast, it probably would have been in the doldrums.

Ukraine has implemented most reforms, including privatization, more slowly than Russia. As a result Ukraine's privatization has been worse than Russia's, with more ownership going to managers and employees and less being sold on open markets. Ukraine's corporate governance also remains far worse than Russia's, where nearly 800 enterprises actually paid dividends to their shareholders in 2000.

"Russia Cannot Collect Taxes"

This allegation is based on sheer disinformation. Russia collects one-third of its official GDP in general government revenues—slightly more than the United States, whose citizens complain that taxes are too high. Not only has Russian tax collection been high, it has also been very stable.

The misperception about Russian taxation is the result of superficial observations. Most outsiders tend to focus on federal revenues. But those represent only a part of total revenues, which also include regional and local tax revenues as well as several extrabudgetary funds, notably the pension fund. Another source of confusion is that many observers, including some Russians, take for granted that Russia should have state revenues as high as Western Europe or the former Soviet Union, ignoring that such taxation harmed growth in both places. For Russia a more plausible tax rate, in line with its level of economic development, would be 15-25 percent of GDP.

The real problem is not that Russia cannot collect taxes, but that the government collects too much. These revenues are spent improperly and aggravate corruption. According to the World Bank, at least 16 percent of Russia's GDP went to enterprise subsidies in 1998. (Small wonder that state finances crashed.) Furthermore, tax collection is ruthless. The lawlessness of tax inspectors has emerged as one of the most serious concerns of the post-Soviet era.

The obvious solution to these problems was a low, flat tax rate. Earlier this year Russia introduced a flat income tax of just 13 percent (a rate that the United States and Western Europe could only dream about). Income tax revenues instantly jumped 70 percent as people abandoned expensive schemes for avoiding taxes.

"Russia's Infrastructure Is Falling Apart"

Think again. Dramatic news stories, such as the tragic sinking of the submarine Kursk and the fire that engulfed the Ostankino television tower in Moscow, have created the impression that Russia is coming apart at the seams. In fact, Russia has seen extraordinary improvements in its infrastructure. Investment in fixed assets (buildings, equipment) increased 18 percent in 2000, reaching a healthy 20 percent of GDP (higher than the standard U.S. ratio of 16 percent). Admittedly, the Soviet Union had investment of about 30 percent of GDP, but that was an indication of waste. The Soviet Union was notorious in its neglect of infrastructure and maintenance. Today privatization and market pricing have revived much of Russia's infrastructure. Market competition has fostered incredible expansion in telecommunications. Airports and airlines have similarly improved. Road construction is up. New ports have been built around St. Petersburg. Whereas ruins once blighted the landscape of even Moscow, modern-day Russia has initiated a widespread building boom.

Maintenance problems persist, however, where state monopolies linger—notably in the natural gas monopoly Gazprom, the state-owned oil pipeline monopoly, and some public utilities.

"Russia Suffers from a Terminal Health Crisis"

Granted, recent health statistics from Russia are shocking. Male life expect-

ancy plummeted from 64 to 57 years between 1989 and 1994, and the country's population is dropping by more than 500,000 people a year. The population decline has two causes. The first is low birth rates, which are common throughout Europe. The other cause is high death rates. The population pyramid is badly skewed because there were so few births in 1930-45 due to government terror and war, and the large age group born before 1930 is now dying.

According to the most recent United Nations projections, Russia's population decline—28 percent through 2050—will not be drastically worse than that in parts of Western Europe. The main causes of the drop in male life expectancy are cardiovascular disease and accidents, partly fueled by alcoholism. Nothing suggests that health care standards in Russia have fallen. The quality of health care is closely linked to infant mortality, which plunged 17 percent between 1993 and 1998. Public and private spending on health has risen sharply as a share of GDP. Capitalism has made medicines widely available that were unknown during the Soviet era, and hospital equipment has greatly improved.

Yet the proliferation of illicit drugs and AIDS, both of which are inevitable consequences of becoming an open society, is cause for genuine concern. Another worry is tuberculosis—a new drug-resistant strain of the disease is particularly troubling. Moreover, because the health care system remains predominantly public, it suffers from low salaries, low efficiency, and widespread bribery.

"Russia Has Been a Black Hole for Western Aid"

A profound misperception prevails that the West has provided enormous aid to Russia. In fact, such aid has been trivial. Between 1992 and 2000 the U.S. Agency for International Development (USAID) committed $2.6 billion to Russia. But actual disbursements have been much less: Russia received only about $200 million a year in grants from the United States, while the European Union gave barely $150 million a year. The United States has also given food aid, partly in grants and partly in credits—but that has been at the behest of the U.S. agricultural lobby and qualifies more as financial aid for U.S. farmers. In fact, food aid has hampered agricultural reform in Russia. (The United States has also financed denuclearization in the former Soviet Union, but again that is driven predominately by U.S., not Russian, interests.)

Russia has drawn nearly $15 billion in stabilization credits from the International Monetary Fund (IMF), all of which must be paid back with interest, and the country has already returned nearly half that amount. The World Bank has committed $12 billion, but that is also in the form of credits that must be repaid with interest. Thus since the end of the Cold War the West has provided Russia with public grants totaling about $5 billion—equivalent to U.S. aid to Israel and Egypt in a single year—most of which has been spent on Western consultants.

For its part, the United States has benefited enormously from the peace dividend that came with the disappearance of the Soviet military threat. In the 1980s the United States spent 6 percent of its GDP on defense, compared with 3 percent—$300 billion a year—today.

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A Member of Parliament Returns Home After an Eventful Day

"Hi honey, you seem so happy. Have you been elected to another board of directors or did you receive some more bribes?"

From the Hungarian Daily *Népszabadság*

Market Bolshevism Harmed Russia

by Peter Reddaway

Market Bolshevism is a term coined by Dmitri Glinski and me to refer to the policy of using authoritarian methods to impose quasi-market institutions on Russia. The application of this policy since 1991 by Presidents Boris Yeltsin and Vladimir Putin has been accompanied by its necessary political corollary, the emasculation of democracy. The outcome, as we argue in our new book (Peter Reddaway and Dmitri Glinski, *The Tragedy of Russia's Reforms: Market Bolshevism against Democracy*, U.S. Institute of Peace Press, Washington, D.C., 2001), was the emergence by the mid-1990s of a political and economic order that had little legitimacy in the eyes of most Russians, who felt alienated from an oligarchically run state.

In the past 11 years, notwithstanding some elements of progress, the economy has shrunk by about 40 percent (according to many careful estimates) and operates in a business, legal, and political environment permeated by corruption and crime. It is not clear if Russia's GDP will be able to sustain its recent return to growth. Meanwhile, society is profoundly divided along class lines, with a small and extremely wealthy elite, a struggling middle class that was hit hard by the financial crash of 1998, and some three-quarters of the population—including many well-educated people—trapped in poverty.

Cataclysms Retrospective

Market Bolshevism represents the latest of a series of major reform programs carried out by Russian governments since the 16th century. These programs have featured prominently in successive cycles of state repression and instability. In cases like the programs of Alexander II in the 1860s and 1870s and Mikhail Gorbachev in the late 1980s, leaders have promoted reforms designed to take effect at least in part from below. More often, though, as under Alexander III in the late 19th century, Vladimir Lenin in 1917-21, and Joseph Stalin in the 1930s, change has been imposed from above. The resulting alienation of most Russians from the political system eventually led to the wholesale collapse first of the Tsarist state in 1917, then of the Soviet Union in 1991.

Tragically enough, both these collapses produced revolutionary change that was based on a false and simplistic economic determinism. First, Lenin's Bolsheviks held that nationalizing the entire economy was the key policy that would open the door to social justice and prosperity. Then, 74 years later, Yeltsin's market Bolsheviks proclaimed that denationalizing most of the economy overnight was the key to achieving the same goals. In the first case, democracy was explicitly rejected in favor of a bloody, self-proclaimed communist dictatorship that killed, imprisoned, or forced to flee abroad at least 20 million people. In the second, the promising emergence and growth of democracy in1987-91 was deliberately if surreptitiously halted by Yeltsin—and then, with his destruction of the popularly elected (though irresponsibly led) Parliament by tank fire in 1993, reversed.

From that time on, it was clear that Yeltsin's main goal was to stay in power at any cost. To that end, he had to keep market Bolshevism as his central strategy even though it was producing profoundly negative social, economic, and political consequences. To acknowledge its failure and change course would have risked the coming to power of opposition groups. Moreover, market Bolshevism justified authoritarianism. The government claimed, in effect: "We know better than the people's representatives what is good for the people, so we'll use whatever methods we want."

Creating Capitalism from Scratch

What, then, was the economic medicine that Yeltsin, his key "shock therapists" Yegor Gaidar and Anatoly Chubais, and the West were so sure would be therapeutic? Their program had several elements:

- First, dealing with the 1991 crisis in the supply of goods by freeing many prices from government control.

- Second, balancing the budget by drastically cutting government spending on industrial and agricultural subsidies, the military as a whole, and the procurement of weapons.

- Third, obtaining large-scale financial aid from the International Monetary Fund (IMF), the World Bank, and Western governments.

- Fourth, privatizing—in 1992-95—most of the almost entirely nationalized economy.

- Fifth, creating simultaneously the institutional and legal infrastructure needed by a market economy: banking and insurance systems, stock exchanges, regulatory bodies to combat monopolies and fraud, a land register, and so on.

But performing these daunting tasks—creating capitalism almost from scratch in a few years—was, first and foremost, culturally impossible. The process had taken two centuries in Western countries. It was also politically impossible. In 1992 Russia possessed a rudimentary democracy. If Yeltsin had followed the urgings of Western advisers like Jeffrey Sachs and

Anders Åslund and tried to use "iron political will" to force his utopian program on Russia wholesale, he would quickly have been impeached and ousted from power. So he compromised. For eight years he tried to impose his program piecemeal. This approach enabled some observers to claim that shock therapy was never seriously tried in Russia.

Politically, Yeltsin's market Bolshevism required the subversion of democracy. Because the majority in successive Parliaments opposed the Kremlin's economic strategy, Yeltsin often, in effect, ruled by decree. His team either got around or ignored the rather weak constitutional barriers to such authoritarianism. They manipulated elections, threatened to dissolve Parliament again, co-opted members of the opposition by bribing them with privileges and money, and bought the support of super-wealthy oligarchs by letting them use endless ingenious schemes to plunder the state treasury. As a result, by 1998 Yeltsin's regime and the Russian state had become not just terribly weak and corrupt, but also—to an alarming extent—financially and politically dependent on Russia's wealthy elite and the West.

Daunting Legacy

The economic and social outcome of market Bolshevism was that, along with a restored supply of goods and most people being able to privatize their apartments for free, came wildly fluctuating inflation, frequent nonpayment of wages and pensions, a steady fraying of the social safety net, widespread impoverishment, a massive brain drain of talented professionals going abroad, seriously declining demographic and health indicators, plunging investment, the de-industrialization of much of the economy, a major loss of research capacity, the stagnation of agriculture, and a growing mountain of debt to Western creditors.

The West bears much of the responsibility for these outcomes. It pushed Russia to pursue the inappropriate "one size fits all" strategy of shock therapy. Moreover, it continued to do so way past the point where the resulting policies had contributed mightily to the criminalization of the economy, the corruption of democracy, and the alienation of most Russians from the state.

This daunting legacy is not, in my view, one that Putin, a product of the Yeltsin years, really intends to change much. Worse still, even if he suddenly craved real reform, he would probably just end up confirming his own apparent suspicion that he is a prisoner of the system. Thus a sustained improvement in Russia's plight is not, alas, in sight for the time being.

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Now let me make some specific comments on Anders Åslund's article.

Åslund has nothing but praise for the effects of the rapid privatization carried out by his associate Anatoly Chubais (at a time when Åslund was an official adviser to the Russian government). Thus he ignores well-documented studies showing that privatization had some deeply negative effects on the Russian economy and polity. In particular, it resulted in a rather small number of bankers and businessmen acquiring valuable state assets at little or no cost and then, as noted, being allowed to plunder the state treasury in partnership with ministers and bureaucrats. The Kremlin did all this first because it wanted to buy these people's political support and second because some of the top tycoons had skillfully corrupted Yeltsin's family and so could pressure the president.

In the process, of course, the Kremlin revealed its contempt for the rule of law. Moreover, since the authorities were not applying the law to the rich and powerful, and since they needed the political support of the bureaucracy as well, they did nothing to stop poorly paid officials from extracting ever more bribes from ordinary businessmen and citizens. Åslund rightly deplores this phenomenon but does not consider its root causes. In this environment occasional weak efforts by the government to create a level playing field—that is, to establish the rule of law—stood no chance of success. As the banker and oligarch Aleksandr Smolensky said, "Unfortunately, the only lawyer in this country is the Kalashnikov."

Another negative effect of Chubais's privatization that Åslund does not mention is the fact that most Russian businessmen are, as might be expected, opposed to market competition. This was made clear at the June 2001 congress of the top Russian association of business leaders—on whose support Putin relies—when many spoke out against Russia joining the World Trade Organization, at least for several years.

Åslund also fails to note, in discussing the Kremlin's default of August 1998, that in addition to its salutary effects, it generated some heavy costs. To mention just two, Western confidence in the Russian economy plummeted and, with the ruble losing three-quarters of its value against the dollar, foreign travel became out of reach for most Russians unless they had a foreign sponsor.

Åslund also makes an odd argument that IMF and World Bank loans of $27 billion to Russia did not constitute aid because the loans had to be repaid. Clearly, though, the Kremlin saw these low-interest loans with extended repayment schedules as a highly desirable form of aid, or it would not have solicited them. The value of this aid is underscored by the fact that at the time when many of the loans were being made, the government was having to pay sky-high interest rates on its own treasury bonds—up to150 percent a year.

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Economic Recovery Is Slowing in Russia; Banking Reform Is on the Agenda

Banking reform and economic diversification are crucial tasks, emphasized Christof Ruehl, the World Bank's senior economist for Russia, during a recent press conference in Moscow. As he pointed out, Russia is still heavily dependent on exports of oil, gas, and metals. "For the medium term, we are cautiously optimistic, but for the longer term, everything depends on the degree to which a diversified economy is developed," said Ruehl. The World Bank is ready to offer support with programs that improve the business environment and strengthen the government's ability to implement reforms and address social problems, such as the spread of AIDS and tuberculosis.

A well-functioning banking sector is also crucial for Russia's long-term economic health. Russia has more than 1,300 banks, but many serve as little more than captive treasury operations to the companies that control them, and few provide significant lending to small and medium-size enterprises. According to Ruehl, differences between bank lending and deposit rates are too high, the large number of banks makes it difficult to achieve economies of scale, and lending as a share of GDP is extremely small.

Russian officials have prepared recommendations for bank reform, and the reforms are to be put forward in late September 2001. The influential Russian Association of Industrialists and Entrepreneurs has proposed limiting full bank licenses to the country's largest banks, with restricted licenses for state banks and small regional banks. The association also called for banks to use international accounting standards, improve capital adequacy ratios, and be subject to better regulatory control. But in a letter to President Vladimir Putin, an association of regional banks warned that this plan would threaten the stability of the country's regions.

Growing demands for banking reforms have been made against a background of fears of a credit crunch, with companies unable to find ways of funding growth and investment. In the wake of the banking system's 1998 collapse, which left out of pocket ordinary depositors as well as corporate creditors, many have called for compulsory deposit insurance. In addition, private banks have proposed selling the state's substantial network of commercial banks—including Sberbank, the state savings bank, which holds more than three-quarters of retail deposits.

According to the World Bank's Ruehl, Russia's inflation will reach 20-22 percent in 2001, above the government's forecast of 17-18 percent. GDP should expand by about 5 percent. Both inflation and economic growth could slow in 2002.

Russian economists are worried about rising inflation. Consumer prices rose 11 percent in the first five months of 2001 (on an annual basis), compared with 5 percent for the same period in 2000. Higher inflation could jeopardize growth in consumer demand.

In the first five months of 2001 output of goods and services by basic industries rose 5.5 percent, half the rate of the same period in 2000. Investment grew 4 percent (down from 16 percent last year), and foreign trade 8 percent (down from 33 percent). Retail trade is probably the only area to have seen higher growth, rising from 8 percent to 10 percent. Thus while investment drove economic growth in 2000, this year rising consumer demand is the impetus for growth.

The Ministry of Economy and Trade predicts 4 percent GDP growth this year. Yevgeny Gavrilenkov, director of the Economic Analysis Bureau, expects growth to decline further. "It is inevitable, since the necessary structural and institutional reforms are not being implemented fast enough." As he pointed out, most investment in 2000 was concentrated in just two sectors: electricity and transport. This investment structure cannot be sustained over the long term.

So far the real appreciation of the ruble has not hit local producers too hard, said Ruehl. But he cautioned that the authorities need to deal with the increased inflow of hard currency, which creates excess liquidity and could rekindle inflation. The central bank might reinvigorate the stagnant bond market, thus soaking up extra liquidity, Ruehl suggested. The ruble firmed by more than 10 percent in the second half of 2000, according to the Ministry of Economy and Trade. In the first quarter of 2001 the 11 percent (annualized) increase in imports was twice that of exports. In the second quarter import growth, at 29 percent, was four times that of exports.

Replacement of imports by domestic products, spurred by the 1998 ruble devaluation, has slowed. Lackluster demand for domestic goods has affected the financial position of enterprises and is leading to lower investment and output, warns the Ministry of Economy and Trade. A survey by the State Statistics Committee found that two-thirds of enterprise directors do not expect the demand for their products to expand in the third quarter of 2001.

Based on news agency reports as well as articles in Delovye Lyudi *(a Moscow-based bimonthly) and the* Financial Times.

Continued from page 17

Åslund is even more puzzling on the question of health care. Ignoring the findings of the most reputable Russian and Western experts on the subject, he baldly asserts: "Nothing suggests that health care standards in Russia have fallen." He also claims that "public and private spending on health has risen sharply as a share of GDP." But he does not consider whether the system's pervasive corruption, which he notes, might have preempted potential improvements in health care.

Numerous studies show that not only has health care not improved in Russia (except for the rich), it has gotten much worse. A recent report by Judyth Twigg of Virginia Commonwealth University and Kate Schecter, a consultant to the World Bank, is partly based on extensive consultations with Russian doctors and health officials. The report concludes that the state system provides a "dreadful quality of medical care."

While Åslund claims that "hospital equipment has greatly improved" and "capitalism has made medicines widely available that were unknown during the Soviet era," the study presents a different picture. It says that "a shockingly high percentage of health facilities have no hot water or sewage systems, and most still use glass syringes and reusable needles....Patients suffer long waits even for urgently needed care. A long list of medicines is not only unaffordable, but unavailable....The most vulnerable parts of the population" are now "unprotected....Universal access to some level of free medical care has been destroyed."

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A Bumpy Transition in Southeastern Europe

Bulgaria and Romania Struggle to Beat the Odds

by Marvin Jackson

What role have domestic politics played in Southeastern Europe's "hesitant restructuring"—a phenomenon seen even in Bulgaria and Romania, the region's leading economies? Beyond the simple fact that institutional and policy reforms occur in a political process, it must be remembered that countries do not make these decisions—people, as political actors, make them. Their decisions result from some combination of their motivations (objectives, values) and incentives (the terms on which alternatives are shaped by their circumstances).

Was hesitant restructuring mainly the consequence of adverse initial conditions, armed conflicts and wars, and unfavorable geographic location? Or were other matters important—such as the self-interest of politicians? The literature on policy failures offers several explanations: lack of understanding of what drives the economy, ignorance of the facts and difficulties of accurate forecasting, weak political coalitions or implementing bureaucracies, and objectives other than the public good.

Unfavorable Initial Conditions

The records of Bulgaria and Romania through the end of 1996 provide significant evidence that public resources were diverted into private hands through abuses of political connections, the banking system, management seats in state-owned firms, monopoly positions and privileged licenses, and others. Although all transition economies—and indeed even Western economies—suffer these problems, in Bulgaria and Romania their scale was large enough to seriously impair the transition. These dysfunctions added to the negative effects of difficult initial conditions and international spillovers. Indeed, the two might have been mutually reinforcing.

Before the transition, rock-solid communists ruled Bulgaria and Romania. Both populations were pushed hard to accommodate to rapid industrialization. Both countries were relatively closed, though Romania far more so than Bulgaria. A number of Bulgarian companies were set up abroad, often said to be fronts for the country's security service. Otherwise, neither country developed any notable international business expertise.

Bulgaria's foreign debt exploded after 1985, and payments were suspended in 1989. Romania was forced to suspend foreign debt payments in the early 1980s, after which the Ceausescu regime mobilized all possible exports and cut imports to the bone. Although the debt had been repaid by the start of the transition, consumers and industry were weakened by the effort.

Bulgaria's Communist Party started a moderate economic decentralization in 1988-89—just enough to enable the *nomenklatura* to secure a profitable position in the economy. The only decentralization in Romania might have been the unintended breakdown of an economy under pressure and a collapse of central authority.

Transition emerged in Bulgaria when party officials voted out Communist Party

Head Zhivkhov. It exploded in Romania, though whether it was a real revolution or a coup d'etat is still debated. The results were the same. Old communists trying to look like social democrats won the first elections in 1990. Civil disorder and strikes forced Bulgaria's prime minister to resign in late 1990. The ensuing short-lived provisional governments could not create stability. Then in 1994 the former communists turned socialists won the elections and ruled through the end of 1996. By contrast, Romania's formerly communist political leaders violently repressed civil demonstrations and strikes in 1990 and 1991. They won the election in 1992 and stayed in power until losing the election in late 1996.

Striking Similarities

Despite different political developments, Bulgaria and Romania enacted similar partial reforms between 1990 and the end of 1996. In both countries economic performance, especially in the long run, was weakened and fell below what might have been possible with other reforms. In addition, the people who benefited most were those connected to the former regime—including managers of state enterprises, members of the former state security services who became businessmen, and any administrators and politicians who could trade favors for bribes.

Bulgaria's Former King Announces Economic Program

Simeon Sakskoburggotski, former King Simeon II, who won Bulgaria's June 2001 elections and in early August became its new prime minister, has announced his first package of economic measures. Simeon defeated the two main parties that had dominated Bulgarian politics since 1990: both his predecessor Ivan Kostov's party, the Union of Democratic Forces, and the main opposition Bulgarian Socialist Party. Simeon promised to significantly improve the situation of ordinary Bulgarians within 800 days.

The economic package foresees higher utility tariffs and minimum wages, cuts in public administration and several taxes, and establishment of a fund for small and medium-size enterprises. Simeon also plans macroeconomic rigor, a better environment for foreign investors, and active financial management.

His policy proposals are pragmatic:

- On the macroeconomic front, he intends to maintain the course set by the previous government, which saw inflation for the first seven months of 2001 held to 0.6 percent against an annual target of 4.5 percent, and economic growth that moved from an 18.0 percent contraction in 1996-97 to real growth of 4.5 percent in 2000 and a projected 5.0 percent in 2001. The government also plans to support these trends by implementing a balanced budget policy.
- On the microeconomic side, Simeon plans to create a better environment for small and medium-size enterprises through deregulation, tax cuts, and development of a venture capital sector; to expedite privatization, including the sale of telecommunications and tobacco monopolies; to liberalize prices, notably in the energy sector; to develop the capital market; and to root out corruption.
- The new government plans to continue preparing Bulgaria for EU accession by introducing active management of the country's $10 billion in foreign debt and encouraging foreign investment.

The program involves some risks. Aiming for a balanced budget will make it harder to support small and medium-size enterprises. Raising energy prices may boost budget revenues, but it will further reduce real wages and increase pressures on Bulgaria's long-suffering population. Privatization and higher energy prices will prompt further rationalization in industry, but that may increase unemployment—which at 17 percent is a major source of popular discontent.

At the same time, Simeon has more maneuvering room in the international area, and the administration seems well-equipped to manage this dimension of the country's transition. The former king is an experienced businessman, Finance Minister Milen Velchev used to work for Merrill Lynch, and Economy Minister Nikolai Vasilev for Lazard Capital Markets. The government will introduce tax incentives for foreign direct investment, which has been growing steadily and reached nearly $1 billion in 2000. But foreign direct investment per capita remains under $3, compared with almost $2,000 in Hungary and $1,600 in the Czech Republic. With labor so cheap in Bulgaria—real unit labor costs fell 19 percent in 2000—there is enormous scope for increasing foreign direct investment.

In seeking to maintain the preceding administration's sensible macroeconomic orientation while introducing policies to develop private enterprise and elaborating a broad strategy for integrating the economy with global financial and technological networks, Bulgaria's new government is demonstrating an impressive sureness of touch.

Excerpted from a report by Oxford Analytica, the International Research Group, Oxford, United Kingdom.

There were other striking similarities between the two countries; some originated before the dramatic political changes in 1990:

- Foreign funds borrowed by Bulgaria in 1985–89 were recorded as "errors and omissions," hinting at capital flight. Such funds are thought to have ended up in the hands of a few top officials and members of the security services who established themselves abroad as businessmen. In Romania the books on Ceausescu's foreign bank accounts disappeared, and no inquiries were launched to locate the money. The government later denied the existence of the records and the accounts.
- In 1990 both countries' new, formerly communist leaders proclaimed their intention to create a market socialist economy with a "French-style" planning system. Both plans were fantasies. In both countries attempts have been made to blame the problems of ordinary people—rising unemployment, inflation that reduces the real value of pensions, and worsening public education and health services—on unspecified "profiteers." Officials have avoided discussing whether subsidies should be given to favored enterprises and possibly their workers or to better support pensions, public education, and public health.
- Neither country enacted legislation to regulate and modernize the civil service until the late 1990s.
- Although both countries passed laws mandating the return of agricultural land to peasant farmers before privatization, restitution became a political football, was resisted by the managers of collective farms, and was followed by extremely slow surveying and granting of clear titles. Local prefectures—mostly controlled by the "socialist" leaders—often put pressure on peasants and other land claimants to vote for the right party and pay bribes. Large supply, mechanization, and marketing organizations remained unprivatized until late in the transition, and even after privatization were in the hands of the former managers.
- In its *Transition Report* the European Bank for Reconstruction and Development (EBRD) has classified both countries as "slow liberalizers"—a term reflecting reforms of domestic prices, foreign exchange and trade, and small-scale privatization. Slow liberalization and reform reversals have provided opportunities for great profits for holders of import and export licenses. Large margins were also available for farm marketing organizations and others benefiting from extended controlled prices.
- In both countries medium- and large-scale privatization has been very slow and created great opportunities for insiders. Romania's privatization funds created many well-paid jobs and provided insider opportunities to former bureaucrats and other officials of the old system. Moreover, the state ownership fund initially resisted selling shares in some of the most profitable enterprises.
- State-owned and favored privatized enterprises in both countries have received huge sums of soft money that has never been adequately accounted for. Although politicians considered it justified to subsidize workers in critical enterprises (such as those providing the primary employment in a weak region), there is no adequate proof that funds were used for that purpose—rather than being siphoned away by managers. Several of these enterprises were bailed out—either through the banking system or through formal restructuring programs—with the only result being that favored enterprises ended up in more debt than before.
- Both countries experienced reversals in macroeconomic stabilization in 1995, 1996, and 1997. Partly at fault were efforts in both countries to buy votes by releasing funds for favored regions and enterprises. Bulgaria came close to financial collapse as a result of mismanagement by its second "socialist" government.
- Both countries fare rather unfavorably in the international comparisons of corruption and crime data published by various international organizations.
- The EBRD's *Transition Report* shows that Romania's income distribution is the most unequal among Central and Eastern European countries. Between 1989 and 1997 Bulgaria, Macedonia, and Romania showed the greatest increase in inequality in the region.

Uncertain Future

Bulgaria and Romania elected noncommunist, reform-committed governments in late 1996 and early 1997. Both had to deal with outdated institutions, and both inherited inflation and budget deficits. Although Bulgaria's government faced worse initial problems, over the next four years it did a better job than Romania's government, which lacked experience. Moreover, Romania's coalition government never really worked, though three successive prime ministers tried to keep it alive. While modest progress was made, most problems remained unresolved—and even the new politicians were drawn into corruption. As a result, last year Romanian voters voted back into power Ion Iliescu and his party, who in 1996 had been voted out. Doing a better job did not help Bulgaria's governing party in recent elections; it too was voted out—but by the party of former King Simeon II (see box).

Thus a number of issues remain unresolved, and one wonders how experts can write prescriptions based on the assumption that those in charge—from governments to mafia bosses—necessarily benignly seek some "public interest." The problem is not the absence of good recipes and great plans, but of effective implementation. So will the rich just get richer and the poor get poorer? Or will the European Union be able to pull the rent-seekers in line, demanding reforms before accession? Not all citizens will benefit from EU accession, so the outcome is uncertain. In the meantime, we should not hold our breath.

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Romania's Poverty Hampers Structural Reforms

Romania's Social Democratic Party inherited an improving economic situation from its center-right predecessors when it came to power in late 2000. But the new administration, led by Prime Minister Adrian Nastase, has also increased confidence in the country's economic prospects:

- The prime minister has established authority over his ministerial team.
- The Social Democratic Party agreed to continue the 2000-06 economic strategy agreed to by the European Union and the previous government, which commits Romania to moving toward a market-led economy.
- In February 2001 the government signed a one-year pact with the main trade unions in which the unions promised not to undertake industrial action in return for social protection measures, including a pledge to raise real wages by 4.0-4.5 percent and the minimum wage by 10 percent in 2001, and to cut unemployment to less than 10 percent from its current 11 percent.
- In June 2001 the government and the central bank launched an anti-inflationary program based on exchange rate targets and focusing on more restrictive income policies (particularly for utilities and state enterprises), faster privatization, and tighter monetary and foreign exchange policies.

These internal developments were accompanied by positive external reactions. In March Standard & Poor's raised its credit ratings for Romania. In July the World Bank announced the impending completion of its two-year private sector structural adjustment loan (PSAL-1) aid program, which is worth $300 million and is designed to accelerate the privatization of state enterprises and reform of the financial sector (particularly banks). The completion of the program was dependent on the sale of Banca Agricola, the country's fifth largest bank, which was completed in April after long delays. Negotiations for a PSAL-2 program are due to be finalized in September, with the privatization of Casa de Economii si Consemnatiuni, the dominant institution in the retail deposit market and the only fully state-guaranteed bank, viewed as one of its likely priorities.

However, the International Monetary Fund's (IMF) failure to reach a new accord with Romania after its standby credit expired in February indicates that serious concerns remain over economic performance and government strategy. According to the IMF:

- The current account deficit of 3.7 percent of GDP budgeted for this fiscal year is too high. Nearly two-thirds of the deficit is being financed by foreign loans, and the deficit is likely to increase because of extra spending.
- Banking reform and privatization of energy utilities are vital to create viable foundations for a functioning market economy. Only about one-third of the economy has been privatized. Moreover, the private sector provides nearly all tax revenue, while much of the rest of the economy is a heavy drain on the exchequer.
- Much faster progress is needed on establishing a transparent fiscal system.

Nastase appears keen to finalize a new standby agreement with the IMF by the fall.

The government's ability to implement structural reforms is weakened by domestic suspicion of foreign takeovers of state industrial holdings. This suspicion is illustrated by the recent crisis over the fate of the country's third largest steel mill, Combinatul Siderurgic Resita, which was bought last year by the U.S. firm Noble Ventures. Since the sale, relations between the new owners and the workers have deteriorated. Workers concerned about layoffs and claiming a failure to modernize the plant grew increasingly restive, and Privatization Minister Ovidiu Musatescu announced that judicial proceedings were being launched to annul the contract with Noble Ventures. But fears that the failure of the Resita privatization might affect negotiations with Ispat, the Anglo-Indian steel manufacturer negotiating to buy Sidex, Romania's largest state industry, proved groundless. Sidex loses around $25 million a year and has $9 million in debt, making it a heavy drain on the budget.

Romanians' purchasing power is now less than half of what it was under communism. At the end of 2000, 45 percent of the population (up from 22 percent in 1996) lived below the poverty line. Opposition to further austerity measures is now high. Nastase argues that economic restructuring needs to take into account these social realities and that the budget deficit needs to be at least 3.5 percent of GDP for the time being, to stem the potential for industrial unrest to completely derail reforms. The government has sought to calm public opinion by encouraging criminal investigations of former privatization chiefs accused of having profited from sell-offs before 2001 and by setting up a national agency to combat poverty.

Given current economic circumstances, Bucharest cannot afford to frighten off foreign investors. But some domestic investors have little interest in a long-term foreign presence and want to produce low value added goods at low cost, with comparatively few benefits for the wider economy. Moreover, a few investors have been accused of stripping assets and indiscriminately firing workers.

In sum, economic indicators are healthier than they have been since the

mid-1990s, but the disposal of ailing state enterprises poses serious dilemmas for the government. EU and IMF structural reform recommendations are anathema to much of the population and many supporters of the Social Democratic Party. In the current social context, reconciling these conflicts is an enormous political challenge.

Based on Early Warning Report, *a monthly publication by the Romanian Academic Society, an independent think-tank based in Bucharest (www.undp.ro) and Oxford Analytica.*

The World Bank's Strategies for Bulgaria and Romania: Scenarios on the Table

In mid-June 2001 the World Bank approved its country assistance strategy for Romania, which will guide the Bank Group's efforts in the country during 2002-04. In the strategy the Board of Executive Directors warned that continued Bank support depended on sustained commitment and clear evidence of structural reforms and sound macroeconomic management from the Romanian government.

The Bank Group's strategy presents two distinct lending scenarios:

- If Romania sustains accelerated reforms, under the high-case lending scenario Bank Group assistance will support a broad set of structural and sectoral reforms to accelerate growth and pave the way for Romania's eventual accession to the European Union, in addition to an enhanced program of poverty-focused interventions. The Bank's commitments would increase to a maximum of $995 million over 2002-04, with three or four operations a year, in contrast to lending commitments totaling nearly $600 million in 1998-2000. This increase would be mainly due to adjustment lending (up to $550 million over the three-year period) to support reforms in the enterprise, energy, and financial sectors as well as in governance and institution building.
- Under the low-case lending scenario the Romanian government would take a more hesitant approach to reforms or even reverse past progress in some areas, resulting in a sharp drop in Bank Group support to $60 million over this period. The number of operations would also be significantly reduced, to one or two a year. This low-case lending program would focus on reducing poverty and strengthening public institutions on a modest scale, and would be complemented by nonlending advisory services aimed at maintaining the policy dialogue with the authorities. These services would include policy notes on energy issues, a public expenditure review, and a country economic memorandum focusing on EU accession.

Romania joined the World Bank in 1972. Since 1990 the Bank has committed more than $3 billion for 31 operations, 21 of which are being implemented. The latest, a $50 million social sector development loan approved in June, will help modernize the labor market, strengthen social safety nets, and develop microbusinesses.

The Bank's country assistance strategy for Bulgaria is still in draft form, but—in a signal of a new era of transparency—is already on the Internet (www.worldbank.bg/). The Bank is ready to receive proposals and suggestions and to integrate them with the final text. "The preparation of the Bank Group's new assistance strategy provides an opportunity to revisit Bulgaria's development priorities with the Government, the private sector, politicians, the public, [nongovernmental organizations], and Bulgaria's development partners and to fine-tune the strategy to ensure that it is responsive to Bulgaria's evolving needs."

The draft identifies some of Bulgaria's most pressing needs:

- Reducing high poverty and unemployment, which will require strong safety nets, investments that reduce poverty directly (including temporary employment programs), and growth policies that ensure the benefits of growth reach the poor.
- Improving the business climate to promote private investment and accelerate growth.
- Accelerating implementation of the many remaining structural reforms.
- Meeting EU accession requirements.

Total lending in 2002–04 could range from $220 million (low case) to $750 million for up to four operations a year (base case), depending on progress in implementing comprehensive reforms. Under the base case the Bank would provide self-regulating program adjustment loans—where actual disbursements would depend on the strength of the reforms implemented—worth up to $450 million over the three-year period. Another $300 million would be provided for various investment projects. If progress on reforms is not sustained, the Bank would not consider the program adjustment loans and would focus on projects that depend less on macroeconomic and structural reforms, including cadastre and land registration, community-based development, rural development, social protection, and health.

Since Bulgaria joined the World Bank in 1990, commitments to the country have totaled about $1.54 billion for 27 projects.

Local Government and Public Service Reform Initiative

Open Society Institute

Reforms on the Silk Road: Institutional Reform in Central Asia

by Tony Verheijen, Sergei Sirotkin, and Anastazia Kozakova

Before regaining independence, Central Asian states—Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan—had similar institutional systems, based on the leading role of the Communist Party. Their public institutions, established by law, were duplicated and superseded by the unregulated party administration. Thus once the Soviet Union fell apart, initial institutional reforms aimed at eliminating this duplication and establishing basic democratic institutions. This did not mean that the former communist nomenklatura left the political scene in mass, rather that they moved into new nonparty institutions. Thus in Central Asia the composition of the ruling elite has changed less than institutional systems.

The development of new democratic institutions can be roughly divided into two main phases:

• In the first phase of chaotic or naive democracy, between 1991 and 1995, national assemblies became more influential. But the increased political role was not accompanied by higher professionalism. As a result political processes became more spontaneous. Attempts by parliamentary institutions to intervene in the turf of the executive branch pushed the executive power to limit the role of these democratic institutions. By the mid-1990s it became obvious that the government had lost control over social and economic processes in most of the region's states.

• During the second phase, which began in the mid-1990s and continues today, presidential power became stronger in response to the perceived loss of government control over social and economic development. Thus it would be a mistake to interpret the institutional transformation in Central Asia solely as a development toward authoritarian rule. The centralization of power in presidential institutions was the result of a search for more effective governance. Parliaments in Kazakhstan and the Kyrgyz Republic recently made moves to regain some of the lost ground—possibly indicating another shift in the balance of power between state institutions.

Specifics of Democratic Transition

The democratic transition in Central Asia faces several obstacles:

• *It is ethnically centered.* The renaissance of national identity has occurred at the expense of the region's non-native-speaking populations. As a result a substantial percentage of ethnic Slavic citizens have emigrated and are continuing to leave Central Asia. Apart from the civil war in Tajikistan, the primary causes of emigration are discontent over measures to promote national languages as state languages and related concerns that the rights of ethnic Russian minorities may suffer. In Kazakhstan during the first half of 2000 the population shrank by more than 53,000, compared with 45,500 during the same period in 1999. More than half the emigrants were ethnic Russians. Similar trends prevail in other countries of the region; in the Kyrgyz Republic the portion of ethnic Russians fell from 8 percent in 1989 to 3 percent in 2000. Tajikistan has lost more than 75 percent of its Russian minority, who now constitute just 2.7 percent of the population. In all five countries the Russian-speaking population has been practically removed from top-level policymaking. The departing citizens possess vital technical expertise and managerial experience. Thus the ongoing emigration is potentially damaging to economic stabilization efforts and institutional development.

• *The traditional clan structure.* Historically, all Central Asian nations are divided into clans and tribes that form larger territorial factions. The political status quo reflects the balance of power between clans and factions. Preserving this balance is crucial to maintaining political stability. (The power relations between clans and factions were observed even by the communist administration during the Soviet era.) Developments in Central Asia cannot be accurately assessed without heeding this phenomenon. Changing the clan structure that serves as the framework for the governing elite is much more difficult than implementing institutional reform. Often, the modern and (semi-)democratic institutional system is just a thin layer covering the traditional clan structure (see page 26).

• *Significant discrepancies between the existing legal model*

and the main features of policymaking. Various traditional and informal practices, bypassing democratic institutions, play an important role. In other words, a modern institutional system is filled with traditional cultural and mental "stuffing" that substantially affects how the system functions. Widespread nepotism based on clan affiliation coexists with (and fills in) the modern legal and institutional framework for the civil service. The functioning of the institutional system simply cannot be understood and explained without paying attention to these traditional informal practices and structures.

Public Administration Reform

Public administration reform is slowly gathering pace. Over the past two years Kazakhstan, the Kyrgyz Republic, and Tajikistan have adopted civil service legislation, and Kazakhstan and the Kyrgyz Republic are engaged in ongoing structural reform of the central administration. Public sector reform is also a declared key objective of the government of Uzbekistan. Less is known about the development of a modern system of public administration in Turkmenistan.

Regardless of recent progress, all Central Asian states have a long way to go until professional and impartial civil service systems and effective public administration systems are in place. The Soviet legacy and the importance of clan relations have had a particular impact on public administration reform.

- In Kazakhstan in the late 1990s, the number of ministries and the direct ties between the state administration and the economy were sharply reduced. The Civil Service Agency, created to manage implementation of the Civil Service Law (1999), has emerged as the driving force in administrative reform. The agency has had to cope with strong resistance from line ministries wary of having restrictions imposed on their recruitment and dismissal practices. So far the agency has been able to overcome this resistance: a system of job descriptions and job classifications has been created and is being piloted.
- In the Kyrgyz Republic the civil service law adopted in 1999 is already being reviewed by a working group because the law provides limited protection against political dismissals and lacks clarity in defining the boundaries between political office and state administration. But progress is being made on restructuring the state administration; several years of across-the-board staff cuts, driven by ever-declining budgets, have created a system of small and weak central ministries that are running an extensive network of subordinated bodies with insufficient human resources.

Administrative reform is at a much earlier stage in the region's other three states:

- In Tajikistan political conditions still do not allow the government to focus on capacity building, as security continues to top the political agenda. Nevertheless, a civil service law was adopted in 1999, and a special Public Administration Reform Unit has been created under the president's administration, with the support of the World Bank.
- In Uzbekistan public sector reform was designated a priority by President Islam Karimov in 2000. The development of a training system and the adoption of a civil service law are being considered, although little information is available on the current state of these two initiatives. Administrative reform appears to be focused on transferring functions to lower levels of government, as well as decentralizing certain social welfare functions to the community level.
- In Turkmenistan the Institute of Democracy and Human Rights, under President Saparmurat Nyazov, has been commissioned to develop a concept on strengthening local governance. (This indicates that administrative development is on the table even in the most closed of the Central Asian states.)

Decentralization as Deconcentration

In 1990 the Soviet Union adopted a law on the main principles of local government. The law served as a basis for the legislation of Central Asian countries but failed to provide actual safeguards (financial, material, organizational, or legal) to the local authorities, which made enforcement of the local self-government principles unfeasible. The countries of Central Asia still have a predominantly centralized culture, inherited from the past. (Decentralization is understood in this region as the transfer of powers from the central government to the local government—what is perceived as deconcentration in Europe.)

The structure of local government has not undergone any substantial changes; it has remained the same as or very similar to that under the Soviet regime. It has three descending hierarchical levels—regions (*oblasts*), districts (*rayons*), and towns and villages—where government offices are based to represent the president and the central government. Self-governing authorities exist only at the grassroots level (except in the Kyrgyz Republic, which has instituted municipal self-government).

Local authorities in Central Asia include both representative (elected) and executive bodies. But (except in the Kyrgyz Republic) both are part of the state government. The powers of local governments are enshrined in the constitution.

A multitier system of local government is also reflected in budget systems. The main sources of revenues for local budgets are tax revenues, nontax revenues, and financial assistance from higher budgets. Local budgets provide funding for preschool, elementary, and secondary education, as well as for social, cultural, and health programs. The financial instability

of local government bodies presents a serious problem in terms of policy implementation at the local level. In addition to the lack of appropriate legislative and institutional arrangements, public officials lack the skills and experience needed for sound local budget management. Further, many managers at the local level held executive positions during the Soviet era, and their work style is still marked by a predisposition for centralism.

Reform Agenda

Decentralization in Central Asia is still in the early stages and calls for numerous reforms. The most important are:

- Clarifying the division of powers between the state government and the local self-government at all levels.
- Strengthening financial management to sustain economic prosperity and ensure the efficient allocation of funds.
- Increasing local sources of revenue, stabilizing spending responsibilities, and giving the authorities greater financial autonomy—including less restrictive central control.
- Clearly identifying responsibilities for procuring public services.
- Promoting the convergence of national and local development objectives.
- Involving citizens in decisionmaking and policy planning.
- Developing sustainable capacities to promote professionalism among local government officials.

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Tribes, Clans, Hordes—Traditional Bonds Shape Political Cultures and Attitudes in Central Asia

by Askat Dukenbaev and Valimjan Tanyrykov

The legacies of communism and the traditional social structure and mentality of Central Asian societies and people have significantly affected political culture in contemporary Central Asian societies.

Transformation of the Ruling Party

Following the failure of the coup against Mikhail Gorbachev's government in Moscow in August 1991, all Soviet Central Asian republics declared their independence. The communist parties in all the newly independent Central Asian states voted to cut their ties with the Soviet Communist Party. Three months later the communist parties in Turkmenistan and Uzbekistan changed their names to the Democratic Party of Turkmenistan and the People's Democratic Party of Uzbekistan. But the party leadership remained in place, under President Saparmurad Niyazov in Turkmenistan and President Islam Karimov in Uzbekistan. (In a few months the Democratic Party of Turkmenistan had a membership of nearly 52,000, 48,000 of whom were former communists.) These parties have retained a dominant position in the executive and legislative branches. In Uzbekistan's 12 provinces as recently as 1994, all the leaders had been Communist Party bosses at the oblast (provincial) level.

Although Tajikistan's Communist Party was suspended after the failure of the coup in Moscow, it was able to retain its property. Just before the sanctions were imposed, the party changed the adjective in its name from communist to socialist. In December 1991 the party reassumed its original name and began a vigorous campaign to recapture its earlier monopoly hold on power. After the civil war in 1992–93 the Communist Party remained the country's largest party, though its membership was far smaller than in the late Soviet era. The communists gave Tajik President Rakhmonov solid support.

In Kazakhstan and the Kyrgyz Republic the communist parties were declared illegal in September 1991 but allowed to reregister in 1993. In Kazakhstan the Communist Party made poor showings in the 1994 elections. President Nursultan Nazarbayev has tried to create a "presidential party" to serve as a training ground for future officials, a tool for political and social mobilization, and a channel for the implementation of state policy. His first attempts to create such a party with the socialists and the People's Congress Party failed. Nazarbayev's third party, the People's Unity Party, remained loyal to the president, though it was unable—even with considerable government help—to elect enough deputies to give Nazarbayev control of the 1994–95 parliament. The People's Unity Party formally incorporated itself as a political party in 1995.

In the Kyrgyz Republic the best organized among 28 parties is the communists', which took 4 of 15 seats reserved for parties in the February 2000 parliamentary elections. Although President Askar Akayev has not shown his affiliation to any party (all attempts to create official—that is, "presidential"—political parties in the Kyrgyz Republic have failed), the com-

munist style of administration and remains in the Kyrgyz Republic.

Legacy of Traditions

Beneath the surface of established political and administrative institutions, political culture and life in Central Asia are influenced by tribal, regional, and other kinship factors. Tribal and clan ties are often reflected in patterns of appointments and networks of power. Regional and clan ties also play a significant role in political infighting.

Until the 20th century the people of Central Asia were divided into two classes, nomad and settled. The nomads were called Kyrgyz, while settled people went by the name Sart. There were economic groups, not ethnic and much less "national" ones. Until the late 19th century the Tajik and Uzbek peoples, who had lived in proximity for centuries and often used each other's languages, did not perceive themselves as two distinct nationalities. Consequently, such labels were artificially imposed when Central Asia was divided into five Soviet republics in the 1920s.

In addition, despite attempts by Soviet nationality policy to dilute tribal consciousness and impose new ethnic (national) identities, tribal identity remained a significant factor in social relations. For example, in Soviet Turkmenistan collective farms were often formed according to clan and tribal affiliation. Nearly every Kazakh, Kyrgyz, and Turkmen, except in urban areas, is still aware of his parents'—and so his own—tribal affiliation.

Country Specifics

• Tribal and regional kinship is a significant factor in Kyrgyz society and politics. Kyrgyz identity in public and private life is determined primarily by membership in one of three clan groups known as wings—*ong* (right), *sol* (left), and *ichkilik* (neither)—and secondarily by membership in a particular tribe within a wing. The left wing includes seven clans in the north and west of the country. The right wing contains only one clan, the Adygine. Located in the south, it claims to be the most genuinely Kyrgyz clan. The southern ichkilik is a group of many clans, some of which are not of Kyrgyz origin, but all claim Kyrgyz identity. The Kyrgyz are still very conscious of clan membership in competing for social and economic advantage. Support for fellow clan members is usual practice in politics. Because tribal communities are affiliated with specific regions and provinces, regional factors also play a significant role in political relations.

• Historically, the Kazakhs identified themselves as members of tribes, called hordes, each of which had traditional territories. The Lesser Horde controlled western Kazakhstan and the Middle Horde migrated across what is now northern and eastern Kazakhstan; those groups came under Russian control first. Members of the Great Horde came to dominate once the Bolsheviks took power, especially after Kazakhstan's capital was moved from the Lesser Horde town of Orenburg (now in Russia) to a Great Horde wintering spot, Almaty. With the fading of the Communist Party and its patronage networks, clan and horde membership has come to play an increasingly important role in the economic and political life of the republic.

• In Tajikistan during the Soviet period, all post-Stalinist communist party bosses came from the northern province, Leninobod (now Khodjent), which was mostly populated by ethnic Uzbeks. The collapse of the Soviet Union broke the established balance of power. In late 1991 and early 1992 leaders from eastern Tajikistan and the southern Kurgan-Tiube region aligned in a coalition to unseat the ruling groups. But with military assistance from Russia and Uzbekistan, the Khodjent faction consolidated its control, led by President Imamoli Rahmonov. [In 1992 Tajikistan descended into a civil war between Islamic conservatives and the secular government. Although a peace agreement between the United Tajik Opposition and the government of President Emomali Rakhmonov was signed in 1997, implementation has progressed slowly, and Russian-led peacekeeping troops remain posted throughout the country. The editor].

• In Uzbekistan the Tashkent region, the Fergana Valley, Samarkand and Bukhara, the northwest territories of the Autonomous Republic of Karakalpakstan, and the southern region have provided the power base for successive heads of the Communist Party. Often clan-based, regional allegiances remain important in both the politics and the social structure of post-Soviet Uzbekistan. In the struggle for political control or access to economic resources, for example, regional alliances often prevail over all-Uzbek ethnic identity.

• In Turkmenistan, among the 30 main clans, the most important are the Yomud, located in the western and northern parts of the country; the Teke, located around the state capital, Ashgabad; and the Goklan, located in the area west of Ashgabad. Historically, Turkmen tribes remained relatively isolated and politically independent. Their dialects differed greatly, and each large tribe had a unique culture and brand of identification.

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Preventing Conflicts through Water Management in Central Asia

by Iskandar Abdullaev

Water resource management is an important part of political stabilization in Central Asia. The region's centralized water management system is not functioning properly, resulting in an unsatisfactory water supply for water users and tensions between the countries of the region.

Central Asian countries have more than 8 million hectares of irrigated land, most of which receive irrigation water from two main rivers—the Amudarya and the Syrdarya. More than half of the region's irrigated lands are in the middle and lower sections of these two rivers. The normal level of water resources of the two rivers is about 77 cubic kilometers, 96 percent of which is used for irrigation.

Water Scarcity

In 2000 all Central Asian countries had water supply problems because the water resources of the two rivers were 20 cubic kilometers less than average. As a result many analysts and journalists dealing with water resources in Central Asia—particularly with their political aspects—have begun to voice concern over possible regional conflicts related to the allocation of water resources.

The region's water resources are distributed unevenly, and no international accords regulate the allocation of water resources. That notwithstanding, each Central Asian country has claimed ownership over water sources located in its territory. Further, water is allocated based on Soviet-era quotas. Needless to say, such an approach no longer meets current demands. This pattern of water allocation exacerbates discontent in the Kyrgyz Republic and Tajikistan, the two countries that possess the bulk of the region's water resources.

Despite accords and initiatives aimed at creating a Central Asian intergovernmental agency to manage water resources, the region's countries are not ready to settle their conflicts over water management. The breakup of a Soviet-era water management system and the poor financial situation of water management organizations across the region have brought the largest hydraulic facilities—reservoirs, canals, and pumping stations—into disarray. Observation, control, and distribution equipment in the 39 water reservoirs (22 in the Syrdarya and 17 in the Amudarya river basin) has been marred by a chronic lack of maintenance.

Another serious problem is the lack of a concerted effort to improve the region's farming. Each country seeks to expand its irrigated land and its free water resources. The area under irrigation in Central Asia has grown by 7 percent since the mid-1990s—a significant increase given the amount of free water resources. Even in the Soviet era the cultivation of a personal plot would provide the principal livelihood for an average household in Central Asia. Today cultivation of these plots fetches rural households as much as 90 percent of their earnings. Indeed, water shortages have hit poor households the hardest.

Hot Spots

Thus water-triggered conflicts are becoming increasingly likely across the region. There are several "hot spots" of such conflicts, including:

- The use of water from the Naryn River and the Toktogul water reservoir for power generation and irrigation. Under Soviet rule the entire system of the Syrdarya River was used to supply water to irrigated areas in Kazakhstan and Uzbekistan. This setup no longer suits the Kyrgyz Republic, which controls 40 percent of the region's water resources. Further, in 2000 the Kyrgyz Republic began using water to produce cheap electricity. As a result 120,000 hectares of Uzbekistan's pastures and irrigated areas were flooded last winter. In response the Uzbek and Kazakh media sharply criticized the Kyrgyz Republic's measure. Relations between the three nations could be seriously harmed if this situation occurs repeatedly.
- As many as 22 rivers and water systems are located within the borders of Central Asian countries. Most rivers are small and low-volume, and so are not included in interstate statutes. In these river systems, local populations are trying to change historically established water distribution. Populations at higher elevations want to increase their water intake, which will decrease the water supply of lowland areas.
- The division of the Amudarya River waters between Turkmenistan and Uzbekistan. The division has been made on a 40/40 basis (with 20 percent of the water resources under international control), though the river basin is inhabited by 14 million people on Uzbekistan's side and by 4 million on Turkmenistan's. Contributing to the tension, after indepen-

dence Turkmenistan built a bypassing canal from the Tuyamuyun water reservoir—an action that created serious problems for the water management system in some regions in Khorazm province in Uzbekistan.

- Tajikistan may demand cuts in the consumption of water from the Zarafshan River, which is feeding the dry Samarkand province in Uzbekistan.

How to Prevent Confrontation?

Are there ways to impose sustainable water consumption patterns across Central Asia? If so, what should be done?

- First, Central Asian countries should sign a water pact to regulate the allocation of transborder water resources in keeping with universally accepted practices (as in the Mekong, Jordan, and Grande river basins) and with due regard for the nations' shared history. Each country's quota should be determined by its population and by its contribution to the formation of water resources. This water pact should be the cornerstone for tackling the water management issue, because lawlessness always leads to violence and the arbitrary use of scarce water resources.
- Second, maximum opportunities should be created for water management institutions to cooperate at the regional level rather than setting up new interstate entities. If each country creates new national institutions simply to highlight its independence, no practical results will be achieved.
- Third, regional cooperation in agriculture should be encouraged by dividing the region into a number of crop-growing areas. This kind of cooperation, in contrast to the situation under Soviet rule, should rely on the market rather than on ideology. This measure would make it possible to significantly reduce water consumption.
- Fourth, the Central Asian Bank for Development should make water management a priority, and special funds should be allocated to finance the maintenance and operation of the region's water management system. Contributions made to the bank for these purposes could be funded through the introduction of irrigation fees.
- Fifth, market regulation in water management should be encouraged through the creation of a water resources pool. In accordance with the water pact, each country should have a quota assigned from the total amount of water resources. Such a step would allow any country to sell to other partners any part of its water quota that remains unused, according to a special tariff.

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Source: Relief Web (A project of the United Nations Office for the Coordination of Humanitarian Affairs).

Kazakhstan Struggles with Migration Issues

by Akhas Tazhutov

Although Kazakhstan is the second largest country in the Commonwealth of Independent States and the ninth largest in the world, its population has never exceeded 18 million. At the same time, for the past century the country has been the scene of intensive migration movements. During the first half of the 20th century waves of immigrants swept into Kazakhstan. As a result the country's population, which totaled 5 million at the turn of the century, increased to more than 15 million in the 1960s (despite the loss in the early 1930s of almost half the indigenous population, which formed an overwhelming majority at that time).

Later, migration out of the republic began to gain momentum. The nonindigenous, mainly European, population started to leave. In the 1970s the country's leaders tried to halt the process, and granted travel allowances and other benefits to attract immigrants from other republics. These measures helped stabilize migration. But with the disintegration of the Soviet Union, the migration outflow from Kazakhstan accelerated. In the first three years of Kazakhstan's independent statehood, 1.13 million people left the country while only 343,000 arrived. Over the past 10 years the population dropped by nearly 3.0 million, including 2.7 million Europeans (mainly Russians), mainly because of mass emigration. Apparently the authorities believed that the emigration of the nonindigenous population would be compensated for by a natural increase in the Kazakh population and repatriation of Kazakhs from abroad without harming the general demographic situation.

But these expectations were never realized. In parallel with mass emigration, a sharp decrease in the birth rate and a rapid increase in the death rate now threaten to reach a critical "demographic cross" situation, with subsequent depopulation. The inflow of Kazakh immigrants from abroad can hardly be compared with the outflow of emigrants (180,000 compared with 2.5 million). Among European emigrants, 63 percent have been of working age, and only 13 percent have been retirees. So, the country's creative labor potential suffered enormous losses.

The returnees, on the other hand, not only experience the imperfections of local legislation, bureaucracy, and corruption but also face psychological alienation from both native "fellow" Kazakhs and other "naturalized" Kazakhstanis. Action is needed to prevent the possibility of violent ethnic, religious, and social conflicts with unpredictable consequences.

Kazakhstan is already experiencing migration pressure from the outside (chiefly from its southern and eastern neighbors, which are faced with the problems of overpopulation and a shortage of natural resources), which tends to increase progressively. The sooner that policymakers and decisionmakers become aware of the situation and take appropriate measures, the sooner the country will be able to avoid the adverse consequences.

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LGI/OSI Publications

Emilia Kandeva, editor, ***Stabilization of Local Governments: Local Governments in Central and Eastern Europe***, volume 2. LGI Books, OSI Local Government and Public Service Reform Initiative, Budapest, 2001, 472 pp.

This publication is part of an LGI Books series on local government systems in Central and Eastern Europe. This volume focuses on eight countries in Southeastern Europe: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Moldova, Romania, and FR Yugoslavia. The country chapters summarize local government structures and operations, and evaluate major development trends over the past decade. The country studies are complemented with tables and figures in a comparable format.

Each country chapter follows a similar pattern, but with a strong emphasis on country-specific characteristics. The main sections of the country studies are:

- Structure of local governments
- Local politics and decisionmaking
- Relationship between state and local governments
- Public participation
- Local service provision
- Local finances
- Next steps and recommendations for reforms.

The book is recommended for policymakers in the region, consultants working on local government issues in these countries, and academic researchers, who may find timely information on Southeastern Europe. If you are interested in getting a copy of the book (free of charge for residents of Central and Eastern Europe), please send the order form (available at http://lgi.osi.hu/index.html) to LGI.

Email: lgprog@osi.hu (subject line: "Volume II. order").
Mailing address: OSI LGI, H-1357 Budapest, POB 519, H-1397 Budapest, Hungary.

How Can Ukraine's Government Be Made More Effective?

by Alex Sundakov

There is a general consensus among the Ukrainian government and foreign donors that the existing machinery of government is not capable of designing and implementing the policies needed to achieve the government's objectives. Recent administrative reforms have generated some improvements, but the government still lacks effective levers to achieve the transition of the Ukrainian economy and society. Moreover, there is increasing concern that administrative reforms to date have not focused on key priorities and have failed to address underlying problems. This is despite considerable donor involvement in the process.

All government agencies in Ukraine now function under three key influences:

- Leftover Soviet elements, including the definition of the function of government, lack of initiative, day-to-day work habits, and hierarchical relationships.

- Elements of spontaneous adaptation—the kind of change that occurs without deliberate design, forced by changes in external circumstances. For example, whether they like it or not, government agencies have had to adapt to the existence of independent businesses and mass media.

- Finally, change that has been driven by deliberate policy action within the context of intentional administrative reform.

In effect, old methods and practices have been superimposed on the new economic structure, creating a situation where the best intentions and efforts of political leaders and public officials translate into substandard performance. The problem, by and large, is not with the individuals, but with the poor fit between institutional arrangements and social needs.

Obstacles to Policymaking

Five factors hamper policy formulation and implementation:

- The government cannot prioritize among strategic issues and is unable to cut through organizational structures and allocate reform responsibilities to specific ministers.

- Decisionmaking lacks open public consultation; government committees follow bureaucratic structures, which creates tension between political advisers to the prime minister and government civil servants.

- The delegation of responsibilities within the government gives too much decisionmaking power to ministers, who at the same time have very little control over policy formulation.

- Policy implementation is still dominated by legalistic decisions; there is no built-in method for civil servants to learn from mistakes and from each other; and time pressure inhibits wider use of experiments and pilot projects.

- Advanced control mechanisms are missing from the public administration, which does not support diagnosis for future strategy design. Instead of planning activities, government units formulate unrealistic "concepts" and political statements.

The Ideal Government

What would be the main characteristics of a government machine that can deliver to a democratic, market-oriented society?

- It would be able to deal with legitimate conflicts of interest consistently and predictably. Such conflicts would be resolved based on well-understood policy, rather than at the whim of an individual official.

- It would set the rules of the game but would not play the game itself. In particular, the machinery of government would not tilt the playing field in favor of interests associated with officials.

- It would be under constant scrutiny, and would consult and incorporate the views of the civil society.

In operational terms, these broad principles need to be translated into specific organizational and managerial features of public agencies. In essence, transformation of the system of public administration will be complete once agencies are under fiscal control, are held accountable, and are professional, transparent, and reliable (predictable).

The key acts of deliberate policy appear to be:
- Reducing the number of ministries.
- Creating new agencies, such as an Antimonopoly Committee, that are explicitly designed for the new policy objectives.

• Recent changes in decisionmaking at the Cabinet of Ministers level, which have highlighted the relative roles of political decisionmakers and civil servants.

Donors' Responsibility

Donor activity plays a particularly important role in Ukraine's reform process. This stems both from a lack of domestic financial resources and from a lack of experienced and trained personnel. Donor advice is critical in shaping the debate. Comparing arrangements for foreign technical assistance in Central Europe—the countries in line for integration with the European Union—and in Ukraine reveals instructive differences in approach. The key differences:

• Central European countries had a unifying framework for technical assistance—preparation for EU integration. By contrast, it is difficult to identify a unifying principle for foreign assistance in Ukraine. Donor priorities appear to be more supply driven, and chosen according to political criteria.

• Technical assistance projects in Central Europe appear to be largely built around specific implementation benchmarks required to transform institutions to EU standards. By contrast, technical assistance to Ukraine rarely envisages implementation as the main product of a project. Rather, projects tend to provide advice, on the expectation that the government will take care of implementation once the political will is present.

• Technical assistance projects in Central Europe tend to provide systematic access to information and personnel in the West, integrating officials into international networks. Projects in Ukraine tend to provide one-off training and sporadic access.

Elements of Better Assistance

Some of these differences were an inevitable product of different social, economic, and political conditions in these countries. But it is important to consider how much of the differences were really necessary, and how many Ukraine's different approach to technical assistance may be delaying its transition.

• In designing assistance projects, donors should take into account how that assistance will be integrated with government processes, and in some cases should impose conditions on how such processes should be changed before a project can go ahead. A foreign consultant may write an excellent policy paper, but if that advice is not part of the internal policy development process, it will be treated as a piece of academic research and will have little effect.

• In providing advice, donors are often reluctant to engage the civil service, and try to short-circuit the bureaucracy by attaching advisers directly to politicians. But while it may be important for foreign advisers to have the status of advisers to a minister (or prime minister), they will not be effective if they stand outside the established decisionmaking process. The bureaucracy will not go away; it will remain powerful, and the best contribution an adviser can make is influencing its work.

• Foreign advice tends to be focused on what to do (such as what policy to adopt) rather than on how to reach a rational decision. Foreign advisers are paranoid about presenting Ukrainian decisionmakers with alternatives because they fear that a "wrong" alternative will be chosen. Senior officials often express the view that foreign advisers are self-serving. By contrast, successful examples of foreign assistance typically involve a direct effort to improve the work of a particular institution, to set up a new process, or to provide advice within an established process.

• Few donor programs appear to be aimed at "teaching the teachers." For example, many technical assistance programs involve study tours by Ukrainian officials to donor country institutions. But it is rare for such projects to require written reports by the returning officials, or to provide resources for follow-on seminars or the dissemination of collected material. Most Ukrainian officials operate in extreme intellectual isolation and have no Western peer groups. This inevitably means that they fall back on Soviet habits of thought and action. The objective should be to integrate Ukrainian officials with international networks of civil servants and policy advisers.

The main challenges facing Ukraine's system of public administration are managerial rather than structural; there is an urgent need to develop required skills and processes, while relatively little can be gained in the short term from structural changes such as reallocating functions among agencies. More important is improving decisionmaking, which should include strengthening strategic planning in order to build consensus and develop collective wisdom; intensifying public consultations to ensure appropriate feedback; and enhancing policy management.

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This article is based on his recent paper, "Public Sector Reforms in Ukraine: On the Path of Transformation," *LGI Discussion Paper 18, 2001.*

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The Great Reversals: The Politics of Financial Development in the 20th Century

by Raghuram Rajan and Luigi Zingales

A growing body of evidence indicates that the development of a country's financial sector greatly facilitates its growth. Why then do so many countries still have underdeveloped financial sectors? The simple answer, and one favored by many economists, is the absence of demand. According to this view, when opportunities that require financing arise in an economy, the economy will develop the necessary markets and institutions to finance them. For example, the enormous financing requirements of railroads in the United States ($1 billion by 1867 and $10 billion by 1890) led to the development of public markets for corporate debt and later for stock, with 40 percent of this capital coming from Europe. Financial institutions such as investment banks, including the famous Morgan Bank, emerged to underwrite and distribute these securities and to reassure European investors that the money was properly invested. Thus the financing needs of the railroads led to the creation of a financial infrastructure in the United States, which was then available to finance industries that came later. What we have just described is nothing but the reverse of Say's Law—demand creates its own supply.

Behind the Divergence

Certainly demand is a prime driver of financial development, but it cannot be the only explanation; demand cannot explain why countries at similar levels of economic development differ so much in the level of their financial development. For example, why was the stock market in France much bigger as a fraction of GDP than markets in the United States in 1913, even though per capita GDP in the United States was no lower than that in France? It is hard to imagine that the demand for financing in the United States at that time was inadequate—the demand for more, and cheaper, credit was a recurrent theme in political debates in the United States, and the country was among the most industrialized in the world even then.

An alternative explanation centers on structural impediments that prevent supply from rising to meet demand. Perhaps a country lacks the necessary social capital or "savoir faire" to create a viable financial sector. Or perhaps it has not inherited the right legal, cultural, or political system. In particular, the seminal work of La Porta, López-de-Silanes, Shleifer, and Vishny (1997, 1998) shows that countries with a common law origin (with law based on custom, usage, and court decisions) seem to have better minority investor protection and more highly developed equity markets. While there has been some debate about the precise channel through which a country's institutional inheritance affects its financial development, the evidence of a strong empirical correlation in recent times between whether a country is financially developed and whether it has British colonial origins is hard to ignore.

But one implication of the "structural" theories of financial development that has not been explored is that financial development should either take off permanently (for example, once a country attains the necessary social or human capital) or remain permanently constrained (for example, if the inherited legal system is hostile to investor protection and financial markets).

To test this implication, we collected indicators of financial development in developed countries over the 20th century. By most measures, countries were more financially developed in 1913 than in 1980 and only recently have surpassed their 1913 levels of financial development. Furthermore, the pattern across countries in 1913 was quite different from that in the 1990s. In 1913, stock market capitalization in France as a fraction of GDP (0.78) was almost twice that in the United States (0.41)—even though the French civil code is not friendly to investors, according to La Porta and others (1998). By 1980, the situation had dramatically reversed—stock market capitalization as a fraction of GDP in France (0.09) was barely one-fourth that in the United States (0.46). And in 1999, the two countries seemed to be converging (1.17 and 1.52).

More generally, by most indicators the main countries of continental Europe were more developed financially in 1913 than the United States. In fact, in contrast to the findings of La

Porta and others (1997) for the 1990s, we find that countries with common law systems were not more financially developed in 1913. What is especially interesting is that indicators of financial development fell in all countries after 1929, reaching their nadir around 1980. Since then, there has been a revival of financial markets.

Influence of Interest Groups

A comprehensive theory should be able to explain the variation in financial development both over time and between countries. In our view, the strength of political forces favoring financial development should be a major aspect of such a theory. Clearly, there may be structural aspects to these forces, which we discuss shortly. But equally clearly, the prime mover is the dominant interest group, so we propose an interest group theory of financial development.

One challenge with such a theory is identifying who might oppose something as economically beneficial as financial development. We believe that incumbents—especially in finance, but also in industry—can be hostile to arm's-length markets because anonymous markets do not respect the value of incumbency and instead can give birth to competition. Specifically, financial markets disproportionately favor new entrants over incumbents. Nevertheless, it is possible to mute the incentives of incumbents to oppose financial sector development. One such situation is when an economy experiences both cross-border trade and capital flows. The resulting competition from external sources, especially in financial markets, coupled with the constraints on government financing, makes it difficult and unprofitable for domestic incumbents to keep the domestic financial sector repressed.

The greater challenge with any theory that suggests that politics matters is how to test it. Structural measures of a country's political system are notoriously difficult to capture. It is no wonder that the evidence thus far is mixed. Apart from differences in data and accuracy of measures, the difference in results may stem from differences in the incentives of the interest group in power. But how do we identify the most powerful interest group, and how do we determine its incentives?

The following example should illustrate the problems. In France, financial liberalization was kicked off in 1983 by a Socialist government. By many structural theories, France would be an unlikely country to initiate liberalization, and socialists seem to be an unlikely interest group to push for it. A more detailed study (Helleiner 1994) suggests that there was a liberalizing faction in the French Socialist party, led by Prime Minister Pierre Mauroy and Finance Minister Jacques Dolors, whose hand was strengthened by France's increased trade integration into the European Community. This faction argued that liberalization was necessary to preserve trade, and won the day. How could one ever hope to capture the strength of such factions in a large-sample, cross-country study without a subjective country-by-country exercise?

Free Trade Can Accelerate Financial Development

Our theory suggests a way. Regardless of the nomenclature of the party in power or the structure of government, we can use the extent of an economy's openness as a proxy for the strength of incumbents' opposition to financial development. While crude, this approach gives us an objective way to sidestep the morass of trying to identify specific interest groups in different countries and their ability to exert power. Of course, there could be a more direct economic reason for trade to be correlated with financial market development. Our theory offers an additional prediction that helps deal with this concern: it is at times that cross-border capital flows are plentiful that trade should matter. We take these predictions to the data.

We find that in the initial decades of the 20th century and in the closing decades, both periods in which cross-border capital flows were relatively plentiful, measures of a country's financial development are strongly correlated with exogenous measures of its openness to trade. This evidence is consistent with our hypothesis that incumbents' incentives to oppose financial development are relatively muted when a country's borders are open. By contrast, in the intermediate periods (from the 1930s to the 1970s), when cross-border capital flows had dwindled to a trickle (for reasons ranging from the autarkic policies adopted during the Great Depression to the Bretton Woods agreement that favored trade at the expense of finance), we find that trade openness did not have as strong a positive correlation (if any) with financial development. These findings suggest that it takes openness in both product and financial markets to mute incumbents' incentives to oppose financial development. They also suggest a reason for the decline in indicators of financial development between the 1930s and the 1970s: cross-border flows, especially of capital, were relatively small.

Finally, we attempt a synthesis of our private interest theory with structural theories, which affords more testable implications. It has been argued that in countries with a civil law origin (with law based on written legal codes), policies can be imposed more easily. This should imply that civil law countries are much more prone to capture by focused private interests, such as incumbents. If so, we would expect to see that as cross-border financial flows ebbed in the 1930s, trade openness became a much less potent force for financial market development in civil law countries than in common law countries. By contrast, as financial flows resumed in the 1990s,

incumbents in more open civil law countries should have had a stronger incentive and ability to press for financial development, so that trade openness would become a more potent force for financial market development in civil law countries. This is in fact what we see in the data.

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Traps in Decentralizing Financial Institutions: Some Interesting Lessons from China

by Albert Park and Minggao Shen

Liberalization and decentralization of the financial sector have been a main focus of reform for the past several decades in developing countries and more recently in transition economies. Financial liberalization transforms a heavily regulated system into a market-oriented one. Decentralization vests greater decisionmaking authority in local managers so that they can compete effectively in a market environment. Like other types of decentralization, financial decentralization aims at both promoting local (lenders') initiative and exploiting local information so that better decisions can be made in allocating resources.

Dewatripont and Maskin (1995) present a second motive for decentralization. They show that the division of large banks into small ones can serve as a commitment device that helps lenders harden the budget constraints of borrowers. Unlike large banks, small banks are incapable of refinancing ongoing projects independently. Other potential lenders may be unwilling to refinance projects if they have imperfect information about firm quality. Entrepreneurs with bad projects who anticipate refinancing thus may find that it is not profitable to seek financing in the first place.

Other factors may undermine the potential benefits of decentralization. The disadvantages of decentralization are associated with both agency problems and commitment failures, which are frequently observed in the underdeveloped markets or poor regulatory environments commonly found in developing and transition economies. We consider two agency problems and one commitment failure associated with decentralized systems:

- Collusion between local bank managers and borrowers.
- Collusion between local bank managers and local government officials (or government influence).
- The commitment problem of lenders inclined to refinance bad projects (excessive refinancing).

First, in a decentralized world where information is costly, agents may benefit from colluding with each other at the expense of the principal. In the case of financing, borrowers can bribe local bank managers to approve loans. This idea is similar to that of Strausz (1997), who uses a principal-supervisor-agent framework to show that collusion between the supervisor and the agent may occur if the principal rewards the agent on the basis of information generated by the supervisor. The principal hires a supervisor and delegates control rights if and only if she can provide collusion-proof contracts. Strausz (1997) shows that collusion can be deterred if the principal is able to commit to not renegotiating the contracts between the principal and the supervisor.

Second, another agency problem often observed in developing and transition economies is government influence. Local government leaders, as social planners for local communities, internalize not only the economic benefits of running firms but also noneconomic ones. Local government leaders may be concerned with, and frequently rewarded on the basis of, enterprise and employment creation, potential tax extraction, and indicators other than investment profitability. This may lead them to support low-return projects and to apply political pressure to local bank managers over whom they may have influence. Policy lending and soft budget constraints are a notorious problem plaguing financial institutions in transition economies. Such problems are considered to be less serious at lower administrative levels, however.

Finally, in contrast to Dewatripont and Maskin (1995), we argue that **even if decentralization improves local information, lenders still will be inclined to refinance bad projects**, which softens the budget constraint of borrowers. In the context of a corporation, Cremer (1995) shows that more information may hurt the principal's ability to refuse renegotiation. More accurate information may reduce the agent's incentive to work diligently to signal a strong ability to refuse renegotiation. Berglof and Roland (1998) show that, contrary to Dewatripont and Maskin's (1995) finding, decentralization does not necessarily lead to hard budget constraints if the

lender's opportunity cost of refinancing is low and the lender can afford to refinance. In particular, when the liquidation cost is high because of inadequate institutional infrastructure, the lender may lack the credibility to liquidate financially distressed projects.

Surprisingly, we could find no empirical research on the validity or relative importance of different theories explaining financial decentralization. We use bank-level data on managerial decisionmaking authority in a large transition economy to rigorously test whether theory can explain observed heterogeneity in the decentralization of lending authority in financial institutions. The unique data set was collected in surveys of rural financial institutions, enterprises, and local government officials in southern China in 1998.

The ongoing financial transition in China offers a particularly appropriate setting for empirical tests. China is an interesting case because banks recently became commercialized but supporting institutions are not fully developed, leading to rich variation across space in the extent of decentralization and its causes. Financial reform in China aims at transforming financial institutions from government-run banks to independent financial intermediaries. Important aspects of China's financial reform include the introduction of competition among state-owned banks in the early 1990s and the strengthening of profit incentives for managers. Most policy loans were transferred to newly established policy banks. Individual banks have been allowed to decide for themselves whether or not to decentralize loan decisionmaking to local bank managers.

Interestingly, however, despite the apparent benefits of decentralization, our data show that increasingly commercialized banks with more discretion to delegate lending authority have chosen to centralize control. We speculate that the current trend toward centralization reflects severe agency and, especially, commitment problems. The financial transition in China is far from complete. Government interventions have declined but not yet disappeared. Market institutions (such as secondary markets) and legal institutions remain poorly developed. Centralization can help resolve agency and commitment problems, although probably at substantial cost in lost information and reduced incentives for local managers. This outcome in China suggests that rapid commercialization of banking systems in transition economies will not automatically lead to substantial improvement in financial intermediation unless core agency and commitment problems are solved as well.

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Report from the Field

A regular column written by recipients of the William Davidson Institute Fellowship in Business Journalism

After the Battle, Everybody's a General—but Czech Privatization Really Was in Need of One...

by Jan Machacek

There are at least three good reasons to stop and take a look at the 10-year-old Czech privatization process. First, the sale of Komercni Banka to the French Société Générale has brought the long, exhausting process of bank privatization in the Czech Republic to an end. Second, on a recent visit to Prague, former World Bank Chief Economist Joseph Stiglitz called the Czech way of privatization a failure. And third, large-scale privatization has taken 10 years.

Privatization Is a Must

There is a Czech saying, "After the battle, everybody is a general." My American colleague offered up the saying "Hindsight is 20/20." No matter how one puts it, we can all agree that it's easy to be smart now. It's so easy to look back and see the weak points and identify the mistakes.

For example, the transformation of ownership in the Czech Republic had no comparable precedent in scale and timing. Foreign advisers could offer only limited advice because they had only limited experience.

But even the limited advice might have been useful to those who ignored it. Many foreign advisers were brushed off and criticized at the beginning of the 1990s for providing "cheap advice for expensive money." That was hubris, which always brings punishment.

Everything in economic policy or economic transformation has been tried somewhere, with results, costs, and benefits that can be measured. One can always draw geographical or historical parallels, or both, in any area one considers: taxation, pension reform, trade barriers, exchange rate policy, anti-inflation measures, deregulation of energy production, free trade and distribution, bank and capital market regulation.

Consider the challenge: rapid privatization of 99 percent of a country's property, which had been nationalized (stolen) almost half a century before. This had never happened before and probably (hopefully) will not happen again anytime soon.

But privatization is a must. All reform governments have had to carry it out somehow, no matter how socialist or conservative they claim to be. Private property, private interests, and private capital are the foundation of the market. In a democracy, privatization is always an unpopular process, used later by the opposition as a basis for attacks on the government.

The Czech Republic's voucher privatization experiment (the distribution of property through vouchers) relied on public involvement, and enabled the government to use other methods of privatization to push through other reforms with political support. People developed an "illusion of participation." The mixed results, including major fraud schemes, later became a political tool for the opposition, enabling Milos Zeman's Czech Social Democratic Party (CSSD) to win the elections in the end.

Every Reform Country Differs

Hungary and Poland privatized differently. Periodically (in polls conducted in the early 1990s), around 80 percent of the population surveyed in these countries considered privatization a sham. Can such a privatization be called a success? Hardly.

Hungary sold most of what any foreigners were willing to buy in order to pay back a huge foreign debt it inherited from the communist regime. Paradoxically, this strategy served the Hungarians well, although this "selling out the country" to foreigners was extremely unpopular.

Poland gave foreign capital a larger opening, but most of its smaller companies were "privatized through bankruptcy." This strategy was relatively quick, but not very transparent.

Czech communists didn't accumulate a major foreign debt. That gave Czechs the luxury of talking about what limits there ought to be on foreign investment, and about the "family silver," the "Czech way," and many other shining ideas that later lost their luster.

No Good Way

The Czech Republic combined privatization methods. All seem bad at first glance, so why not combine them?

1. Selling companies to the highest bidder
In this method, the winning bidder pays the price of the company through a bank loan. Then he has to pay back operational and investment loans along with a "privatization loan." He either tunnels the company and hurts smaller shareholders or goes bankrupt. Or he pays back none of the loans or just some of them, and the cost of the transformation goes to the bank, which amasses bad loans. The real cost is passed on to taxpayers, who finally save the bank. These loans didn't make sense on economic grounds. They were provided on such a scale in the Czech Republic because of fraud, corruption, and political pressure. Forty years of communism had done little to prepare bankers to do good business.

2. Selling to the highest bidder, but ruling out the use of a bank loan to pay the bill
This method would have increased the chances of those who accumulated money under the communists or those with links to nontransparent sources of money abroad.

3. Selling to the entrepreneur with the best business plan
Nobody can properly evaluate a business plan. This method is the most direct route to corruption and makes it likely that companies will be bought with bribes.

4. Selling to the current managers and experienced entrepreneurs
Current managers were rarely any good, and there were no "experienced entrepreneurs" with a proven track record.

5. Selling everything to foreign investors
This is clearly politically impossible except when absolutely necessary. The opposition would fight tooth and nail against "selling out" national assets and "selling the country" to foreigners.

6. Using voucher schemes
The Czech Republic combined a voucher scheme with all the methods mentioned above. The voucher scheme did not bring in new capital, and property control ended up too dispersed.

7. Selling gradually through a stock exchange
This method was impossible because no stock exchange existed yet.

At the Top of the Learning Curve

Banks in the Czech Republic should have been privatized to foreign direct investors fully and at the beginning of the reforms. But almost no economists (forget about politicians for now) called for this until 1994–95. Foreign direct investment should have been given a lot more space from the beginning. The voucher scheme should have been used on a much more limited scale and should have been accompanied immediately by standard capital market regulations. Nonprivatized banks should not have been allowed to launch investment funds. And the investment funds collecting the vouchers should have been run by established foreign investment banks and companies.

From the start, foreign experts should have been asked to help establish standard capital market regulations, a standard stock exchange, and regulatory bodies. From the start, the Czech Republic should have paid for hundreds of young people to study and work abroad. Companies should have been sold outright because otherwise bureaucrats in charge of privatization become the major obstacles to it, especially when they sit on the boards of semiprivatized companies. Standard bankruptcy proceedings should have been instituted much sooner. The list goes on.

Czech privatization can be called both *a* success and a failure. Outside of coal mining, there is no successfully privatized (profitable) large industrial company owned by Czechs. The successful Czech-owned companies are new ones, established from scratch after the revolution, or very small companies. That's a major failure. But those who don't believe that Czech privatization is also a success should have seen the country 12 years ago.

The Current Government's Privatization Effort

Once a country's reform potential has been squandered (people are generally receptive to reform for only a couple of years after any revolution), privatization gets stuck. More obstacles are created when privatization is taken out of the hands of professional economists and managers and given to the political party secretariats. Maneuvering politicians and party bosses are deeply locked into all kinds of vested interests. Some of them, paradoxically, are economists who became politicians.

Today's socialist government is also a schizophrenic one. It wants to control as many companies as possible (because control over state-owned companies means power), but it also needs as much cash as possible to finance its incredible appetite for spending. Moreover, it wants to be friendly with trade unions, which usually oppose privatization (as in the case of energy production and distribution), and it makes warm overtures to other lobbyists and vested interests. And it must be friendly with the Civic Democratic Party (ODS), which shares control over privatization and state-owned companies. Zeman's government has been successful in completing the privatization of the banks. Congratulations. To a large extent, this was the only way to avoid a truly deep crisis. But other than concluding the privatization of Skoda Auto, the rest of its privatization efforts have been a complete failure (including CEZ, Transgas, Unipetrol, SPT Telecom, Skoda Plzen, Ceske Radiokomunikace, and gas and energy distributors)—it isn't moving ahead at all. The best opportunity to sell all those companies has been wasted. The Czech privatization of the early 1990s is easy to criticize, but at least there was some. Now, is privatization even possible?

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Russia and the World Trade Organization: Myths and Reality

Many myths surround Russia's potential membership in the World Trade Organization (WTO). To dispel some of these misconceptions, which are clouding the views of many in Russia about WTO membership, the Center for Economic and Financial Research (CEFIR) sponsored a study to examine the concerns that lie behind the myths.

Myths That Impede

Myth 1. WTO membership means complete exposure of the economy to global competition, leading to the displacement of domestic industry followed by mass unemployment.

This myth rests on a number of assumptions:
- Current tariffs protect Russia's industry against competition.
- WTO membership will lead to a drastic reduction in this tariff barrier.
- WTO membership means that the government will lose the key instruments it uses to protect local industry.
- Opening the economy as required by WTO membership amounts to a death sentence for domestic industry.

The truth is more complex:
- Current tariff rates are low, some 7–15 percent at the two-digit industry level, too low to be very effective by international standards. Moreover, customs administration functions so poorly that only about half the tariffs are collected.
- Joining the WTO will not necessarily lead to a reduction in tariffs. Tariff rates will be decided during accession negotiations, and some tariffs may even be raised. Because the rates are likely to be fixed once the accession agreement is signed, government and industry must think carefully about the levels of future tariffs.
- The government will not lose its ability to protect domestic producers. Members of the WTO are permitted to implement temporary defensive measures. Also, keeping the real exchange rate low can help protect domestic producers.
- Although it is true that exposure to international competition may be detrimental in the short run to some sectors of the Russian economy, such as the food and machine building industries, the long-term consequences of not joining and not restructuring are even more harmful.

Myth 2. WTO membership will open agricultural markets to cheap products from abroad, and domestic producers will be unable to compete successfully. The Russian agricultural sector will wither, and the country will become dependent on imported food products.

Almost every country in the world protects its agricultural sector. By world standards Russia's agricultural tariffs and subsidies are not very high. Joining the WTO is unlikely to exacerbate the current situation if, during accession negotiations, Russia reaches agreement on a high and stable tariff system for agriculture. Moreover, WTO membership does not prohibit agricultural subsidies. It requires only that countries establish a subsidy ceiling, which may not be exceeded. Recently, Russia negotiated with the WTO a $16 billion ceiling for agricultural subsidies, well above what Russia now spends or plans to spend on agriculture.

The claim that the Russian agricultural sector will wither once the economy becomes more open is unfounded. Many of the sector's problems will persist regardless of whether Russia joins the WTO. Many of the current problems cannot be called "development-inducing" by any definition—soft budget constraints, vague property rights, opportunistic behavior by managers, and difficulties obtaining credit. Institutional reforms, including land reform, founded on a new system of incentives and greater specialization can propel Russian agriculture to a prominent place in the global economy.

Myth 3. The Russian banking system, insurance industry, and pension funds are still too small to face foreign competition. WTO membership will lead to a devolution of Russian financial institutions while international bankers collect citizens' savings and move them abroad.

The main problems for the Russian financial sector relate to the poor investment climate and weak protection of creditors'

rights, not WTO membership. Similarly, a lifting of the controls on capital flight, much discussed in Russia these days, will not be enough to improve Russia's investment position without reforms in laws and regulations, accounting procedures, corporate governance, and financial regulation.

The monopolistic position of the Russian financial sector should be broken. After 10 years of isolation under infant industry protection, Russian banks are still unable to perform basic functions. WTO membership does not mean that Russian financial markets will immediately face foreign competition. Russian banks will have time to prepare themselves to operate in a more competitive environment.

Myth 4. Tariff reduction will boost imports at the expense of foreign direct investment.

Theoretically, in countries with poor investment climates and internal markets protected by tariffs, it is cheaper to build a factory inside the country than to import goods. If the markets are open, goods will be produced abroad and imported. However, the experience of countries that have joined the WTO demonstrates a different reality. WTO accession attracts foreign direct investment, both during the accession process and once a country becomes a member.

With WTO membership, export-oriented Russian producers will become more attractive for foreign investors. Guarantees to protect the rights of creditors, a part of WTO membership, will shield foreign investors from discrimination by regional authorities. Horizontal investments (those oriented toward the domestic market) will go to regions with greater concentrations of population, and vertical investments (oriented toward export) will move to border regions with concentrations of skilled labor. Again, improving the investment climate is a prerequisite for achieving long-term economic growth—whether Russia joins the WTO or not—since tariff rates are only a small part of the transaction costs motivating foreign investors.

Myth 5. WTO membership limits opportunities for corruption in the bureaucracy, diminishing the need for administrative reform.

This myth arises from a distrust of the government's ability to reform itself. True, WTO membership provides foreign producers with tools to resolve conflicts with Russian authorities, so that in cases of discrimination, Russian exports will be subject to fines and levies in global markets. However, WTO membership does not preclude the pressuring of domestic businesses by the Russian authorities, which could continue. Administrative reform is thus a must. If the government does not reform itself, Russian business may lose rather than benefit from WTO membership.

Myth 6. Regional free trade agreements are becoming more important than the WTO. Membership in the WTO will not offer Russia any special advantages, and may even weaken its position if the Customs Union with the Commonwealth of Independent States is abandoned.

If Russia joins the WTO, it will be able to acquire all the advantages of that organization. As for the Customs Union, all of its functions may be preserved through bilateral agreements or the establishment of a formal regional free trade association.

Myth 7. Because of Russia's geographic position, WTO membership will not improve the investment climate in any significant way.

David Ricardo long ago refuted the old argument of the irrationality of trade in the context of high production costs for all products by demonstrating that comparative advantage is more important than absolute advantage. True, a colder climate increases transaction costs. But cold is not a decisive factor in the current development of the Russian economy. In growth regressions, the geographic variable loses its significance when bureaucratic corruption, an index of economic openness, and the quality of laws are controlled for.

Myth 8. The problem of the Russian economy lies in the "Russian character." Although the market economy may work elsewhere, peculiar features of the Russian culture that emphasize collectivism preclude markets from functioning well in the country.

Markets function in Russia as they do anywhere else. The problem is that some parts of the Russian economy are still not functioning under market conditions. Many sectors remain unexposed to competition, so that growth of total factor productivity is slow in those sectors. However, Russian managers have demonstrated their ability to survive under adverse conditions. Russians are highly educated, with a proven ability to adjust and compete. Reducing trade restrictions would tap more of the vast potential of the stock of Russia's human capital.

Factor Mobility, Offering a Chance for Success

Resolving many vital problems in Russia does not depend on WTO membership. The challenges of structural unemployment, a negative investment climate, and implementation of structural reforms will remain whether Russia joins the WTO or not. However, the opportunities for success may turn out to

be greater, and the social costs lower, if Russia decides to become a member. To take advantage of these opportunities, the country needs to improve factor mobility across enterprises, sectors, and regions. So the question is: "What should Russia do once it joins the WTO?"

Competitiveness in the world economy depends on:

- Labor mobility, both geographic and professional.
- Corporate mobility, the ability of a firm to innovate and change its administrative structure.
- Capital mobility.
- Information mobility, a precondition for lowering transaction costs.

Geographic mobility: WTO membership will allow Russia to restructure its economy faster, encouraging people to move to more productive sectors. Deregulation alone will not do it for sectors and regions with depressed demand and high unemployment. The key measures for improving geographic mobility are lowering administrative barriers, opening centers for support and retraining of migrants, getting informational support from the mass media, and developing credit markets. Greater geographic mobility will increase regional competition for qualified labor. Regional governments will be forced to do more to keep labor and capital in the region.

Professional mobility: The Russian labor force is one of the most educated in the world. To take advantage of this factor of production, the state needs to do more to improve the professional mobility of labor. But an educated labor force is not enough. Also needed is a willingness to learn and adjust to the new realities of changing technologies and markets. For Russia this may be even more of a problem than geographic mobility, because unlike the system of secondary and higher education, centers for retraining workers are not well developed. Education should be regulated as a value added sector, through a clear tax system and quality monitoring and implementation of contemporary structures of corporate governance in nonstate institutions of higher learning.

Corporate mobility: The solution to corporate mobility is to improve the professional education of managers. The country needs people who can move firms away from the hierarchical system of governance to the contemporary, network-based system. Changes in organizational structures need to be supplemented by development of professional consulting and accounting. WTO membership and exposure to international competition will provide positive stimuli for Russian firms to restructure.

Capital mobility: One way to smooth the transition to WTO rules is to allow greater capital mobility from depressed to more successful sectors of the economy. For that to happen, transaction costs in capital markets need to be lowered. The state can deal with this if it takes action in four areas: tax policy, deregulation, capital market development, and corporate governance. Lowering the tax burden, in particular, could stimulate investment. Capital gains need to be made tax free, at least temporarily. Reform of the judicial system would curb bureaucratic corruption and strengthen protection of property rights.

Information mobility: Russia needs to take advantage of new information technologies. Greater access to the World Wide Web will improve information mobility and aid the transfer of capital and labor to more productive economic sectors. Although the Internet is a public infrastructure good (like a highway system), the private sector should share the cost of its financing.

In sum, without greater mobility, Russia risks becoming trapped in a vicious (closed) cycle of survival without modernization, with moderate growth, at best, during years of high oil prices and stagnation or even depression during years of low prices for natural resources. With greater mobility—horizontal, vertical, and information mobility of capital and labor into the most promising sectors—Russia can be successful in the global economy. Investing in the more progressive areas of the economy helps improves the quality of education and contributes to higher mobility of the factors of production.

The quality of human capital remains Russia's biggest comparative advantage. Human capital will be the driving force for investment in new sectors of the economy if Russia joins the WTO. If Russia waits too long, however, the potential of this factor could be wasted, and the chance to break the vicious cycle missed.

Thus the sooner Russia joins the WTO, the easier it will be to adjust to the new realities of the world economy. WTO membership means more than lower tariffs. It also implies deep structural changes in the economy as a whole. Such structural reforms are essential for Russia to benefit from WTO accession.

The co-directors of this project are Vladimir Preobrazhensky, Club 2015; Sergei Guriev, CEFIR and New Economic Schoo;, and Ksenia Yudaeva, CEFIR. Maria Gorban, CEFIR, is project coordinator. *For the full text versions (Russian and English) of the paper on which this article is based, see www.cefir.org or www.cefir.ru. Information about Club 2015, a group of leading Russian managers and specialists, and its activities can be found at www.club2015.ru.*

Mobility of Russian Workers Raises Productivity—New Research on Job Creation and Destruction

by J. David Brown and John S. Earle

Is Russia restructuring? While it is evident from a variety of sources that an extraordinary number of jobs have been destroyed in the Russian economy since radical reforms began, much less is known about the character of this process: Is it Schumpeterian "creative destruction," weeding out the least efficient jobs and making way for reallocations to more productive uses? Or is it simply destruction, reflecting either indiscriminate collapse throughout the economy or, worse, a concentration of job losses in firms and sectors of relatively high productivity? "Sclerosis" is a real possibility in Russia, where governments may protect weak firms, where profitable companies are subject to public and private predation, and where stripping of assets is practically a national sport.

Job Flows in the Old Industry

Following the methodology developed by Davis and Haltiwanger, we analyze gross job flows (job destruction, creation, reallocation, and excess reallocation) in Russian industry using nearly comprehensive data on large and medium-size manufacturing firms with annual observations for 1985–99. While the data, like those available for most countries, including in Eastern Europe and the former Soviet Union, do not lend themselves to a complete quantification of all job flows, they are well suited to a study of job reallocation in the old industrial sector that was built up during the socialist period. The behavior of this sector is also of particular interest in Russia and other transition economies, where socialist planning resulted in a large concentration of capital and skilled labor and where the price, technology, and competition shocks of transition have been particularly severe.

To study the impact of reforms, we examine whether job flow patterns changed over the 15-year period of our data and began to resemble more closely the behavior in market economies. The analysis treats the "big-bang" liberalization of 1992 as the dividing line between what we refer to, for simplicity, as the "pre-reform" and "post-reform" periods. We also analyze the persistence in job flows and the heterogeneity within and across groups of firms, defined according to industry, region, size, ownership, product market concentration, import penetration, exports, labor market concentration, capital intensity, electricity intensity, average wage, and labor productivity. Again, our interest is whether economic reforms have produced patterns of job flows more akin to those in market economies, a purpose for which our panel data are well suited.

Baltic Development Forum Summit on EU–Russia Relations

With the upcoming enlargement of the European Union, the Baltic Sea region is increasingly moving to the center of EU interests as well as EU-Russia relations. EU enlargement, to include Estonia, Latvia, Lithuania, and Poland, offers great promise to the region—and great challenges. The Third Annual Baltic Development Forum Summit, ***"Closing the Gap: Creating a Win-Win Situation in the Baltic Sea Region,"*** will take place on 23-25 September in St. Petersburg, historically Russia's window city to Europe and the fulcrum of its contact with the rest of the Baltic Sea region. The summit will bring together leading business executives, top politicians, high-ranking officials, and academics from the countries of the region and beyond.

Speakers will address three main themes: mapping the future of Europe and the Baltic Sea region—in search of a coherent approach; mapping the region's core competencies—is business ready to harvest the fruits?; and the Northern Dimension Action Plan—monitoring progress and overall implementation. The business-oriented theme will include the launch of a comprehensive strategy for business development in the Baltic region designed by Michael E. Porter, Harvard University, and Orjan Solvell, Stockholm School of Economics, in cooperation with SITE, the Baltic International Centre for Economic Policy Studies (BICEPS) in Riga, and the Baltic Development Forum.

Based in Copenhagen, the Baltic Development Forum (www.bdforum.org) is the region's central summit organization, an exclusive forum for discussion and networking. Its mission is to advance the growth potential of the Baltic Sea region through a new partnership between leading politicians, high–ranking public sector officials, business executives, academics, and media representatives. In organizing the summit, the Forum is joined by the Pro Baltica Forum (www.probaltica.de) and the EastWest Institute (www.iews.org and www.iews-tfcp.ru).

Behind the Job Allocation Process

Besides measuring the patterns of job flows in the old industrial sector in Russia, the most important contribution of our work is the analysis of the impact of job flows on productivity, enabling us to distinguish sources of aggregate productivity change: employment reallocation across industries, employment reallocation between firms within industries, and average within-firm productivity growth. With these data we can assess whether labor reallocation has become more productive since reforms began.

Previous research on transition economies has documented several important patterns: the rise in job and worker flows associated with reforms, the rise in the proportion of worker flows associated with job flows, the greater rise in job destruction than in job creation, the dominance of small firms (generally new private start-ups) in job creation and of large firms (generally privatized and state-owned enterprises) in job destruction, and the relatively large role played by intersectoral shifts in excess job reallocation.

We employ our Russian data to examine these and other empirical regularities. Compared to the data used in the previous studies, our data have the advantage of covering a much longer time span, reaching far back into the socialist period, and including essentially the entire sector of old firms inherited from the socialist period. Among the disadvantages of these data are the inability to reliably track exit and entry or to measure flows in the dynamic small firm sector. Because of these limitations, we focus on the nature of the job allocation process in the old sector, in particular investigating the degree to which job flows are productivity enhancing or "sclerosis" producing (unproductive firms survive because of market imperfections and government policies). None of the previous studies of transition economies examined the productivity consequences of job flows, a major gap in a literature that attempts to understand the role of labor markets in facilitating economic restructuring.

Job Flows Improve Productivity

We find that job destruction is by far the dominant flow in the post-reform period, an unsurprising result given the focus on the old industrial sector. But we also note substantial changes in the patterns of flows since 1992: an overall increase in flows relative to the pre-reform period, and a large increase in the heterogeneity of flows and of firm-level growth. We also find that the impact of job flows on productivity, while negligible before 1992, turned strongly positive thereafter; this result holds equally well for job reallocation within industries and between industries. Our regression results imply that privatization and the unleashing of domestic product market competition have strengthened the within-industry productivity effects. Thus even as the Russian industrial sector goes through a difficult period of downsizing, the overall direction of job reallocation has changed to make destruction more creative.

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Next ABCDE Europe in Stockholm

The World Bank's Annual Bank Conference on Development Economics (ABCDE) is one of the world's best known series of conferences for the presentation and discussion of new knowledge about development. Since its first event in 1988, the conference has become increasingly important as the world's economies have become more interconnected and the distinction between development economies and other disciplines has become more ambiguous. Stockholm is the fourth city in Europe to host the conference, which will take place June 24-26, 2002. The Stockholm ABCDE will be co-hosted by the World Bank and the Swedish Ministry of Foreign Affairs. In cooperation with the main organizer, Boris Pleskovic, research administrator of the World Bank, SITE will have the role of academic coordinator of the conference. For additional information as it becomes available, see www.worldbank.org.

Club 2015: Toward a Positive Future for Russia

After the August 1998 crisis a group of leading Russian managers and experts, feeling the urgency of assuming a more active role in Russia's development, created Club 2015. This independent body seeks to design and participate in forward-looking initiatives to help Russia get past the crisis and return to a path of progress.

One such effort is *Book 2015: Scenarios for Russia*, a project led by Vladimir Preobrazhensky. At a three-day seminar some 100 Russian decisionmakers in industry and government were invited to share their ideas about what they anticipate in Russia over the next 15 years. Participants identified future scenarios grouped under three broad categories:

- Disaster.
- Change is absent or occurs too slowly—Tales of Lost Time.
- A positive and dynamic future.

Readers may access *Book 2015*, which includes scenario descriptions, essays, and results of the Club's brainstorming sessions, on the Club's Web site: http://www.club2015.ru. The personal scenarios were written at the end of April 1999, and the essays in July and August 1999. In the months that followed, these scenarios were more or less confirmed by real events.

Is There a New Russia?

A report by the Center for Economic and Financial Research (CEFIR and SITE) sums up the economic policy challenges facing the Russian government and suggests reform priorities.

The Russian economy is growing. Thanks to the ruble devaluation and favorable oil prices, growth is broader, involving more industries and more regions, than ever before. More important, for the first time in a decade, Russia's political and economic circumstances are conducive to the broad institutional reforms needed to put the economy on a path of sustainable growth. Wide popular support has allowed President Putin to make significant progress in loosening the hold of the interest groups that have blocked reform, and he has put his weight behind an ambitious reform program. The concentration of powers in the presidency, however, holds major risks. Moreover, the lack of clear reform priorities threatens to derail the government program. The CEFIR report, based on the latest research and data analysis, helps define the challenges facing the Russian government and establish reform priorities.

The growth challenge facing Russia is daunting. Not only are Russian firms dramatically less productive than their counterparts in the West, but the productivity gap has been increasing rapidly over the last decade. While Western firms became more efficient, productivity fell in all major industries in Russia through most of the 1990s. Recently, with increased demand starting to reverse the decline in production and firms now utilizing more of their capacity, productivity seems to have improved. Vast additional improvements could be achieved simply by introducing better business organization, but managers have not had sufficient incentives to restructure their firms. The fragmentation of product and labor markets has weakened competitive pressures. And poorly functioning corporate governance and soft budget constraints have severed the link between performance and consequences for managers.

Russia cannot achieve sustainable growth without new investment. Investment declined for most of the 1990s, and the capital stock has aged alarmingly. New investment is important not only in itself, but also because of the productivity improvements that accompany it, particularly foreign direct investment. Regional data show strong positive spillovers from such investment, but the size of the spillovers depends critically on the quality of human capital and the extent of economic reforms. The high quality of Russia's human capital, an important component of productivity, can no longer be taken for granted. Recent figures show that while the number of university graduates is increasing, the quality of education is deteriorating as a result of a "brain drain" and the exclusion of more and more young talent from the university system for financial reasons.

Business Climate Matters

On the whole, what promotes productivity improvements also generates more investment. Investments in the education system are critical for sustaining productivity improvements and increasing spillovers from new investment in manufacturing and services. Poor protection of property rights, especially weak enforcement of existing laws, undermines the incentives of investors as well as managers. More generally, the entire political and legal context—the business climate—matters. The concentration of power at the federal level and within the executive branch has come at the expense of special interests and the Russian regions. While this concentration of power opens up an unprecedented opportunity to implement critical structural reforms, it also creates a commitment problem. Experience from around the world shows that when rules are unclear, or when the power of the ruler is unchecked, economic growth suffers.

The main objective of the reform program should be to establish the checks and balances necessary for the government to commit to stable institutional rules conducive to sustainable economic growth. Russian—and foreign—entrepreneurs and investors need stronger protection of property rights. In particular, the privatization results, as deplorable as the process was, must be accepted once and for all. And allowing businesses to own land and streamlining the regulatory environment are important for reducing the scope for bureaucratic arbitrariness and corruption. But to contribute new risk capital, outside investors also need stronger protection against expropriation by insiders, and minority investors must have better assurances against the abuse of power by majority stakeholders. In the balance between the interests of strategic owners and minority investors, the growth challenge facing the economy must come first. Russian industry desperately needs strategic investment and thorough restructuring to increase productivity.

The Russian legal framework needs further improvement, but enforcement is the critical task. Judicial reform should raise the pay of judges and introduce discipline through clearer rules and more accountability through jury trials. Administrative re-

form should also clarify the rules for allocating resources within the federal structure. Elements of healthy competition between and within levels of administration would help promote a better business climate. Sustainable growth requires sustainable institutions and predictable rules of the game.

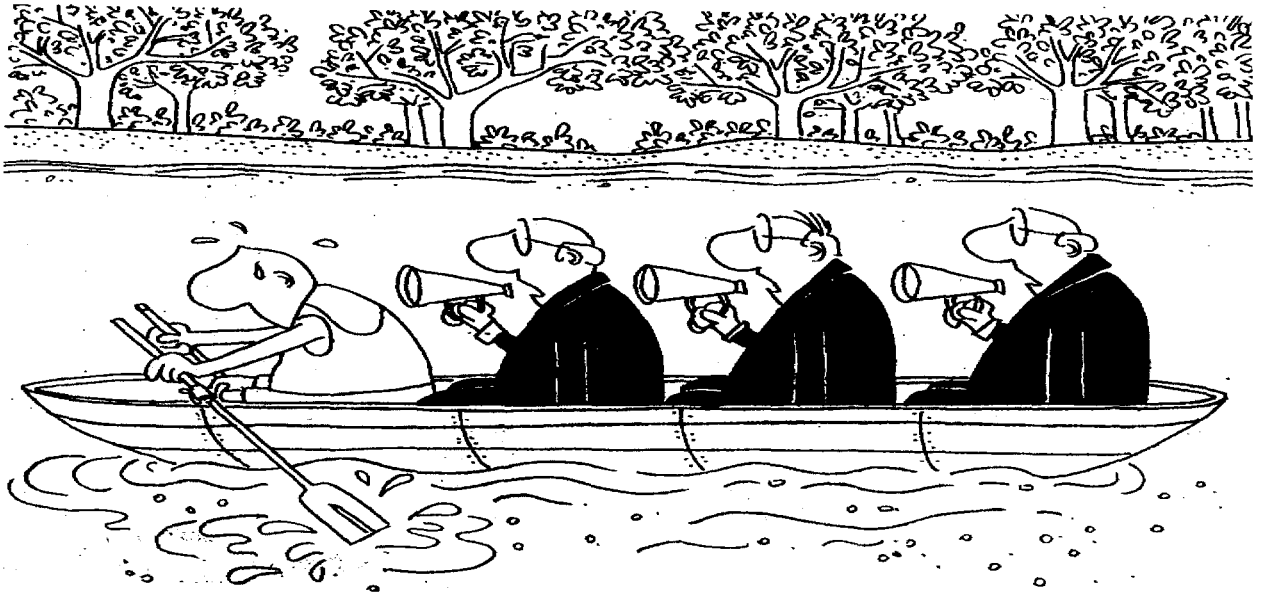
Banking System Needs Upgrade

In the long term generating investment requires a functioning financial system that transfers capital from savers to investors and monitors how the funds are used. The Russian financial system—what remains of it after the financial crisis of August 1998—is very underdeveloped by international standards. The banks play little or no role in the supply of capital for investment. Credits to the private sector have increased significantly since 1998, but little has been done to reform the banking system. Poorly capitalized banks working in a soft regulatory environment are unlikely to screen investment effectively or monitor how funds are used. Unfortunately, the Central Bank, with the backing of the current administration, still lacks the political will to implement the necessary reforms. The prospect of a new financial crisis over the next couple of years, as the revenues from oil exports level off and the ruble appreciates further, should focus attention and sharpen resolve.

The key priorities are judicial, administrative, social, and banking sector reforms. Judicial, administrative, and social reforms are now under way, but implementation remains a daunting challenge. The prospects for genuine bank restructuring are less encouraging. Implementing the reform program and bolstering the long-term credibility of the new institutional rules would be greatly furthered by deeper integration of Russia into the world economy. As painful as it may be, accession to the World Trade Organization is critical for putting Russia on a path of sustainable growth. Preparations for membership would improve enforcement of critical reforms and put additional pressure on the Central Bank to reform the banking system. A free trade area with the European Union—and the prospect of an even closer association—would provide a sense of direction and an outside anchor for Russia's reform program. Ultimately, greater international accountability will also help the Putin presidency commit not to use the tremendous powers it has amassed.

SITE and CEFIR prepared this report for the Baltic Development Forum as part of the Forum's Third Annual Summit (see announcement on page 42). It is based on new research and data analysis performed mainly at SITE and CEFIR. CEFIR is an independent economic think-tank based in Moscow and staffed by young Russian economists, many of whom received degrees from top Western universities but decided to return to Russia. CEFIR researchers have presented papers on the Russian economy at major international conferences and participated in a number of policy advice projects.

Advisors in Action



Stroke! Stroke! Stroke!

From the Hungarian Daily *Népszabadság*

Budget Crisis Looms in Poland

The administrative paralysis gripping Poland in advance of the September 23 parliamentary elections is beginning to undermine the economy. After a decade as the economic star of the transition economies, Poland is running into mounting difficulties. Economic growth has slowed from an average of 5 percent in the past three years to below 2 percent. Foreign direct investment is falling, and unemployment is rising rapidly and now stands at 16 percent. In less than two months the zloty has declined some 16 percent against the euro. Standard & Poor's Ratings Group downgraded the zloty's long-term outlook from positive to stable. In a July study by the Brussels-based Central European Opinion research group, more than 70 percent of Poles surveyed evaluated their country's present economic situation as "bad" or "very bad."

Just after Finance Minister Jaroslaw Bauc warned that without urgent austerity measures Poland's 2002 budget deficit could balloon to 11 percent of projected gross domestic product (88 billion zlotys), from an estimated 4.2 percent of GDP this year, Prime Minister Jerzy Buzek, in a surprise move, sacked him just three weeks before the election. Buzek argued that Bauc hadn't informed the government quickly enough about this perilous development. He appointed former Deputy Finance Minister Halina Wasilewska-Trenkner, an experienced budget specialist, to Bauc's post.

The 2001 budget, as drafted by the Finance Ministry, overestimated value-added and excise tax revenues, despite a two-year declining trend. "It would take probably 15 to 20 billion zlotys ($3.5 to $4.7 billion) in expenditure cuts in next year's budget to make up for errors in the 2001 budget," pointed out Witold Orlowski, director of the Independent Center for Economic Studies in Lodz. He estimates that errors in the 2001 budget account for roughly one-third of the money the government is trying to come up with through spending cuts to keep the budget deficit for 2002 under control.

As a consequence, the government passed measures capping the 2002 deficit at 40 billion zlotys, or about 5.1 percent of projected GDP, but has failed so far to agree on a plan for cutting the 30–50 billion zlotys needed to reach that target. Economists warn that unless Poland revamps the budget's pension and public sector wage increase mechanisms, it risks long-term financial instability that could undermine its chances for entering the European Union with the first wave of applicants in 2004.

The government has until September 30, a week after the election, to submit next year's budget bill to parliament. As the Democratic Left Alliance (SLD) is expected to win the general elections, the new government is unlikely to be in place by then. Thus it will likely fall to the outgoing government to introduce the necessary belt-tightening measures. Among the proposals on the table are an increase in the value-added tax on some goods, a temporary 5 percent tax on imports, and a freeze on pensions and public sector wages.

The new government has to tackle corruption and reestablish trust in the administration, notably in its privatization policy. It must also breathe new life into structural reform. Since the 1990s the pace has slowed in the face of opposition from vested interests including bureaucrats, public sector managers, and trade unions. The country urgently needs labor market liberalization and cuts in loss-making industries such as coal. Even the most successful of Poland's many entrepreneurs balk at hiring staff because of the high costs and complex employment rights.

The SLD's economic program so far remains quite vague. According to party leader Leszek Miller, who is expected to become prime minister after the election, the SLD will review public finances, support education, reduce bureaucratic costs, and implement tax measures aimed at promoting exports, investment, job creation, and small and medium-size enterprise development. Marek Belka, the party's most prominent economic policy figure and probably the next government's finance minister, warned that the SLD should not make unrealistic promises. Reduction of the 2002 budget deficit to more acceptable levels will require significant spending cuts. This will be a precondition for continued foreign direct investment inflows, needed to finance the current account deficit and modernize the economy in preparation for EU membership. Moreover, high foreign debt repayments scheduled for the coming years require unrestricted and advantageous access to international financial markets.

EU membership negotiations will also limit the economic policy freedom of the SLD. The new government will likely be strongly intent on joining the EU in 2004, counting on the beneficial impact of EU funds to become visible to the electorate before the 2005 general election. Paradoxically, relatively slow GDP growth and high unemployment may force the left-wing government to proceed with unpopular structural and labor market liberalization measures, even if those are totally absent from its current economic program.

Based on news agency and press reports.

New Scoreboard of Economist Intelligence Unit Ranks Business Climates across the World

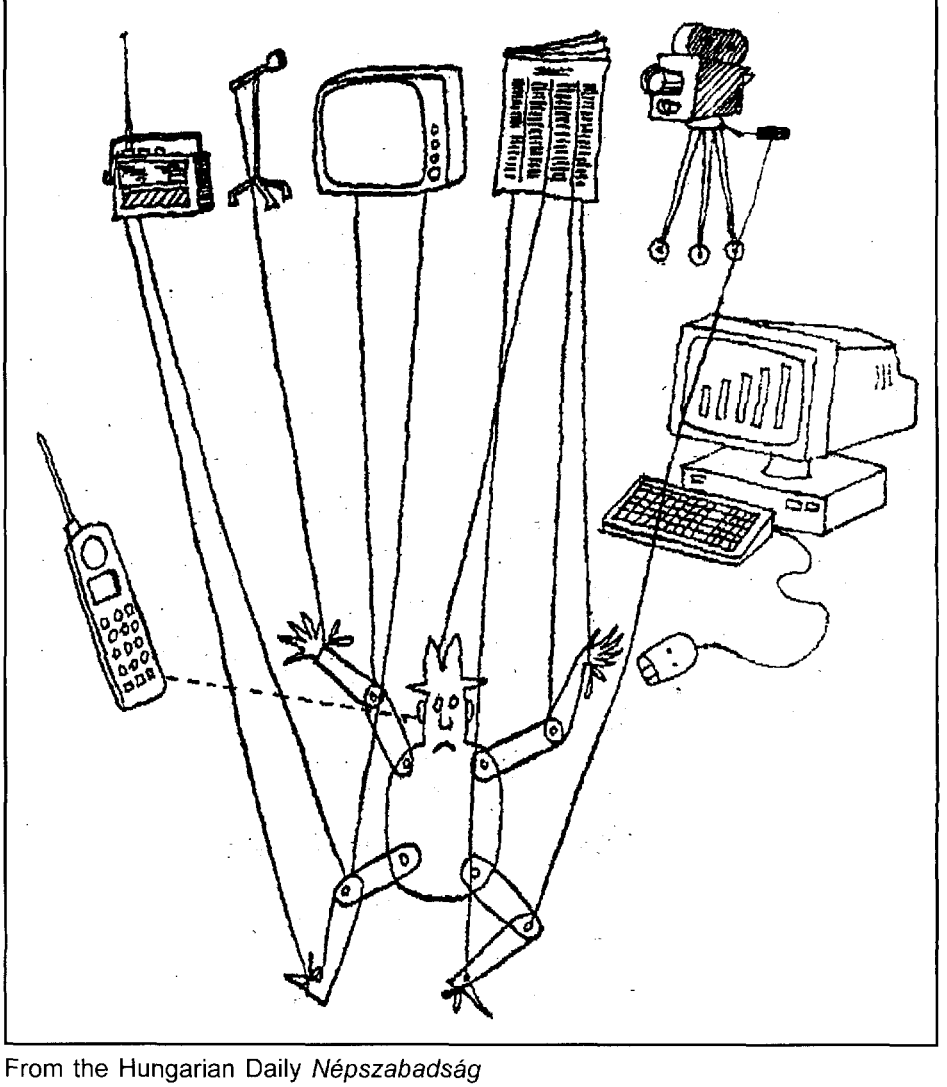
The Netherlands is expected to be the best place in the world to conduct business over the next five years, because of its political environment, its policy on foreign investment, its liberal foreign trade and exchange regime, and the availability of finance, according to the latest business ranking of the London-based Economist Intelligence Unit (EIU), published in mid-August.

All regions are expected to improve their operating environment over the next five years, although their relative attractiveness will remain unchanged, predicts the EIU. The biggest improvement will come in Central and Eastern Europe, in part reflecting the enormous scope for improvement from a weak starting position. Ratings of operating environments are expected to advance from "moderate" to "good" for Hungary (now ranked 27 out of 60 major countries surveyed), Poland (30), the Czech Republic (32), and Slovakia (35) from poor to good. At the bottom of the scoreboard, operating environments are expected to advance from "very poor" to "poor" for Azerbaijan, Vietnam, and Romania. The business environment in Ukraine—ahead only of Nigeria and Iran—is expected to remain "very poor."

The EIU's global business rankings model measures the quality or attractiveness of the business environment and its key components in 60 countries, generating scores and rankings for the past five years and the next five. Using EIU economic forecasts and assessments of likely business and political developments, the model examines 10 categories: the political environment, the macroeconomic environment, market opportunities, policies on free enterprise and competition, policy on foreign investment, foreign trade and exchange controls, taxes, financing, the labor market, and infrastructure. Within these categories the model assesses 70 indicators (ranging from 4 indicators for foreign trade and exchange regimes to 11 for the political environment) affecting opportunities for (or against) the conduct of business for the last five years and the next five.

Almost half the indicators are based on quantitative data (such as GDP growth), and most are drawn from national and international statistical sources for the historical period (1996-2000) and from EIU forecasts for the prospective period (2001-05). The other indicators are qualitative (such as quality of the financial regulatory system) and are drawn from a range of data sources and business surveys adjusted by the EIU for 1996-2000. All forecasts for the qualitative indicators covering 2001-05 are based on EIU assessments.

Independent Mind



From the Hungarian Daily *Népszabadság*

Business Environment Scores and Ranks

Economy	1996-2000 Total score	1996-2000 Rank	2001-05 Total score	2001-05 Rank	Change in total score	Change in rank	Qualitative assessment 1996-2000	Qualitative assessment 2001-05
Netherlands	8.67	2	8.84	1	0.17	1	very good	very good
United States	8.72	1	8.80	2	0.08	–1	very good	very good
United Kingdom	8.62	4	8.75	3	0.14	1	very good	very good
Canada	8.59	5	8.74	4	0.16	1	very good	very good
Switzerland	8.40	7	8.65	5	0.25	2	very good	very good
Ireland	8.30	8	8.59	6	0.29	2	very good	very good
Finland	8.27	9	8.57	7	0.30	2	very good	very good
Singapore	8.47	6	8.56	8	0.09	–2	very good	very good
Sweden	8.11	10	8.52	9	0.41	1	very good	very good
Hong Kong, China	8.64	3	8.51	10	–0.13	–7	very good	very good
Germany	7.93	13	8.51	11	0.58	2	good	very good
Denmark	8.00	12	8.50	12	0.50	0	good	very good
Belgium	7.92	14	8.30	13	0.39	1	good	very good
Australia	7.89	15	8.27	14	0.38	1	good	very good
France	7.76	16	8.26	15	0.50	1	good	very good
New Zealand	8.06	11	8.17	16	0.11	–5	very good	very good
Norway	7.58	18	8.09	17	0.51	1	good	very good
Taiwan, China	7.37	21	8.06	18	0.69	3	good	very good
Austria	7.59	17	8.04	19	0.45	–2	good	very good
Spain	7.42	19	8.00	20	0.59	–1	good	very good
Chile	7.40	20	7.88	21	0.48	–1	good	good
Italy	6.87	23	7.85	22	0.98	1	good	good
Portugal	7.00	22	7.60	23	0.60	–1	good	good
Israel	6.75	25	7.54	24	0.79	1	good	good
Korea, Rep. of	6.33	29	7.38	25	1.04	4	moderate	good
Japan	6.73	26	7.36	26	0.64	0	good	good
Hungary	6.42	28	7.26	27	0.83	1	moderate	good
Thailand	6.29	30	7.25	28	0.97	2	moderate	good
Greece	6.12	33	7.15	29	1.03	4	moderate	good
Poland	6.22	31	7.07	30	0.85	1	moderate	good
Mexico	6.09	34	7.02	31	0.93	3	moderate	good
Czech Republic	6.18	32	7.01	32	0.83	0	moderate	good
Argentina	6.54	27	6.99	33	0.44	–6	good	good
Malaysia	6.80	24	6.88	34	0.08	–10	good	good
Slovakia	5.46	37	6.57	35	1.11	2	poor	good
South Africa	5.51	36	6.49	36	0.98	0	moderate	moderate
Brazil	5.44	38	6.44	37	1.00	1	poor	moderate
Philippines	5.52	35	6.44	38	0.92	–3	moderate	moderate
India	5.19	45	6.42	39	1.23	6	poor	moderate
Peru	5.40	41	6.17	40	0.77	1	poor	moderate
China	5.33	44	6.15	41	0.82	3	poor	moderate
Saudi Arabia	5.43	40	6.13	42	0.70	–2	poor	moderate
Colombia	5.35	43	6.12	43	0.77	0	poor	moderate
Egypt	5.44	39	6.07	44	0.64	–5	poor	moderate
Sri Lanka	5.02	47	5.97	45	0.95	2	poor	moderate
Turkey	5.35	42	5.94	46	0.59	–4	poor	moderate
Bulgaria	4.03	56	5.94	47	1.91	9	very poor	moderate
Indonesia	5.15	46	5.80	48	0.64	–2	poor	moderate
Kazakhstan	4.30	52	5.59	49	1.29	3	very poor	moderate
Russia	4.12	53	5.49	50	1.36	3	very poor	poor
Ecuador	4.06	55	5.39	51	1.33	4	very poor	poor
Azerbaijan	4.35	50	5.28	52	0.92	–2	very poor	poor
Venezuela	4.73	48	5.27	53	0.54	–5	very poor	poor
Vietnam	4.48	49	5.25	54	0.78	–5	very poor	poor
Romania	4.10	54	5.24	55	1.14	–1	very poor	poor
Algeria	4.02	57	5.07	56	1.05	1	very poor	poor
Pakistan	4.33	51	4.96	57	0.63	–6	very poor	very poor
Ukraine	3.27	59	4.95	58	1.69	1	very poor	very poor
Nigeria	4.01	58	4.64	59	0.63	–1	very poor	very poor
Iran	3.24	60	4.20	60	0.96	0	very poor	very poor
Average	6.28	-	6.98	-	0.70	-	-	-
Median	6.25	-	7.04	-	0.79	-	-	-

Qualitative grades are assigned as follows: more than 8, very good; 6.5–8, good; 5.5–6.4, moderate; 5–5.4, poor; less than 5, very poor.

Source: Economist Intelligence Unit.

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(http://www.bof.fi/bofit/)

Nonresidents and the Russian Financial Crisis of 1998

by Alexei Medvedev

Traditional View of the Russian Crisis

The Russian crisis of August 1998 is usually attributed to purely domestic causes that surfaced following an almost 60 percent decline in world oil prices in 1997–98. The fall in export revenues had a strong impact on incomes throughout the economy and, ultimately, on government finances. Federal budget revenue fell sharply even in nominal terms in the spring of 1998, while the stock of short-term T-bills (GKOs) grew rapidly. Thus the earlier state policy of extensive domestic borrowing, especially in 1996, and the added bad luck of unfavorable external conditions were the clear determinants of Russia's debt crisis.

Nonresidents in the T-Bill Market

Faced with the high cost of domestic debt service (almost 5 percent of GDP in 1996), the government sped up liberalization of the T-bill market. Restrictions on nonresidents' participation were gradually softened, then eliminated at the beginning of 1998. Nonresidents' share of the market (excluding the central bank) had more than doubled by the end of 1997, to 40 percent. The Russian market benefited from the inflow in 1997, with the interest rate on short-term debt (GKO) reaching its historical floor of 13 percent in August 1997, a time when consumer price inflation was at an annual 15 percent.

The behavior of nonresident investors had its first adverse effect in late autumn of 1997, when the Asian crisis was having a global impact. The central bank intervened heavily in the T-bill market in an attempt to hold down interest rates. Contemporaneous market analysis suggests that nonresidents were among the first to start selling T-bills and thereafter were behind all significant price fluctuations. This view seemingly contradicts the traditional view that the Russian crisis was due to purely domestic and nonfinancial external factors. One might suspect that the presence of nonresidents added unnecessary volatility to prices and exacerbated the government's financial distress.

An empirical study by the author found that nonresidents were indeed behind the major contractions in the T-bill market in late 1997 and 1998 (table 1). Nonresident outflows from the market noticeably exceeded domestic outflows during all four major episodes, particularly the near collapse of the market in May 1998. Analysis revealed that this trend had a fundamental origin and did not merely reflect differences between leading foreign and Russian market participants. Moreover, the major market contractions associated with external events show that Russia suffered from contagion. This contagion was probably related to a "wake-up call" effect, whereby a crisis in one country induces investors to reassess market fundamentals in others. Empirical studies on the transmission of crises suggest that weaker economies are more vulnerable to contagion, and this seems to apply to Russia in 1998.

The uncertainty over the July 1998 emergency loan from the International Monetary Fund (IMF) resulted in large swings in foreign flows to the T-bill market. The IMF loan was intended to boost confidence among foreigners, and for a while it had the expected effect. After the loan was announced, $1.7 billion of nonresident money flowed in and The government managed to restructure part of its short-term debt but failed to control the situation in the longer term. One possible reason that the market failed to recover after the loan was that the financing was insufficient. Although the promised financing was large (more than $20 billion), its timing was conditional and did not keep pace with the depletion of official foreign exchange reserves (about $1 billion a week in August).

Did Russia Benefit from Financial Liberalization?

Even if foreign investors contributed strongly to the contractions in the T-bill market, that does not mean that Russia lost from financial liberalization. Russia benefited from foreign in-

flows during most of 1997, when the costs of borrowing fell significantly. Later, however, the T-bill market suffered from several bouts of selling by nonresidents. The empirical evidence can support two claims:

- Nonresidents played a decisive role in the 1998 debt crisis, but they actually delayed a crisis that would have happened earlier without their entry.

- Nonresidents played no decisive role in the crisis, which was fully attributable to domestic factors and unfavorable external conditions.

Both claims imply that nonresidents cannot be blamed for the 1998 debt crisis, although they had an unambiguous effect on its timing. This conclusion leaves unresolved the larger issue of what general role nonresidents played. But the study shows that the Russian experience clearly demonstrates the costs and benefits of financial liberalization.

Table 1. The Path to Russia's August 1998 Crisis: Treasury Bill Interest Rates and Capital Outflows

		GKO interest rate (percent)		*Capital outflows (US$ billions)*	
Period	*Event*	*Before*	*After*	*Non-residents*	*Residents*[a]
Nov. 97	Asian crisis	18	37	3.0	1.8
Jan. 98	Indonesian currency crisis	30	44	1.1	0.8
May 98	Indonesian currency crisis	30	80	1.9	0.2
Jul. 98	Uncertainty over IMF loan	50	120	1.1	0.2

a. Dealers only (licensed professional investors).
Source: The author.

Alexei Medvedev is senior economist at the Central Bank of Russia. This is an unabridged version of his article published in BOFIT's Russian Economy—The Month in Review, *July 9, 2001. It has also been published as BOFIT Discussion Paper 6/2001.*

Foreign Direct Investment in the Baltics

by Tuuli Juurikkala

Cumulative inflows of foreign direct investment (FDI) in the three Baltic countries reached $2 billion in 1999. While FDI flows to Latvia and Lithuania started later than those to Estonia, they have recently outpaced Estonia's. At the end of 2000, FDI stocks stood at $2.6 billion in Estonia, $2.3 billion in Lithuania, and $2.1 billion in Latvia.

High Relative Importance of Foreign Direct Investment

Measured as a share of GDP, FDI has been relatively substantial in all three Baltic countries. Estonia ranks third in FDI per capita in Eastern Europe, after Hungary and the Czech Republic. FDI flows to Estonia and Latvia were equal to almost a third of gross domestic investment in 1997–99.

FDI has also been significant for current account financing in the Baltics. In 1997–99, FDI equaled 86 percent of Estonia's current account deficit, 75 percent of Latvia's, and 51 percent of Lithuania's. In Eastern Europe, FDI's significance for financing the current account was highest in the Czech Republic and Hungary and lowest in the Russian Federation, where capital imports in the form of FDI failed even to match the rate of capital flight.

Nevertheless, some commentators have questioned the extent of FDI's presumably positive effects on Eastern European economies. They ask, for example, what effects, if any, FDI has had on economic growth. Countries courting FDI, including the Baltics, have made certain policy decisions in an effort to create attractive investment climates. Studies of spillover effects tend to validate such policies, finding positive effects on local production, including pressure to raise quality and deliver products on time. These positive spillover effects are strongly displayed in subcontractor relationships between local suppliers and foreign-owned companies.

From Privatization toward Greenfield Investment

One of the main factors behind the FDI inflows into Estonia, Latvia, and Lithuania has been the privatization of formerly state-owned companies. Privatization started soon after independence and is now essentially complete except for large transactions in infrastructure (especially the energy sector). Thus the focus of FDI is rapidly shifting to greenfield investment. Denmark, Finland, and Sweden (along with Germany and the United States) have all established a strong investor presence in the Baltics. The leading sectors receiving FDI have been manufacturing, trade, transport and communications, and financial intermediation. Subcontracting plays a particularly large role in the electronic equipment and textile industries.

Competition or Cooperation?

Interestingly, while all three Baltics use similar arguments to attract FDI, they have done little to coordinate their strategies. The standard advantages they list include the availability of low-cost skilled labor, good geographic location, and political stability. But for the international investor, the reasons for investing in Estonia, Latvia, or Lithuania are essentially indistinguishable from those for investing in any country in Central and Eastern Europe.

Recently, however, Estonia seems to have recognized the need to distinguish itself from others competing for FDI. Eight months ago, it introduced tax breaks for reinvested earnings, which have probably contributed to this year's increase in FDI.

The harmonization of laws and regulations preceding accession to the European Union makes the Baltics all the more attractive for FDI. Over the long term, most foreign investment will probably flow from neighboring EU countries. Indeed, many firms in these affluent neighbors already consider the Baltics part of their home market.

Tuuli Juurikkala is a researcher at the Helsinki School of Economics. This is an unabridged version of her article published in BOFIT's Baltic Economies—The Quarter in Review, *August 17, 2001. Forthcoming as BOFIT Discussion Paper 6/2001.*

BOFIT Discussion Papers

Jarko Fidrmuc, **The Endogeneity of Optimum Currency Area Criteria, Intraindustry Trade and EMU Enlargement**, DP 8/2001, 28 pp.

Mark De Broeck and Torsten Sløk, **Interpreting Real Exchange Rate Movements in Transition Countries**, DP 7/2001, 41 pp.

Several transition economies have experienced strong real exchange rate appreciations. This paper tests the hypothesis that these appreciations reflect underlying productivity gains in the tradable sector. Using panel data for 1993–98, it finds clear evidence of productivity-driven exchange rate movements in Central and Eastern Europe and the Baltics. Transition economies, particularly the EU accession countries that have begun to catch up, can expect to experience further productivity-driven real exchange rate appreciations. Evidence from a large cross-section of non-transition economies suggests that catching up by 1 percent in productivity is associated with a 0.4 percent real appreciation.

Alessandra Guariglia and Byung-Yeon Kim, **The Dynamics of Moonlighting: What Is Happening in the Russian Informal Economy?** DP 5/2001.

This paper uses rounds 5–8 of the Russian Longitudinal Monitoring Survey to analyze the dynamics of moonlighting by the working-age population. It finds that moonlighting is transitory and is generally associated with career shifts. Survey respondents expressing a desire to switch jobs in the past are more likely to moonlight in the present and to switch jobs in the future. The career shifts tend to be toward self-employment. These results imply that the Russian secondary labor market can provide long-term benefits for the economy as an incubator for new businesses.

Laura Solanko, **Fiscal Competition in Transition Economies, 2001,** DP 4/2001, 39 pp.

Ville Kaitila, **Accession Countries' Comparative Advantage in the Internal Market: A Trade and Factor Analysis,** DP 3/2001, 45 pp.

This paper analyzes trade between Central and Eastern European (CEE) countries and the European Union during 1993-98. The comparative advantages of CEE countries have developed in quite different directions. Some countries have evolved comparative advantage in industries requiring much skilled labor, while others have moved in the opposite direction. This differentiation is also reflected in degrees of capital intensity.

Malgorzata Markiewicz, **Quasi-fiscal Operations of Central Banks in Transition Economies**, DP 2/2001, 37 pp.

This paper reviews issues associated with quasi-fiscal operations of central banks in a sample of countries in Central and Eastern Europe and the former Soviet Union. Transparency in fiscal and monetary accounts is at risk if the central bank undertakes quasi-fiscal operations and the government falls short of providing full coverage of fiscal operations. The lack of transparency in fiscal accounts of transition countries warrants serious concern.

Enforcing Agribusiness Contracts

by Hamish R. Gow and Johan F. M. Swinnen

The May 2000 issue of Transition *included a special section on foreign investment in emerging and transition economies. While many important effects of foreign investment were discussed, there was little discussion of vertical spillover effects. In our studies of Central and Eastern Europe and the former Soviet Union, we find that foreign direct investment (FDI) has increased access to technology, inputs, and capital and spurred institutional innovations for private contract enforcement.*

Beneficial effects of foreign investment can spill over to domestic suppliers and customers in various forms, such as finance and investment assistance. In addition to reducing liquidity constraints and improving access to finance, these assistance programs are often part of innovative enforcement mechanisms that prevent breaches of or "just" delays in contracts, which are widespread in many transition economies. In the absence of effective public contract enforcement mechanisms, such private mechanisms can be successful substitutes for enforcing contracts and providing credible incentives for investments. The effect of this FDI-induced vertical contracting on output, yields, and quality can be dramatic.

Under the communist regime, production and processing were centrally planned and vertically integrated. The central authority enforced contracts, and transacting parties faced a low (or zero) probability of facing delays.

Reforms caused several institutional changes that lead to contract breaches. Privatization and restructuring split vertically integrated chains into many autonomous enterprises. Macroeconomic liberalization caused dramatic changes in prices and financial shocks that, combined with the absence of appropriate contract enforcement mechanisms, led to delays throughout the economy, often in the form of long delays in payment for delivered products. With high inflation, the effects of these payment delays were significant, exacerbating firms' already severe cash flow and profitability problems. Not just suppliers suffered; ultimately everyone ended up worse off, as suppliers, expecting more delays in the future, cut back on investments. As a result, supplies to companies declined, both in quantity and in quality. Meanwhile changes in property rights, restructuring, and macroeconomic reforms affected farms' operation and hence the volume and quality of their output.

Foreign companies have tried to overcome these contracting problems by introducing innovations in contracting with their suppliers. In agribusiness, foreign investment has taken place in the food distribution and the processing industries, with foreign firms and banks supplying farms with inputs (such as fertilizer, pesticides, and machinery) and credit. Some of the strategies these firms have used include the following:

- Guarantee timely payments for farmers' products based on prespecified pledges of quality.
- Introduce input provision programs by helping cash-starved farms obtain easier access to inputs (seeds, fertilizer, chemicals, even bank credit). Inputs are often prepaid for and direct loans extended.
- Provide payment guarantees to input producers or banks for contract-related purchases.
- Combine input and finance programs with technical support and extension programs. In Ukraine, for example, in return for providing agricultural machinery, a multinational company received the right to harvest, transport, store, and sell the grain to ensure payment. In Bulgaria a multinational input supplier, in collaboration with a specialized company, got involved in grain marketing in order to ensure payments from the farms to which they had delivered inputs.
- Form special purpose vehicles (SPVs), companies owned jointly by the processor, input providers, and the bank financing the project. The contract between the SPV and the farms includes output, inputs, and credit. An important advantage of these arrangements is that the partners in the SPV share the risk of contract breach. In Hungary a group of sheep farmers set up a producers' cooperative through which they participated in an SPV-like joint company. The association gave them more bargaining power with other partners, just as a marketing or input purchasing cooperative does in a traditional environment.

Through these schemes, food processors increase the likelihood of their honoring a contract, thereby rendering their promises to do so more credible. As a result, farms are more likely to increase contract-specific investments and avoid breaching contracts.

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World Bank\IMF\EBRD Agenda

Nicholas Stern Calls for Changes to Global Trade Architecture

The international community should make trade a more powerful tool for poverty reduction by changing the global trade architecture, argued Nicholas Stern, World Bank senior vice president and chief economist, at the opening of the new research laboratory at the London School of Economics in mid-July. He said that countries can best achieve the goals of higher incomes, better education, and greater health and security for the poor through a two-pillar development strategy:

- Strengthen the investment climate or business environment to increase productivity and create more jobs.
- Empower poor people to participate in growth through human development and social protection.

Stern called on the international community to launch a "development round" focused on improving market access for the developing countries and providing assistance that would enable these countries to eliminate internal trade barriers, such as inadequate port infrastructure or inefficient customs services.

Europe and Central Asia: Less Lending and Disbursement, but an Improved Portfolio

The downward trend continues in lending to Europe and Central Asia: in fiscal 2001, new World Bank commitments—IBRD loans and concessionary IDA credits—to the countries of the region totaled $2.7 billion for 54 projects, down from $3.04 billion in fiscal 2000 and $5.29 billion in fiscal 1999. Most lending went to Turkey ($1 billion), followed by the Russian Federation (almost $400 million) and Poland ($155 million). Among sectors across the region, banking and finance come first (with $853 million), followed by the social sectors and transportation. In fiscal 2001, IBRD loan commitments amounted to $2.2 billion for 27 projects. Some $539 million in IDA credits supported another 27 projects. The decline in IBRD lending is due largely to delays in finalizing several loans to Turkey because of the economic crisis and the launch of a new reform program. These loans were approved at the start of fiscal 2002. IDA lending, by contrast, increased in all eligible countries of the region, with a particularly strong upswing in Bosnia-Herzegovina.

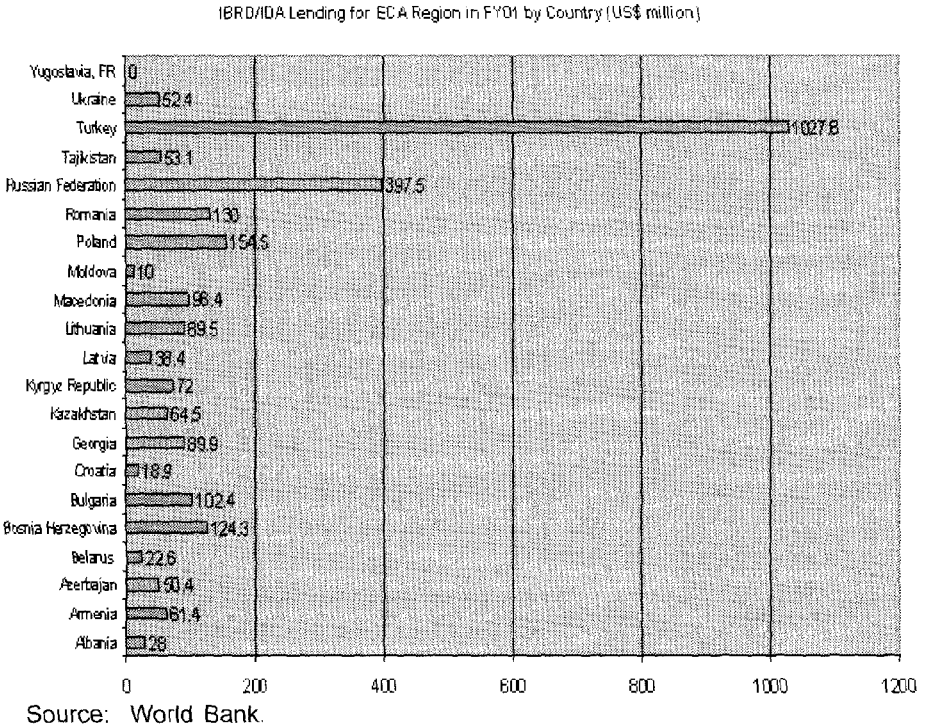
In fiscal 2001, IBRD disbursements ($1.54 billion) shrank to half their level in the previous fiscal year ($3.2 billion). IDA disbursements ($230 million) also fell by half. In addition, the Bank gave $52.4 million in grants and $11.7 million in blended (IBRD and IDA) assistance. Since 1990, the Bank has committed $18 billion to borrowers in Europe and Central Asia.

The quality of the region's portfolio broadly improved in the past fiscal year. The share of projects at risk fell from 17 percent to 12 percent, and the share of commitments at risk from 30 percent to 16 percent. And only 10 percent of the projects completed in fiscal 2001 were rated unsatisfactory with respect to reaching their development objectives, down from 17 percent the year before.

World Bank and IMF Review Poverty Reduction Strategies

The International Monetary Fund (IMF) and the World Bank invite public participation in a comprehensive review of their Poverty Reduction Strategy. Launched in 1999, the Poverty Reduction Strategy Papers (PRSPs) are documents in which governments outline their strategy for promoting growth and reducing poverty and the external financing needed. Representatives of the civil society, the World

Europe and Central Asia Region Announces Operational Results for Fiscal 2001



Source: World Bank.

Bank, and the IMF also participate in the drafting of these documents. By the end of 2001, 15–20 countries intend to complete their first strategy papers. The IMF and World Bank intend to review such issues as the governments' role in providing leadership, the involvement of other participants, coordination between aid donors and recipients, and the extent of support provided by IMF and Bank staff. (For more details go to http://www.worldbank.org/poverty/strategies/.)

World Bank Launches New Environment Strategy

Having moved from a "do no harm" approach to the environment in the 1970s to targeted, long-term environmental assistance today, the World Bank has developed a broad environment portfolio worth some $18 billion. In mid-July the World Bank's Board endorsed a new environment strategy, one that should ensure that economic growth does not come at the expense of people's health and will not worsen pollution or degrade natural resources and ecosystems. The World Bank's strategy spells out three objectives:

- Improving the quality of life—people's health, livelihood, and vulnerability—as affected by environmental conditions.
- Improving the quality of growth—by supporting policy, regulatory, and institutional frameworks for sustainable environmental management and promoting sustainable private development.
- Protecting the quality of the regional and global commons, such as forests, biodiversity, the climate, and water resources.

President Wolfensohn: Rule of Law Central to Fighting Poverty

In St. Petersburg, Russia, in early July, at the Second Global Conference on Law and Justice, World Bank President James D. Wolfensohn called on governments and the international community to recognize that "an effective legal and judicial system is not a luxury, but a key component of a well-functioning state and an essential ingredient in long-term development." Wolfensohn said that empirical evidence shows a large, significant, and causal relationship between improved rule of law and higher income, higher literacy, and lower infant mortality. The difference in per capita income and infant mortality can be about 3 to 1 between a country with relatively good legal and judicial institutions and those with inadequate institutions, he said.

Addressing more than 350 judges, parliamentarians, scholars, lawyers, and government and civil society representatives from 75 countries, the World Bank president said that the rule of law was essential in fighting corruption, empowering the poor—especially women—and ensuring a properly functioning economy. "The rule of law needs to be improved in developing and transition countries to be able to deal most effectively with three key dimensions of poverty—powerlessness, vulnerability, and lack of opportunity. The World Bank's first involvement with legal reform focused on commercial law and on institutions such as bank regulatory commissions. But over the past decade the focus has expanded to place legal reform at the center of the fight against poverty," he said.

World Bank Supports Judiciary in Transition Economies

In Armenia and Georgia, a variety of donors, including the World Bank, are assisting local judicial reform. The reforms include establishing a new court administration system, strengthening the enforcement function, upgrading the institutes responsible for judicial training, and launching a public information campaign. The World Bank is also assisting new judiciaries in Bulgaria, Croatia, and Kazakhstan. In Albania and Georgia, the Bank has supported the recertification of judges. And in Russia, a Bank loan has funded the Russian Foundation for Legal Reform, which has been instrumental in developing textbooks and educating the public about the rule of law. The foundation has also helped make the law more accessible by supporting public interest law centers around the country.

Closure of World Bank's Budapest Office

The World Bank will close its Budapest Regional Office in July 2002, World Bank Country Director Roger Grawe said in an interview with Reuters. Responsibility for overseeing the Bank's activities in the Czech Republic, Hungary, Moldova, Slovakia, and Slovenia will shift to its Warsaw office. The move is a compliment to Hungary's successful transition to a market-based economy and reflects the country's aspiration to become a World Bank donor rather than a borrower. Since Hungary joined the World Bank 20 years ago, the Bank has pledged some $4.2 billion to the country, $500 million of which is still due for repayment. World Bank financing helped overhaul the ailing state pension system in 1998, privatize the banking sector, and boost education.

"After several false starts in moving to a market-based economy, Hungary in the mid-1990s developed sound fiscal policies and began implementing privatization and structural reforms," Grawe said. Although "there was a lot of backsliding in the beginning," Hungary achieved successes in privatizing the financial sector, improving the legal system's efficiency, and increasing transparency in government. Grawe said that the Czech Republic and Slovakia lagged behind Hungary because of delays in privatization and a lack of transparency in both the public and the private sector. "In those countries, some of the fundamentals and transformation reforms that were needed were postponed. Only now are they happening," Grawe said.

IMF Urges Prague to Ease Monetary, Tighten Fiscal Policy

The Czech Republic must find the correct balance in its economic policy to

preserve its current economic recovery, the International Monetary Fund said in a report on the country released on July 25. The Fund's directors agreed that a moderate monetary policy and a stricter fiscal policy would be the right mix. Fiscal policy should no longer stimulate demand, as the widening fiscal deficit could translate into a growing current account deficit. Along with causing a loss of export markets, this trend could undermine economic growth in the medium term, the report says. The Fund urged reforms in the legal and regulatory system, restructuring of the corporate sector, and reform of the pension system.

Loan Supports Structural Reforms in Slovakia

The World Bank approved an Enterprise and Financial Sector Adjustment Loan (EFSAL) of 200 million euro ($177.3 million) for Slovakia, to reinforce the country's financial and corporate sector, attract foreign investment, and support stronger economic growth. The loan will help finance the restructuring and privatization of large and medium-size Slovak banks, improve central bank supervision, settle a large block of bad loans, and improve bankruptcy legislation.

The EFSAL funds will be released over an 18-month period. The first tranche (60 million euro) will be deposited in a special account of the Slovak Central Bank in September. The disbursement of the other two tranches (70 million euro each) will depend on Slovakia taking the agreed steps to back the reforms. The loan is repayable in 14 years, with payment of principal deferred for five years and the interest rate 0.25–0.30 percentage point above LIBOR.

Russian Government to Resume Talks with IMF

The Russian government intends to resume negotiations with the International Monetary Fund in 2002 on a medium-term program in order to get a loan to refinance payments to the Fund in 2003. The principal debt due to be repaid to the IMF in 2003 stands at $2 billion. Annual debt servicing will grow from $14.3 billion in 2001–02 to nearly $19 billion in 2003. The next critical years are 2005, when payments will reach $16 billion, and 2006, when foreign debt payments will reach $14.5 billion, according to *Nezavisimaya Gazeta.*

IFC Investment in Russian Brewery Will Facilitate "Responsible Social Drinking Policy"

IFC will lend $27 million for a $50 million expansion of the brewing company Bravo International in St. Petersburg, Russia. Additional financing will come from Russian and European banks. The project will help create new jobs, promote the development of small enterprises, and increase tax revenues. It will aid the transfer of efficient technologies and business management techniques relating to marketing and quality control, research and development, and transport and distribution systems. The project will also support the expansion of distribution systems, which will mean increased opportunities for small private entrepreneurs, and the development by the company of an employee training program on health, safety, and environmental issues. And the project will support a "responsible social drinking policy" to help educate consumers and aid the government's efforts to reduce alcohol abuse. According to recent estimates, the Russian beer market continues to grow as consumers switch from both hard liquor and lower-end beer to premium Russian beer. The major shareholders in Bravo Holdings Limited are Thor Bjorgolfsson and Magnus Thorsteinsson (Sweden) and the U.S.-based investment fund Capital International.

Small Enterprises Are Key to Economic and Social Progress, IFC Discussion Paper Notes

The creation and development of small enterprises are key to economic and social progress, notes a new IFC Discussion Paper (no. 43), "Firm Size and the Business Environment: Worldwide Survey Results," by Beatrice Weder and Mirjam Schiffer, consultants in IFC's Economics Department. The vast majority of firms have very small beginnings. Drawing on a World Bank survey of 10,000 firms in 80 countries, including the transition economies, the authors find that small firms face steeper obstacles than large ones, suffering from heavy taxes, strict tax regulations, difficulties in obtaining financing, and inflation.

World Bank Warning: Billions Face Threat of Water Shortage

A worldwide water shortage is likely to become severe over the next 25 years, an unprecedented global crisis affecting billions of people. The World Bank recently reported that while today 300 million people live in areas with serious to severe water shortage, in 25 years the number will rise to 3 billion—almost a third of the world's population. Participants in the recent Stockholm Water Symposium warned that the latest predictions of fresh water availability portray a bleak future for the next generation.

Figures issued by the International Water Management Institute show that Asia and Sub-Saharan Africa will be the most severely affected regions, with the shortage likely to extend well beyond semi-arid and arid regions. "Urban centers will experience severe water shortages, but the rural poor will suffer the most serious consequences," Frank Rijsberman, the institute's director, said. "Many already lack access to potable water and to the quantity and quality of water needed to grow food and generate income." Increasing demand for water from both industry and agriculture is the leading cause of the projected shortage. Environmentalists have warned that water use must be reduced to protect lakes, rivers, and wetlands. In China, with 7 percent of the world's fresh water and 22 percent of its population, 300 large cities already face serious water shortages.

Conference Diary

For the Record

The Third Annual Conference on Financial Market Development in Emerging and Transition Economies

This conference, with funding from the Hong Kong University of Science and Technology and the William Davidson Institute, and in cooperation with the Amsterdam Center for International Finance Research (CIFRA) at the University of Amsterdam and the *International Review of Finance,* took place in Hong Kong (China) on June 28–30, 2001. Ten papers were presented, on topics ranging from financial crisis in Asia and the Russian Federation to the role of globalization in firms' financing choices. All the papers will be available as Working Papers on the William Davidson Institute Web site. (http://www.wdi. bus.umich.edu).

Scientific-Practical Methods of Property Valuation. Further Development of Valuation Activities
September 14, 2001, Resort Issyk-Kul, Issyk-Kul Region, Kyrgyz Republic

Organizer: Union of Kyrgyz Appraisers, State Committee of Kyrgyz Republic on State Propery Management, Russian Society of Appraisers, Belarussian Society of Valuers, Chemonics International, and Corporate Technologies Center. (Languages: Kyrgyz, Russian, and English.)
Topics: Valuation and membership of the Kyrgyz Republic in the World Trade Organization, valuation of water resources and other natural wealth, valuation of the land and adaptation of current methods to the conditions in the Kyrgyz Republic, results of the pilot project on city lands valuation, and peculiarities of the valuation for investors and for mortgage crediting.

Globalization of Valuation Activity, International Congress of Appraisers
September 15, 2001, Resort Issyk-Kul, Issyk-Kul Region, Kyrgyz Republic

Organizer: Union of Kyrgyz Appraisers, State Committee of Kyrgyz Republic on State Propery Management, Russian Society of Appraisers, Belarussian Society of Valuers, Chemonics International, and Corporate Technologies Center. (Languages: Kyrgyz, Russian, and English.)
Topics: Globalization of professional valuation activity and standards, problems of valuation techniques in countries of the Commonwealth of Independent States (CIS) and ways of solving them, educational and scientific research fields to valuation activity, property approach for valuation of enterprises in the CIS, and valuation as one of the main bases of corporate management.
Information: Dr. Nikolai Trifonov, Coordination Council for Valuation in CIS. Tel.: +375 29 6776776; email: guild@user.unibel.by.

India: Ten Years of Economic Reforms
September 21–23, 2001, University of Michigan, Ann Arbor

This conference provided increased momentum and visibility to India-related research in North America by bringing together scholars whose empirical work can collectively shed light on emerging patterns in the Indian economy and political system. Along with several young economists and business scholars, this conference featured a number of senior researchers, including John Sutton of the London School of Economics, Arvind Panagariya of the University of Maryland and the Asian Development Bank, and Abhijit Banerjee of the Massachusetts Institute of Technology.
Topics: Growth of the information technology sector, relative effect of privatization, business groups, financial sector reforms, and the role of credit.
Information: Nandini Gupta, assistant professor at the William Davidson Institute. Email: nandinig@umich.edu, Web site: www.wdi.bus.umich.edu.

Community Mobilization for Self-Help Group Formation
September 21–28, 2001, Varanasi, India

Achieving the major objective of self-reliance and sustainability for an income generating and microenterprise development program requires an effective linkage with a microcredit and savings mechanism. This interplay between the two subsystems of socioeconomic development has been particularly smooth and effective in the case of self-help groups. This course aimed to develop the competence and skills needed to train others to organize self-help groups. The course enabled participants to learn capacity building skills and networking to encourage microenterprise creation.
Information: Aseed—Asia Office, Development Manager, C-8/ 8007, Vasant Kunj, New Delhi-110071, India. Tel./fax: 91-11-6130635, 6130242, 6896151; email: npsaseed@nda.vsnl.net.i.

Forthcoming

International Conference: Institutional and Organizational Dynamics in the Post-Socialist Transformation
January 25-26, 2002, Amiens, France

Organizers: Le Centre de recherche sur l'industrie, les institutions et les systèmes économiques d'Amiens (CRIISEA), University of Picardie; and Organisation et efficacité de la production (OEP), University of Marne-la-Vallée, with the support of European Association of Comparative Economic Studies (EACES), East-West Network and *East-West Journal of Economics and Business*, Centre Interuniversitaire d'Etudes Hongroises, University La Sorbonne

nouvelle. (Languages: English, some workshops in French.)
Topics: Post-socialist transformation: organizational, institutional, and systemic approaches; the state and the new social compromise; monetary and financial institutionalization; nature, boundaries of the firm, and corporate governance; networks, entrepreneurship, and industrial cooperation, institutional dynamics of the regional integration (EU, CIE, Far Eastern Asia); foreign investment: organizational and institutional impact.

The transformation of former socialist economies entailed new organizational dynamics and the emergence of new institutions. At the origin of sometimes new and more or less stable social forms, these mechanisms of collective action deeply influenced the specific and the heterogeneous trajectories of the different transitions. After the redistribution of property rights, the implementation of a new legal and regulatory framework, the sometimes problematic consolidation of financial systems, and enterprise restructuring, former and new actors (*nomenklatura*, foreign investors, small entrepreneurs, industrial groups, banks, state agencies, international organizations, employees) take part in the redefinition and the sharing of powers. They establish relations and form organizational fields that constitute laboratories for new rules and coordination modes.

Analysis of the emergence, development, and stabilization of the new organizational and institutional patterns can contribute to an understanding of the factors that influence the growth pace of these economies, their ability to create virtuous circles, their relations with the advanced Western economies (competitiveness, regional integration dynamics, and the like), their monetary and financial strength, impediments to the transformation process, and the characteristics of the late transitions.

All papers accepted for presentation will be published in CD-ROM conference proceedings. Selected papers will be published in a special issue of the *East-West Journal of Economics and Business* (refereed). Authors of accepted papers will be informed during the first week of October 2001.

Spatial Inequality and Development Conference
June 27-29, 2002, London School of Economics, London, UK

Organizers: Cornell University, London School of Economics, and World Institute for Development Economics Research (WIDER).

Amid growing concern about increasing inequality, the spatial dimensions of inequality have begun to attract considerable policy interest. In China, India, Mexico, Russia, and South Africa, as well as in most other developing and transition economies, there is a sense that the spatial and regional inequality of economic activity, incomes, and social indicators is on the rise.

Spatial inequality is a dimension of overall inequality, but it has added significance when spatial and regional divisions align with political and ethnic tensions to undermine social and political stability. Also important in the policy debate is a perceived sense that increasing internal spatial inequality is related to greater openness of economies and to globalization in general.

Despite these important popular and policy concerns, there is remarkably little systematic and coherent documentation of the facts of what has happened to spatial and regional inequality over the past 10–20 years. Correspondingly, there is insufficient understanding of the determinants of internal spatial inequality in a globalizing world.

The conference seeks to attract contributions that document and analyze within-country spatial inequality and its determinants, especially during the increased globalization of the last two decades. A broad view is taken of inequality, covering the distribution of such variables as economic activity, economic structure, population, income, social indicators, infrastructure, and public expenditure. While the main focus is on empirical analysis of recent history, contributions that conceptualize the measurement of spatial inequality or analyze its evolution in a longer historical frame will also be considered.

The papers presented at the conference will be collected in a volume edited by Professor Ravi Kanbur, Cornell University, and Professor Tony Venables, London School of Economics, and published by a leading academic press. Decisions on papers accepted for presentation will be communicated by end December 2001.
Information: Abstracts (or, better, complete drafts) should be sent by November 30, 2001, to Ravi Kanbur, Cornell University 309, Warren Hall, Ithaca, NY 14853, U.S.A.. Fax: 607 255 9984; email: sk145@cornell.edu.

Corporate Governance, Stakeholder Accountability, and Sustainable Peace
November 2-4, 2001, University of Michigan, Ann Arbor

Organizers: William Davidson Institute and the Aspen Institute's Initiative for Social Innovation through Business.
This conference will bring together a select group of academics, researchers, business executives, and NGO leaders to examine the provocative issue of whether corporate governance affects a region's sustainable peace.
Topics: Concepts of peace, corporate purpose and governance, workers' rights and social justice, corruption and stability in a technological age, and the business of peace.
Information: Professor Tim Fort, University of Michigan Business School. Email: timfort@umich.edu, Web site: www.wdi.bus.umich.edu.

New Books and Working Papers

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

World Bank Publications

To receive ordering and price information for World Bank publications, contact the World Bank, P.O. Box 960, Herndon, VA 20172, United States, tel.: 703-661-1580, fax: 703-661-1501, email: books@worldbank.org, Web site: http://www.worldbank.org/publications, or visit the World Bank InfoShop in the United States, at 701 18th Street, NW, Washington, DC (tel.: 202-458-5454).

World Bank Working Papers

Robert Cull, Jana Matesova, and Mary Shirley, **Ownership Structure and the Temptation to Loot: Evidence from Privatized Firms in the Czech Republic,** WPS 2568, March 2001, 39 pp.

Using a new data set on privatized firms in the Czech Republic, this paper examines how the design of privatization affects outcomes. Earlier studies of privatization in the Czech Republic focused largely on how the broad distribution of shares through vouchers may have motivated the new owners to strip assets from privatized firms. The paper finds evidence for static asset stripping, but also for "looting"—borrowing heavily with no intent to repay and using the loans for private purposes. This looting occurred because the larger privatized companies had privileged access to credit from state-controlled banks, which had little incentive to enforce debt contracts. The policy implications are significant: financial incentives and regulation are as important as ownership structure in the design of privatization. *To order: Zeny Kranzer, room MC3-300, tel.: 202-473-8526, fax: 202-522-1155, email: zkranzer@worldbank.org, Web site: http://econ.worldbank.org. The authors may be contacted at rcull@worldbank.org, jmatesova@worldbank.org, or mshirley@worldbank.org.*

Martín Rama, **The Gender Implications of Public Sector Downsizing: The Reform Program of Vietnam,** WPS 2573, March 2001, 37 pp.

Men and women may be affected differently by the transition from central planning to a market economy and especially by the privatization and restructuring of state-owned enterprises. During the massive downsizing in Vietnam in the early 1990s, many more women than men were laid off. But in the coming years, women will be less likely to be retrenched in large numbers. Labor redundancies are concentrated in male-dominated sectors, such as mining, transport, and construction; redundancies are smaller in female-dominated sectors, such as footwear, textiles, and garments. Moreover, temporary and short-term contracts are more prevalent in female-dominated sectors, suggesting demand for women's work.

In addition, assistance programs for redundant workers have potential gender biases. Separation packages defined as a multiple of earnings favor men more, while lump-sum packages favor women more. *To order: Hedy Sladovich, room MC2-204, tel.: 202-473-7698, fax: 202-522-1154, email: hsladovich@worldbank.org, Web site: http://econ.worldbank.org. The author may be contacted at mrama@worldbank.org.*

David Dollar and Aart Kraay, **Growth Is Good for the Poor,** WPS 2587, April 2001, 50 pp.

When average incomes rise, the average incomes of the poorest fifth of society rise proportionately. This is a consequence of the strong empirical regularity that the share of income accruing to the bottom quintile does not vary systematically with average income. This paper documents that empirical regularity in a sample of 92 countries spanning the past four decades and shows that it holds across regions, periods, income levels, and growth rates. It also finds that several determinants of growth—such as good rule of law, openness to international trade, and developed financial markets—have little systematic effect on the share of income accruing to the bottom quintile. Consequently, these factors benefit the poorest fifth of society as much as everyone else. *To order: Emily Khine, room MC3-347, tel.: 202-473-7471, fax: 202-522-3518, email: kkhine@worldbank.org, Web site: http://econ.worldbank.org. The authors may be contacted at ddollar@worldbank.org or akraay@worldbank.org.*

Patrick Belser and Martín Rama, **State Ownership and Labor Redundancy: Estimates Based on Enterprise-Level Data from Vietnam,** WPS 2599, May 2001, 42 pp.

Privatizing or restructuring state-owned enterprises may lead to massive layoffs, but the number of redundant workers is usually unknown beforehand. Analysts have used several approaches to predicting the number of workers who will lose their jobs if state-owned enterprises are privatized or restructured: drawing on international experience, accepting estimates from current directors of state enterprises, and inferring the number of redundancies from ad hoc indicators of profitability, productivity, or labor cost.

This paper estimates labor redundancy in Vietnam by comparing employment levels across enterprises with different degrees of state ownership. The results suggest that if the state share of capital

were reduced to zero, roughly half the workers in the corresponding enterprises would be redundant. This figure is more than 10 times the estimate by the current enterprise directors. The results also show a wide dispersion of redundancy across sectors of activity.
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George R. G. Clarke, **How the Quality of Institutions Affects Technological Deepening in Developing Countries,** WPS 2603, May 2001, 22 pp.
To order: Paulina Sintim-Aboagye, room MC3-422, tel.: 202-473-8526, fax: 202-522-1155, email: psintimaboagye@worldbank.org, Web site: http://econ.worldbank.org. The author may be contacted at gclarke@worldbank.org.

Masahiro Kawai, Richard Newfarmer, and Sergio Schmukler, **Crisis and Contagion in East Asia: Nine Lessons,** WPS 2610, June 2001, 54 pp.

Currency and banking crises such as those originating in Mexico (1994), Thailand (1997), and the Russian Federation (1998) tend to be associated and often take place together across countries. This paper investigates the origins of the East Asian crisis, examines its contagion effects, and discusses the following policy recommendations:

To prevent crises and contagion
• Avoid large current account deficits financed through short-term private capital inflows.
• Aggressively regulate and supervise financial systems to ensure that banks and nonbank financial institutions manage risks prudently.
• Put in place incentives for sound corporate finance to prevent high leverage ratios and overreliance on foreign borrowing.

To manage crises and contagion
• In the context of sound policies, mobilize timely external liquidity of sufficient magnitude to restore market confidence.
• At times of crisis, "bail in" private foreign creditors. When official resources are too limited given the magnitude of the crisis or contagion, and when private creditors are not amenable to coordination, some involuntary private involvement may be needed too.
• Keep in mind that there is no one-size-fits-all monetary and fiscal stance for responding to crises and contagion.

To address the systemic consequences of crises and contagion
• Move swiftly to establish domestic and international mechanisms for dealing with the assets and liabilities of nonviable banks and corporations.
• Cushion the effects of crisis on low-income groups through social policies to ameliorate the inevitable social tensions associated with adjustment.

To develop an effective regional financial architecture
• Improve mechanisms for preventing, managing, and resolving crises and contagion at the regional level in ways consistent with improvements in the global financial architecture.
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Bartlomiej Kaminski and Francis Ng, **Trade and Production Fragmentation: Central European Economies in European Union Networks of Production and Marketing,** WPS 2611, June 2001, 61 pp.

Foreign involvement facilitates the transfer of managerial and technological know-how, so firms benefit from becoming part of a network. Small producers, rather than servicing small local markets, can supply large firms abroad. Foreign participation—through outsourcing or direct investment—may offer direct access to a parent company's global networks. Becoming part of a multinational's production and distribution network is a cheap way to market products. But the unprecedented globalization of the production process has brought the integration of trade and the disintegration of production, with deep implications for the international division of labor.

Have Central European economies been able to take advantage of the global fragmentation and disintegration of production and the division of labor? Ten countries—Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia—have made large strides in readjusting their production structures to international markets, mainly in the European Union. And trade in industrial products has lost its pretransition idiosyncratic character.

But progress in industrial integration with the European Union has been uneven. The first-tier economies (the Czech Republic, Estonia, Hungary, Poland, Slovakia, and Slovenia) are highly integrated in their trade in manufactures. The lower-tier economies (Bulgaria, Latvia, Lithuania, and Romania) are much less so and, despite relatively low wages, have no comparative advantage in assembly in EU markets. Among first-tier economies, three stand out: Estonia and Hungary (in integration into "information revolution" markets) and Slovakia (in restructuring its automotive sector).
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David Dollar and Aart Kraay, **Trade, Growth, and Poverty,** WPS 2615, June 2001, 45 pp.

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World Bank Technical Papers

Julian A. Lampietti, Anthony A. Kolb, Sumila Gulyani, and Vahram Avenesyan, **Utility Pricing and the Poor: Lessons from Armenia,** Technical Paper 497, May 2001, 52 pp.

This paper evaluates Armenia's 1999 increase in electricity tariffs and its potential for improving cost recovery in the water sector, focusing on the accessibility and affordability of services for the poor. It recommends a two-stage approach to tariff reform. In the first stage, revenues should be increased by ensuring payment from households that have reliable service but are not paying their bills. In the second stage, after collection capacity is strengthened, the utility should adjust tariffs, based on improved service and meter-based billing.

Rodrigo Chaves, Susana Sanchez, Saul Schor, and Emil Tesliuc, **Financial Markets, Credit Constraints, and Investment in Rural Romania,** Technical Paper 499, April 2001, 134 pp.

This study evaluates the performance of rural financial markets in Romania based on the 1998 rural household, rural enterprise, and financial intermediary surveys along with other official statistical data for 1997. It presents empirical evidence showing that poor access to credit markets constrains investment by households and enterprises. The study recommends a detailed government strategy to correct the observed shortcomings of rural financial markets and identifies new challenges likely to emerge.

Csaba Csaki and Zvi Lerman (eds.), **The Challenge of Rural Development in the EU Accession Countries: Third World Bank/FAO EU Accession Workshop, Sofia, Bulgaria, June 17–20, 2000,** Technical Paper 504, May 2001, 228 pp.

The papers in this volume consider the reforms and policy changes required in the rural sectors of 10 countries that have started the process for accession to the European Union—Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia. The papers were selected from presentations at the Third World Bank/FAO EU Accession Workshop, held in June 2000.

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Nat J. Colletta, Teck Ghee Lim, and Anita Kelles-Viitanen (eds.), **Social Cohesion and Conflict Prevention in Asia: Managing Diversity through Development,** 2001, 500 pp.

Finance for Growth: Policy Choices in a Volatile World, A World Bank Policy Research Report, World Bank and Oxford University Press, 2001, 200 pp.

Farrukh Iqbal and Jong-Il You (eds.), **Democracy, Market Economics, and Development: An Asian Perspective,** May 2001, 200 pp.

This book, which contains papers by such contributors as Francis Fukuyama, Amartya Sen, and Joseph Stiglitz, evaluates the extent to which democracy is necessary to the achievement of sustainable development in Asia. The book argues that democracy and markets are complementary and that democracy is intrinsic to development. And it contends that liberal and participatory democracy encourages development by providing legitimacy to reform efforts. Moreover, movement toward liberal and participatory democracy allows convergence between the political and economic institutions of Asia and the West. There is broad agreement among the contributors that effective and sustainable development is multifaceted and not based only on changes in per capita income.

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In 15 chapters, this book presents 100 leading cases covering the most important areas of law in the European Union.

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Peter Naray, **Russia and the World Trade Organization,** January 2001, 208 pp.

The economic and social crisis in the Russian Federation is responsible for the delay in its accession to the World Trade Organization (WTO). This book argues that Russia's reformers neglected the country's historical legacy, such as its weak legal system and underdeveloped political and economic institutions, and that that will complicate the country's accession process. The book warns against a fundamentalist approach by the WTO, which could isolate Russia politically and economically, increasing risks to the whole world.

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Werner Baer and Joseph L. Love (eds.), **Liberalization and Its Consequences**, January 2001, 336 pp.

The essays in this volume describe, analyze, and compare the achievements and failures of societies that adopted market-based economies within a democratic polity after a long period of communist rule (the Russian Federation and Eastern Europe) or military authoritarianism (Latin America), tracing the rocky course of liberal economic policies during the 20th century.

Melanie Beresford, **Economic Transition in Vietnam: Trade and Aid in the Demise of the Centrally Planned Economy**, February 2001, 176 pp.

This book gives a detailed and thorough account of how Vietnam's dependence on Soviet aid during the 1960s and 1970s sustained but ultimately undermined the centrally planned economy. Foreign aid provided most of the resources that permitted planned industrialization. Yet, as in other socialist countries, chronic shortages emerged, encouraging individuals and enterprises to divert resources to local uses, particularly when aid supplies were cut after 1975.

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Frederick Nixson, Bat Suvd, Puntsagdash Luvsandorj, and Bernard Walters (eds.), **The Mongolian Economy: A Manual of Applied Economics for a Country in Transition,** January 2001, 288 pp.

The contributors to this volume argue that policymakers in Mongolia have exacerbated the painfulness of the country's transition by underestimating the complexity of the process and pursuing inappropriate or at best overly optimistic policy reforms.

David Parker (ed.), **Privatization and Corporate Performance**, February 2001, 688 pp.

Other Publications

László Csaba, **Ostpolitik and Enlargement of the EU: The Challenge of the Millennium**, CEU Working Papers, IRES 2000/2, Central European University, International Relations and European Studies, Hungary, December 2000, 39 pp.

In the enlargement of the European Union, the growing diversity of issues, inadequate funding, and scarce administrative capacity allow only a gradualist approach. The success of accession negotiations may be determined much more by external factors than parties to bilateral talks seem to recognize.
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Vladimir Gimpelson and Douglas Lippoldt, **The Russian Labour Market: Between Transition and Turmoil,** Rowman and Littlefield Publishers, United States, 2001.

This book examines the plight of Russian workers and employers during the first decade of post-Soviet reforms, providing the first integrated analysis of the Russian labor market. It assesses changes in old jobs at former state enterprises and evaluates job creation, mostly in private businesses. It also examines the evolution of wages and the availability of social protection to workers. A special section considers the political economy of labor market policy. The book draws on a rich array of survey data and several years of fieldwork and research.
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Lutz Hoffmann and Felicitas Mollers (eds.), **Ukraine on the Road to Europe,** Physica-Verlag, Germany, 2001, 313 pp.

To fulfill some of the key preconditions for entry into the European Union, Ukraine must complete its administra-

tive reform, transform its agricultural sector, privatize its energy sector, continue to liberalize prices, improve relations with the International Monetary Fund, attract more foreign direct investment, and encourage capital that fled the country to return. Moreover, to achieve these targets, it must stabilize legislation and increase its predictability, reduce barriers to imports, reduce corruption, cut taxes, eliminate privileges for various enterprises, and "legalize" at least part of the shadow economy. For its part, the EU should demonstrate greater commitment to Ukraine's future membership, accelerate the process for granting the country associate status, expand technical assistance to facilitate the harmonization of laws and procedures, and support Ukraine's bid to accede to the World Trade Organization.
To order: Prof. Lutz Hoffmann, DIW-German Institute for Economic Research, Königin-Luise-Strasse 5, 14195 Berlin, Germany, or Felicitas Mollers, Deutsche Bank AG, DB Research, Grosse Gallusstrasse 10–14, 60311 Frankfurt am Main, Germany.

Leonid Polishchuk, **Small Businesses in Russia: Institutional Environment,** IRIS WP 240, University of Maryland, Center for Institutional Reform and the Informal Sector, January 2001.

After a period of initial expansion, small and medium-size enterprises in the Russian Federation are stagnating or even declining as a result of the lack of institutional foundations for the sustainable development and growth of private businesses. Small businesses are caught in an institutional trap of poor governance that favors large firms. As long as this situation persists, small and medium-size enterprises will remain under pressure.
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Miron Rezun, **Europe's Nightmare: The Struggle for Kosovo**, Praeger Publishers, February 2001, 240 pp.
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Martin Raiser, Maria L. Di Tommaso, and Melvyn Weeks, **The Measurement and Determination of Institutional Change: Evidence from Transition Economies,** Department of Applied Economics WP29, Cambridge University, United Kingdom, 2001, 34 pp.

Institution building is at the heart of the transition process. Without functioning institutions, markets cannot work effectively and the transition process cannot be sustained—as the crisis in the Russian Federation shows. But institutional reform is poorly understood by researchers and policymakers. This paper analyzes the determinants of institutional change using a panel data set that includes 25 transition economies. It finds strong evidence that economic reforms and political liberalization were more powerful forces than the changes in economic structures induced by those reforms. It finds some evidence for a positive spillover effect on institutional changes from early reforms, such as liberalization and privatization, although the effect operates with a significant lag.
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Raymond J. Struyk (ed.), **Homeownership and Housing Finance Policy in the Former Soviet Bloc: Costly Populism,** The Urban Institute, Washington, D.C., 2000, 220 pp.

Subsidy programs for new housing purchases, created to address perceived housing shortages in the transition economies, are often inefficient, poorly targeted, and very expensive—and they will become even more so as these long-term commitments come due. This study looks at public subsidies for mortgage interest payments, housing construction, and down payments; income tax benefits for interest or home purchase costs; government loan guarantees and support for secondary mortgage facilities; sheltering of capital gains from housing sales; and contract savings schemes common in Austria and Germany. The study underscores the lessons learned by nations further along in the transition—lessons that should serve as guidelines for the development of more efficient banking systems and use of public resources in Southeastern Europe and the CIS countries.
To order: The Urban Institute, 2100 M Street, NW, Washington, DC 20037, United States, tel.: 202-833-7200, fax: 202-429-0687, email: paffairs@ui.urban.org, Web site: http://www.urban.org.

Suresh Babu and Alisher Tashmatov (eds.), **Food Policy Reforms in Central Asia,** International Food Policy Research Institute (IFPRI), Washington, D.C., 2000, 221 pp.

Progress in policy reforms has been frustratingly slow in the five Central Asian countries (Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan) despite their own efforts and the external advice and efforts of international and bilateral agencies to help them follow a dynamic growth path. Unless action is taken to jump-start their economies, the Central Asian countries may slide into a state of permanent transition, with enormous social and political costs. A conference was held in Tashkent, Uzbekistan, in 1991 to help develop a regional understanding and consensus on reducing poverty, improving food security, and moving toward sustainable natural resource management as well as to develop a set of priorities for food, agriculture, and natural resource policy research in Central Asia.
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