World Bank Discussion on Second-Generation Transition Issues
Growth, Restructuring, Corruption

The World Bank's recent Annual Bank Conference on Development Economics (ABCDE) organized a discussion on "second-generation" transition issues. The following are excerpts from the papers of the major discussants participating in the meeting, which was moderated by Michael Bruno, Vice President (Development Economics) and Chief Economist of the World Bank.

Michael Bruno: What Is Common, What Is Different?

As is customary, our roundtable meetings are harbingers of the next year's World Development Report. In 1996 the report will focus on the transition process and it will be produced under the direction of Alan Gelb. The transition is now five years old, and there are lessons to be learned, not only for those countries that have left central planning and are heading toward a market economy, but also for those, throughout the world, that are ready to undertake profound institutional and economic reforms.

There is a range of divergence across transition economies. They started from a largely common system, but with differing initial conditions. And they have moved at different speeds. Their macroeconomic indicators differ, as do their institutions, political developments, and culture. One of the many challenges that will face the World Development Report will be to distill some common lessons across countries.

About half of the countries in Central and Eastern Europe have gone through an initial macroeconomic shock, and some are currently among the fastest-growing economies in Europe, notably the Czech Republic, Poland, and Slovenia. Yet even these countries face problems, such as the composition and endurance of their fiscal and monetary balances, and the need to introduce further tough structural and regulatory measures. In many of these countries markets are in a rather chaotic state, particularly financial markets.

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Some early, so-called first-generation debates focused on the speed of stabilization and liberalization. Much has been said and discussed about big bang versus gradualism. There is no clear conclusion, and to a large extent, these issues are behind us. But the interdependence between liberalization, stabilization, and growth, as well as the criteria of establishing sustainable macroeconomic policies, are still open questions.

Fierce debates are waged on whether the East European stabilization programs have undermined economic growth. Cumulative research shows that inflation rates above 30 or 40 percent are very harmful to growth. So should a country like Poland—which has a 30 percent inflation rate, but is doing very well on growth—aim to achieve single-digit inflation before doing other things? This is our first topic.

Our second topic deals with sequencing. Russia first privatized and is now in the process of what looks like macro-stabilization. The impact of mass privatization on restructuring is another major issue. Who controls the firms that have been privatized? Who are the real owners? Why is it that firms, once privatized, lag behind in restructuring?

Our final topic is the rule of law, the very existence of the state. We are all familiar with the alarming reports on corruption and organized crime. Empirical evidence, however, is irregular and sporadic. Is corruption intrinsic in transition economies? Is it the transition itself that generates greater opportunities for rent-seeking and increased corruption? Or is it the legacy of the old system, or the collapse of former restraints? Is corruption caused by too rapid or too slow a transition?

These three issues are separate but they are not selected randomly. Macroeconomic policy is not sustainable without structural adjustment, and the relationship between property rights and macroeconomic adjustment is equally important. Corruption can destabilize and even delegitimize the reform process, because it can weaken the political credibility of and trust in the government.

Stanley Fischer, Deputy Managing Director of the IMF: The Point of No Return

There are at least two interpretations of the title of this session on "second-generation issues in transition." We could be asking what we can tell the second generation of reformers—probably including Cuba and North Korea—based on the experiences of the first generation. Alternatively, we could be asking what problems face transition economies that have come through the first phase of reform and are now moving into the second stage of the transition process. I'll address both interpretations.

The truly important news in thinking about the transition process is that, according to official data, several transition economies are already growing: among them are the Baltic countries, the Czech Republic, Hungary, Poland, Croatia, Slovenia, and Slovakia. If we also include the performance of the unrecorded economy, presumably these countries started growth at least a year earlier, and perhaps other countries are growing too. One important lesson of transition is that stabilization is good for growth. It can almost be said that no transition country has begun to grow without first reducing inflation to the low single digit per month range. Romania is an exception, however, and did begin to grow while inflation was high. Nonetheless, there is a strong relationship between stabilization and growth—in both directions. Countries that have stabilized have generally seen growth a year or two later.

Evidence on these issues is convincingly demonstrated in a paper by Alan Gelb, Martha de Melo, and Cevdet Denizer. It confirms the inverse relationship between growth and lagged inflation; the lower the inflation rate, the higher the growth rate a year later. [The working paper, "From Plan to Market: The Patterns of Transition," is forthcoming as a World Bank publication.]
Anticorruption Crackdown in China

Delivering his annual report to the National People’s Congress, Supreme People’s Court President Ren Jianxin in late March stressed the importance of stamping out corruption. Like Prime Minister Li Peng, he emphasized that the abuse of power poses a genuine threat to Communist Party dominance.

The focus on corruption follows the arrest in February of Zhou Beifang, who is the chairman of two listed firms in Hong Kong, the Shougang Concord International Enterprises and Shougang Concord Grand. Zhou is the son of Zhou Guanwu, who heads the Beijing-based Capital Iron and Steel Corp. (Shougang). The father-and-son team transformed the huge state-owned steel plant into a business empire with interests in such fields as shipping, construction, and electronics. In 1992 Zhou Beifang moved the company into Hong Kong, buying five small listed firms there and injecting Shougang assets into them.

Zhou is accused of committing “serious economic crimes,” allegedly for the purchase in 1992 of an iron ore mine in Peru. He reportedly paid $120 million for it, or twice what other bidders were offering. Zhou’s downfall has sent shockwaves through the Hang Seng (the Hong Kong stock exchange), where many Chinese firms with similar backgrounds are listed.

As a consequence of rapid economic liberalization, corruption is endemic in China:

- In the first 11 months of 1994, the central government received 1.36 million complaints about corruption.
- The March annual report from the Supreme People’s Court reported that over 20,000 people were jailed last year for corruption. Cases of graft exceeded 30,000, up almost 70 percent from 1993.
- In Beijing alone, 4,172 residents were convicted of embezzling public funds or taking bribes in 1994.

In the early days of the open-door policy, corruption was more discreet and less widespread. A number of factors explain the high levels of corruption since 1989:

- Deng’s call for faster growth during his visit to southern China in early 1992 was a signal that “getting rich” was to be encouraged after a three-year freeze on market reform. Government officials, poorly paid but with monopolistic control over scarce resources, face great temptation to abuse their positions for personal gain. The most common forms of bureaucratic corruption are the misappropriation of public funds, price manipulation, and kickbacks from business contracts.
- The stock exchanges of Shenzhen and Shanghai are prone to insider trading, price manipulation, and other irregularities. Acts of corruption are also thought to occur when Chinese firms acquire listed companies overseas and transfer state assets to them. With limited disclosure of information, little is known about how firms spend the large amounts of money they have raised from the stock market.
- In the context of privatization, the division between private and public assets remains murky. Many state enterprises have been turned into stockholding companies. However, with limited supervision from Beijing, there is little to stop the bureaucrats in charge from understating the value of the state assets and dividing the spoils between themselves. Beijing estimates that at least 1 billion renminbi ($118.6 million) is lost in this way each year.

Two groups in particular have been accused of abusing their positions:

- Children of officials, who use their political connections to further their business interests.
- Military and police personnel who are believed to extort money from gangsters, and to smuggle computer equipment, electronic appliances, and other luxury goods. In July 1993, 43 army units involving 300 military officials were found to be smuggling cars from South Korea to the northeastern province of Liaoning.

Periodically, the Communist Party carries out corruption crackdowns. In the last major cleanup operation, in 1993, government departments at all levels were asked to expose major corruption cases and to bar cadres from business activities, including stock transactions, as a way of preventing corruption. Twenty government departments were thoroughly investigated. By the time the crackdown ended, a number of prominent officials had been arrested.

Attempts to control corruption are not very effective for three major reasons:

- There is no independent watchdog to fight corruption. The party relies on traditional Maoist-style political campaigns to “educate” the public about corruption, using slogans, study sessions, and mass meetings to impart its message. Corruption cases are settled internally, not in open courts. The party forbids the media from exposing corrupt officials, except in a few cases. The party has also consistently rejected proposals to set up a nonparty body to fight corruption for fear of undermining its monopoly on power.
- Sentences meted out to senior bureaucrats convicted of corruption are usually light and arbitrary. Most of those found guilty are given “administrative punishments,” such as a temporary demotion. The party fears that a thorough shake-up of its bureaucracy could result in a political backlash.
- It is very difficult to catch serious offenders. This is particularly the case at the local level because of the extensive web of connections powerful political figures have built in their provinces or counties. Only when their political backers are out of favor can offenders be brought to justice.

Based on reports of Oxford Analytica, the Oxford (U.K.)-based research group.
countries such as Colombia, Chile, or Israel have faced in the past. Moderate inflation gives way to tight macroeconomic policy, supported by wage restraint and the use of an exchange rate anchor. But the last part of the journey to industrialized-country inflation rates is difficult. Policymakers have to be sure to take advantage of every favorable price shock to try to lock in inflation reductions and make continuing progress toward stabilization.

A key second-generation issue for those who have already embarked on transition is reform of the fiscal system. The decline in government revenue during transition is dramatic, and some governments have been able to maintain macroeconomic balance only by holding back budget funds (sequestering) or by building up arrears. The unintended consequence is credit creation through the central bank or arrears creation in the private sector. Rebuilding the fiscal system on both the expenditure and tax sides is a high priority. Specifically for taxes, this means moving away from enterprise taxation to indirect taxes such as the value added tax (VAT), customs, and tariffs, and later perhaps to direct taxes. On the expenditure side, it means the creation of a modern system of expenditure management and prioritization.

Another critical second-generation priority for those already in transition is reform of the financial system. The banks are not yet playing much of a role in financing investment in most of the transition economies. Unfortunately, there is a real chicken-and-egg problem here: the banks will not be sound if they lend to companies that are not sound, but the companies cannot develop without external finance. New bank-restructuring programs are needed to get that process off the ground.

Once, stabilization was unthinkable without an exchange rate anchor. But lately, several transition countries, such as Croatia and Kyrgyzstan, have stabilized their economies without pegging the exchange rate. In general, I still would look to a temporary exchange rate anchor in trying to bring down inflation quickly. The Mexican experience has led many to believe this approach is very dangerous, but this is true only if the anchor is never moved. In Poland the initial peg was held for a year, in Israel for a little longer. But it becomes necessary at some point to adjust the rate, and perhaps also the exchange rate regime.

Finally, let me mention the most amazing phenomenon of transition. A few years back everyone was afraid of reversals in the postsocialist world: "If we don't support the Russians, the communists will come back, or if not the communists, then other extremists, and they will gain the upper hand all over Eastern Europe." Five years later, despite the fact that output declines have been far greater than anyone expected, and despite all the other difficulties of transition, the notion of returning to the previous system seems to be far from anyone's mind—except perhaps in some smaller, less-developed former Soviet economies. That is the most remarkable feature of what we have seen in this first generation of reforms: the political maturity of the public has ensured that the economic reform process has continued despite the difficulties they have experienced.

Jana Matesova, Director of Research Programs at the Czech Management Center: Company Restructuring Moves Ahead—A Review.

Does privatization, and in particular mass privatization, spur restructuring? Unlike most Western governments in the past, East European governments often privatize firms ahead of restructuring, leaving it to the new owners to initiate changes in product lines, export markets, company assets, and manufacturing technologies, and to stimulate changes in attitudes and behavior.

So far, three countries have done remarkably well in terms of speed and scope of mass privatization: the Czech Republic, Eastern Germany, and Russia. In the Czech Republic, in 1989, just 1.2 percent of labor and 2 to 4 percent of registered assets belonged to the private sector, which had a mere 1 percent share in GDP. At present, 80 percent of assets are privately owned, accounting for over 56 percent of GDP in 1994. No particular groups of investors were favored or restricted in the privatization process. Privatization proceeded smoothly, thanks to its transparency, good organization, and popular support. Investors or companies were able to choose among various methods of privatization; nonetheless, voucher privatization attracted most of the attention.

Nearly 80 percent of the adult population became shareholders in enterprises and banks. Insiders (managers, workers) ended up with less than 10 percent of the shares in a typical Czech company; still, privatization did not create overly dispersed ownership structures. A large majority of vouchers were bought up by investment privatization funds (IPFs). Thus, in more than half of the
privatized companies, three or four large institutional investors own the qualified majority of 66.7 percent.

As restructuring of enterprises may take 10 years or even more, a year or two after mass privatization is much too early to assess results. But it is reasonably clear whether the process is heading in the right direction.

Aggregate data on the Czech economy, up to 1995, do not yet tell us much about bankruptcies, increasing unemployment, mergers and acquisitions, or typical forms of restructuring. But trade statistics are enlightening. While the former Comecon markets' share in Czech (and Slovak) republic exports dropped from more than 60 percent in 1989 to less than 20 percent by 1994, that of the European Union countries increased to 46 percent (even though the share of low-value-added products in total exports increased slightly in the past five years).

Although in the Czech Republic the unemployment rate is extremely low (it was only 3.6 percent in March), there has been a significant increase in labor mobility among companies, industries, and sectors. According to a survey we conducted among 50 manufacturing companies, between 1991 and 1993, two-thirds of the firms downsized labor by less than 50 percent, and 22 percent by more than 50 percent. Most firms, however, do not yet see labor as an important cost factor.

Investment funds have improved the financial and reporting discipline of enterprises. Even though most funds do not get actively involved in restructuring, they still control enterprise managers more effectively than the government would do in a state-owned company. Managers can benefit from the often conflicting interests of major institutional shareholders and from the limited skill of board directors (in many cases former state officials) who are tempted to trade lenient monitoring for higher fees and better perks.

The number of mergers, acquisitions, and takeovers and the sale of fixed assets have surged in recent months. Privatized Czech firms undergo major ownership changes through the private placements of company shares. Investment funds buy and sell huge blocks of shares, mainly to consolidate their overdiversified portfolio and get rid of their holdings in companies where rival institutional investors dominate. Also, new spin-offs had been set up from the best and most profitable assets of otherwise nonviable companies. And in some cases, parent companies have been transformed into financial holdings with their assets channeled to newly formed subsidiaries. The wide range of organizational changes prepares the field for more efficient restructuring.

Susan Rose-Ackerman, Professor at the Law School and Department of Political Science at Yale University: Bribe Prevention

Corruption thrives in rigid systems where monopoly power rests within the government and multiple bottlenecks impede the free flow of goods and services. A planned economy—where many prices are below market-clearing levels—provides incentives for payoffs as a way to allocate scarce goods and services. In such systems, transactions that would be open and legal in market economies become illegal as bribes are taken and payoffs are exacted. Excess demand for goods at official prices encourages those in command of scarce supplies—in addition to selling goods and services to those offering the highest bribes—to create additional bottlenecks as a way of extracting even more payoffs. Such systems are not only rigid, but arbitrary; consequently, in the former centrally planned economies, the requirements and irrationalities of these systems turned almost everyone into a lawbreaker.

Once authoritarian systems or centrally planned economies collapsed, one would have expected that illegal payoffs and other corruption would have declined and that legal, free market practices would have prevailed. This is not what happened. Corruption appears to be a common problem in the newly democratic states in Eastern Europe and the former Soviet Union. Why? Some would argue that rampant corruption is just one of the growing pains of transition. But if corruption becomes rampant, it could destroy the transition itself.

If pockets of state control remain, they may be the loci of payoffs and other inside dealings. Indeed, the privatization process, although it ultimately reduces corruption by lessening state involvement in the economy, may initially give rise to large payoffs as investors jockey for position. As the state is stripped of any clear lines of authority, the effectiveness of its legal system becomes questionable. And the people, trying to operate within new structures and to find a measure of certainty in their dealings, may try to achieve some control by paying off officials, declining to play by ambiguous rules. What the briber cannot know is whether other officials, ob-
serving the payoff, will create new bottlenecks that require further kickbacks. In the worst-case scenario, people opt out of the first economy, and instead rely on organized crime to provide protection from the state or anyone else who seeks to interfere. In this scenario the state is not just weakened; it becomes irrelevant.

Transition countries should try to establish the rule of law, without recreating the rigidities of the former state-controlled system. Doing so will require liberalizing their economies and reducing possibilities for rent-seeking by eliminating or reducing subsidies, trade restrictions, and preferential treatment in government purchases—in other words, transition countries must deregulate their economies as much as possible. Bribes will become irrelevant once legal pricing mechanisms take their place.

A danger is that less overt bribes may be paid for benefits to be delivered in the future. Corruption could take the subtle form of cozy personal relationships and exchanges of favors between officials and private individuals—a web of relationships and transactions that effectively blurs the line between public and private, further destabilizing the system. A clear remedy for this is a well-established legal system that reduces corruption by curtailing the discretion of officials. The rule of law can be supported by outside checks on the actions of public officials, including an independent prosecutorial and judicial system, a free press, and a dense network of nongovernmental organizations.

**Czech Firms: A Mixed Picture of Restructuring**

Hundreds of investment privatization funds (IPFs) that underwrote the successful coupon privatization program are emerging as the key institutions that will shape the Czech Republic's corporate culture. They control about 29 percent of all outstanding Czech shares, as against the National Property Fund's 40 percent and the industrial and portfolio investors' own 25 percent—but the IPFs are the most influential of the shareholders. These IPFs include Harvard (which does not have a financial backer); Pryan Investicni (PIAS), run by Investicni a Postovni Bank; Expandia, ZB Trust, run by Zivnostenska Bank; KIS, run by Komercni Bank; Creditanstalt Investment Co.; and funds run by the Czech Insurance Co. They are helping to wrest power away from company executives in favor of company owners.

It is a slow process. Even the best-run IPFs have limited resources of finance and personnel to police all the companies in which they have stakes (some have stakes in as many as 200 companies). High management fees also have persuaded some fund managers simply to sit tight and collect easy money. Two main hurdles block further progress, fund managers say.

- The law governing IPFs limits to 20 percent the stake a fund can own in a company. This prevents the greater concentration of ownership that would aid restructuring and help refine corporate governance.
- There is a potential conflict of interest between the banks that manage investment funds and those banks' own corporate lending arms. Some fund managers say bank-controlled funds are too often represented on company boards by members of the banking arm rather than the fund management arm.

The relationship between banks and industry is close and is one that neither side appears willing to end. Hence, decisions that may be in a company's and its shareholders' interest but not in the banks' can be voted down. In practice, this often means companies are forced to borrow for investment, or to undertake bond issues often handled by their house bank. The bank's own IPFs sometimes take up the lion's share of these issues, thus increasing bank influence on companies.

Many IPFs are afraid to weaken their holdings in companies, leading to paralysis in the stock market and to a reluctance to consider new equity issues. Moves are under way to force IPFs to become either portfolio managers or strategic, long-term investors.

In the meantime, gradual real appreciation of the koruna and rapid real wage growth have undermined the competitiveness of Czech firms. Between January and April of 1995, the trade deficit shot up to 29.6 billion koruna, compared with a 14.6 billion koruna surplus in the corresponding period of 1994. Whereas imports rose by 38.2 percent over the same period of 1994, export growth was only 1.2 percent. Trade and Industry Minister Vladimir Dlouhy has predicted that the trade deficit could grow to as much as 60-80 billion koruna this year.

According to Dlouhy, however, a trade deficit of this magnitude need not be a major macroeconomic problem for the country, provided that the deficit in trade continues to be offset by a surplus on the capital account and high revenues from tourism.

The widening trade deficit suggests that the competitiveness of Czech producers is being eroded, which is reflected in the almost unchanged level of exports. This loss of competitiveness has occurred despite an inflation-adjusted rise in labor productivity of 10.4 percent between January 1994 and January 1995. Wages, however, grew by 8.3 percent in real terms in the first quarter of 1995 as compared with the same period last year. To a considerable extent, this offsets efforts to streamline production and raise productivity. Competitiveness has also been undermined by a hidden revaluation of the koruna, caused by the gap between Czech inflation (currently running at around 10 percent) and lower inflation in its principal trading partners against a backdrop of nominal exchange rate stability. The real effective exchange rate of the koruna has appreciated by roughly one-third since 1990.

Apart from concerns raised by the trade deficit, overall prospects for the Czech economy are good. GDP growth in 1995 should exceed 4 percent. Unemployment remains very low—at the end of April, it was 2.9 percent, down from 3.1 percent in March—but this is widely reckoned to be an indication that restructuring still has a long way to go in many enterprises. This trend will probably be reversed over the next two years, when the unemployment rate is expected to rise to 5-6 percent.

*(Based on recent press reports and analysis of the Oxford Analytica international)*
A tidal wave of crime and corruption is sweeping Eurasia, threatening to bury the nascent and fragile democratic institutions in Russia and other countries in the region. Russia alone is under attack from over 5,000 gangs, 3,000 hardened criminals, 300 mob bosses, and 150 legal organizations with international connections. Some 40,000 Russian business and industrial enterprises are controlled by organized crime. Their combined output is higher than the gross national product of many members of the United Nations. The Russian mafia (a generic term for all organized crime in the former Soviet Union) is estimated to be worth $10 billion. More Russians died of criminal violence in 1993 than were killed during nine years of war in Afghanistan.

Growing crime and corruption threaten not only Russia, but the entire world. Russian contract killers have murdered in London, Los Angeles, and New York. Former KGB "specialists" in assassination are available to the highest bidder. Corrupt officials and criminal organizations are involved in a variety of black market activities that generate multi-million-dollar profits. The illegal export of oil, ferrous and nonferrous metals, timber, and diamonds is the most lucrative, followed closely by illegal drug production and distribution. The illicit sale of arms and nuclear materials and technologies represents the greatest threat to Russia's neighbors and to the West. Privatized property is bought up by foreign and domestic criminal organizations to launder and hide illegal profits.

The Russian Interior Ministry estimates that oil smuggling grew by 50 percent from 1992 to 1993. The ministry believes that around 20,000 metric tons of metals, over 100,000 metric tons of oil products, and more than 200,000 cubic yards of timber were smuggled abroad from Russia in 1993, with up to a trainload a day passing through Lithuania and into the Port of Kaliningrad.

Russian officials charge up to $80,000 to register a bank and up to 15 percent of an oil deal's value to issue a license to export. Managers of government-owned industrial enterprises often bill international customers only 10 percent of the price of exported commodities, with the difference between the contract price and the world market price deposited into their offshore bank accounts. Until early 1994, the Central Bank of Russia issued credits to commercial banks and state-owned enterprises at rates much lower than inflation. The banks and enterprises then lent the money at higher market rates. Central Bank officials reportedly received 13 percent of the loan as bribes.

Soviet military officers allegedly sold off the military's strategic supply of fuel to black marketers in Western Europe from 1990 to 1994. There were several million tons of oil in the strategic reserves, enough to fuel planned Russian occupation forces in Western Europe until the year 2006. Russian generals used military aircraft to fly Volvos and other European cars home for sale. The top brass illegally traded in MIG fighters, armored vehicles, and stolen German cars. They even illegally manufactured and sold synthetic drugs using Russian military labs.

The Russian Connection

The Russian mafia landed in the United States in the 1970s. Since then it has become involved in gasoline tax and medical insurance fraud in New York and California. It has cooperated with the Sicilian mob in transporting heroin and with Colombian cartels in shipping cocaine. One metric ton of cocaine was seized in St. Petersburg's Pulkovo airport en route to Antwerp in 1994. While not yet as powerful as the Colombians, the Chinese Triads, or La Cosa Nostra, the Russians are an up-and-coming force in the increasingly globalized world of crime. Russian mafia operations in the United States are thought to be headed by Vyacheslav ("Yaponchik," "Little Japanese") Ivankov, known as "the father of Soviet extortion."

[Ivankov, the reputed top Russian mob boss, now 55, was arrested in the United States by FBI agents on June 8 for allegedly masterminding a $3.5 million extortion scheme. He spent a decade in a Siberian prison for crimes ranging from robbery to drug trafficking, and slipped into the United States on a doctored passport three years ago. The mobster came to Brooklyn's "Little Odessa" to oversee Russian organized crime activities in America, and became the target of an unprecedented joint effort by the FBI and Russian authorities. Eight others are charged with him in the extortion plot. FBI Assistant Director Jim Kallstrom called Ivankov's capture the most important arrest ever made in the war against Russian organized crime in the United States.]
The Russian mafiya is fast developing an international network. Mobsters launder their ill-gotten gains by investing in gambling, luxury car dealerships in European cities like Budapest, and banks, marinas, and resorts in the Caribbean Basin. They also work with top-flight international attorneys in Frankfurt and Zurich to learn money-laundering techniques perfected by Colombian drug lords and Sicilian mobsters. The main technique is to move money electronically among dozens of companies so that eventually it finds its way into respectable investment portfolios in the West.

Russian and other Eurasian criminals also are becoming more involved in the international drug trade. The opium poppy and cannabis (marijuana and hashish) have grown naturally in Eurasia for millennia, from the Ukrainian steppes to the plateaus of Kyrgyzstan. With the collapse of strict police controls, drug cultivation in Eurasia has reached an all-time high. Three million acres of opium poppies are controlled by organized crime in Central Asia, primarily in Kyrgyzstan, Tajikistan, and Uzbekistan. There is no fuel or spare parts for the aircraft that were once used to police these areas. Besides, in many instances the police are "on the take" from drug dealers, and the porous borders in Eurasia allow illegal drugs to pass from Central Asia into Western Europe.

Central and Eastern Europe, Russia, and Eurasia are becoming major transit points for drugs manufactured in Afghanistan, Iran, and Pakistan. Uzbek and Tajik tribes inhabit Afghanistan and have close connections in Central Asian governments; the Central Asians in turn are plugged into the Moscow power structure. Azeris, Armenians, Russians, Georgians, and Central Asian Turks play an important role in maintaining the bridge between the drug manufacturers in Asia and markets in Western Europe. Russia is also becoming a transit point for heroin coming from the Golden Triangle of the Far East (the Burma-Thailand-China border region). The Russian mafiya has established a foothold in Bangkok, Hong Kong, and Singapore, where it cooperates with the Chinese Triads. Moreover, Russian gangs in New York, working with the Mafia's Gambino family, are shipping heroin into the United States.

The Roots of Crime

The problem of crime in Russia and the NIS has many roots. The criminal code of Russia and other former socialist states cannot always deal with the freedom unleashed by the collapse of communism. During Soviet times, such innocent practices as buying and selling for profit or dealing in securities or foreign currency were criminalized. Meanwhile, such simple judicial tools as laws against a conspiracy to commit crime were lacking. Soviet law was ideological and arbitrary, allowing Communist Party apparatchiks to decide the legality of economic transactions.

Legally, there was no private property, so the legal system did not contain provisions for conflict of interest. This legacy has been carried over into the new Russian Federation. Even today, there is no adequate definition of corruption in the Russian criminal code. Nor are there adequate civil service ethics regulations. It is no wonder that Russia and other Newly Independent States have some of the most corrupt bureaucracies in the world. Their legal systems are incapable of preventing corruption.

Soviet-trained judges have a poor understanding of private property. They have not been trained in the Western legal practices of settling property and transactional disputes between private individuals. Before 1992, there was only one state-run arbitration system in the U.S.S.R. There were no forums for corporate dispute resolution. Since everything belonged to the state, nobody really cared whether contracts were honored. Parties to conflicts and their counsel had no personal or business interest in the outcome of the proceedings.

The Dangers of Corruption

The implications of such widespread corruption are potentially devastating:

- **Corruption discredits free markets.** Lacking a legal system capable of buttressing the market economy, Russia and other NIS societies have lost hundreds of millions of dollars to fraud. Legal authorities do not protect investors or consumers from theft, extortion, or fraud. For example, in 1993 a company called Independent Oil Concern stole millions of dollars from investors and transferred the money abroad. The Russian prosecutor's office did not even investigate the matter.

Another example was the 1993-94 MMM (named for the initials of the partners) stock market disaster caused by Moscow entrepreneur Sergei Mavrodi. This was a massively advertised pyramid scheme in which the value of the shares was driven sky-high by the influx of millions of new buyers. In the end, the bubble burst and multi-billion-ruble losses ensued.

The negative impact of all this criminal activity on the image of business and markets is tremendous. The crime and corruption of today are reviving prejudices left over from the days of Soviet communism, giving the old charge that business is "dirty" a new meaning. Widespread crime and corruption are deterring honest, industrious people from joining the ranks of entrepreneurs and are engendering a hostile political climate toward free market reforms.
Transition

Corruption weakens the rule of law. Democracy and free markets cannot survive without the rule of law. However, precious little has been achieved in establishing a firm legal basis for a civil society based on democratic principles. There is hardly any state-run or private enforcement service—with the exception of organized crime. In 1994 dozens of senior police officers were fired for cooperating with the mafia, while others were killed by criminals for refusing to cooperate.

Corruption impedes Western investment. Western businessmen increasingly are harassed by Russian mobsters. American managers in Moscow told the author that they have received anonymous phone calls more than once a day inquiring about their sales volume. Such routine intelligence gathering helps criminals to determine which foreign firms can be targeted for extortion. To cope with the danger, foreign businesses must bear the steep costs of additional security for themselves, their families, and their property. Faced with these costs, which can absorb as much as 30 percent of foreign profits, many firms refuse to invest in Russia and the NIS.

Corruption spreads the dangers of nuclear proliferation and terrorism. The deterioration of central controls since the collapse of the Soviet Union in 1991 has led to the hair-raising possibility of unauthorized sales of nuclear components and material to terrorists and other criminals. By 1993 Germany had arrested more than 100 people involved in smuggling nuclear components from the former Soviet Union. Ukraine, with its diverse nuclear establishment, was a major source of nuclear-related dual-use materials, including heavy water, zirconium, and hafnium, from its Dneprodzerzhinsk production complex. These materials are all on the Nuclear Suppliers Group restricted list (the NSG is an international regime aimed at stopping the proliferation of dual-use nuclear weapon components).

Nuclear facilities are located in such potentially unsafe and unstable areas as Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan. Tajikistan is in the midst of a civil war, while nuclear security in the other republics can be very lax. There are unguarded nuclear components in research facilities such as Dneprodzerzhinsk in Ukraine and nuclear laboratories in Georgia and Armenia. Ex-Soviet nuclear scientists are working on secret and illegal nuclear weapons programs in Algeria, China, India, Iran, Iraq, Libya, and North Korea, in violation of the Nuclear Non-Proliferation Treaty.

Radioactive components for nuclear weapons can be bought in Russia and other parts of the NIS. Since 1990 there has been clear evidence that uranium and plutonium are being smuggled out of the former Soviet Union. Several smugglers died or became severely ill from mishandling the materials, which have been left in railway stations and airports in Austria, Germany, and Lithuania. More than 100 people have been arrested by German, Czech, and other Central European security services since 1991. Russian KGB and military officers have been caught supplying nuclear machinery and weapons systems to Italian mafiosi, who were reselling them to Libyans. Transshipment of nuclear materials were made to Austria, Italy, Sweden, and Switzerland, but the direct route is even easier.

Responding to a Global Threat

Coordinated action is required by the entire international community. If the wave of crime and corruption in Eurasia is to be halted, Russia, other NIS countries, and the Central and East European states should:

- Amend criminal codes to better define organized crime. In particular, a conflict-of-interest doctrine must be incorporated into post-Soviet legal systems.
- Establish a witness relocation program. Protecting witnesses in organized crime trials is crucial to successful prosecution.
- Recruit and train a new judiciary. With weak courts and incompetent judges, the legal systems of these countries cannot function.
- Upgrade the civil courts to handle private sector disputes. Right now many private disagreements are settled at gunpoint by the mafia.
- Improve security, inventory management, and accountability at nuclear production and storage facilities.
- Ease bureaucratic regulation of the economy. Bureaucrats who work together with mobsters are the major source of corruption in the post-Soviet states.
- Reduce the tax burden. High tax rates and corrupt internal revenue services are endemic in Central Europe and the NIS. Low taxes applied uniformly would not only increase the tax base and bolster government revenues; it would reduce the rampant tax evasion that fuels crime and corruption.

Western Cooperation

Since crime and corruption in Eurasia are spilling over into other countries, some degree of cooperation with the West will be required to solve the problem. Thus, Western countries should:

- Share computerized databases on criminal activity.
- Identify trustworthy and reliable law enforcement personnel in the East. Western law enforcement services need all the support they can get from local police establishments.
- Use legal expertise to help Central and East European and Eurasian countries draft laws and train legal personnel.
Expand the International Criminal Investigative Training Assistance Program and other FBI-sponsored programs to all countries of the former Soviet Union and Central and Eastern Europe.

There are at least two actions the United States and its allies can take on their own to curb crime and corruption in Eurasia:

- Track and penetrate Russian and NIS criminal rings dealing in nuclear materials and narcotics.
- Monitor East-West financial transactions better. A significant percentage of the money coming out of Russia represents the proceeds of such criminal activity as extortion and drug trafficking. To battle Russian and Eurasian crime successfully, NIS deposits in Western banks should be screened and tracked more carefully.

Anatomy of the Russian Inflation by Paula De Masi and Vincent Koen

After the many decades of Soviet rule, high open inflation appeared in Russia in 1991, following the introduction in April 1991 of partial price reforms and the de facto loosening of price controls. A comprehensive price liberalization followed in January 1992, and monthly inflation rates remained in the double digits for most of the next three years. By the end of 1994 consumer prices had increased nearly 2,000 times compared to December 1990. Such a huge price increase raises a number of interrelated questions:

- To what extent have relative prices shifted during the transition?
- Are prices moving more in lockstep as the Russian public learns to live with high inflation?
- Have geographical price differences become wider or narrower?
- Have prices overall moved closer to levels in the industrialized countries?
- What are the policy implications of further convergence of Russian and Western price levels?

These questions have thus far received little attention, notwithstanding their important policy consequences.

Process of Realignment

As Russia's old, distorted system of controlled prices was liberalized, individual prices started to adjust at different speeds, which brought major shifts in relative prices. By late 1992 most relative price changes had taken place, especially for nonfood items. Individual food prices, however, kept changing relative to each other, even during 1993, as food subsidies were adjusted.

Another way to look at relative price changes is to contrast the price behavior of goods versus services. In April 1991 and January 1992 service prices rose much less than goods prices (see figure 1), but then service prices started to shoot up, and by late 1994 reached a level that exceeded five times the December 1990 level. In part, this reflects the commercialization of a number of services such as child and health care, previously provided for a nominal fee. Also, prices had to be increased from a very low base to catch up with costs. In the case of housing, for example, rents rose by almost 500 times between late 1992 and late 1994 (compared with a 30-fold increase in the overall consumer price index). A similar "U-curve" pattern has been observed in many other countries of the former Soviet Union.

Figure 1

Evolution of Relative Prices

Exchange Rate Watch

Relative price movements can also be measured by comparing inflation rates for a large number of individual goods. (Figure 2 shows how the variability of relative prices—measured as a weighted variance of item specific inflation rates—evolved, and relates this to overall inflation.) Relative price variability remained very high throughout 1992-93 in comparison with market economies (in 1993, on average, it exceeded more than 20 times the variability in the United States and France). But, by 1993 it had substantially declined compared with 1992, indicating that most changes in relative prices had occurred by that time, and price setting became increasingly synchronized for individual goods, as producers and consumers learned to live with chronic high inflation.

Relative price variability and inflation clearly moved in tandem in 1992-93. In the longer run, however, the relationship between the two may weaken, as price setters increasingly coordinate price adjustments based on some visible and unambiguous signal such as the ruble exchange rate. An excerpt from a recent article in the Moscow-based Kommersant Daily (February 3, 1995) indicates how closely the exchange rate is now followed: "Only about half an hour will pass after the beginning of tenders and thousands of pagers will beep and thousands of telephones will ring announcing the news about the new exchange rate of the dollar. A little more time will pass and the money-changing offices will post new figures on their doors and the announcers on practically all the television and radio stations will interrupt in order to expressively read a couple of four-digit figures...."

Regional Differences Narrow

Prices and nominal incomes have traditionally varied widely in Russia's different regions. (The country is vast, and its climate is harsh, making for considerable distribution costs.) But as uncertainty about new relative prices waned, and local subsidies and other local price controls measures lost their earlier importance, the geographical price differences for both food and nonfood goods narrowed—a sign of market integration. (The disparity was initially larger for food than for nonfood goods, probably because of extensive food subsidization and internal trade barriers in agriculture.) Nonetheless, the degree of regional price dispersion is still high, compared for example, with Canada, which, among the industrialized countries comes closest to matching Russia's climate and distances (see table below).

<table>
<thead>
<tr>
<th>Period</th>
<th>Foodstuffs</th>
<th>Nonfood goods</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 1992</td>
<td>37</td>
<td>28</td>
</tr>
<tr>
<td>July 1993</td>
<td>25</td>
<td>25</td>
</tr>
<tr>
<td>June 1994</td>
<td>17</td>
<td>17</td>
</tr>
<tr>
<td>To compare: Canada 1991</td>
<td>13</td>
<td>...</td>
</tr>
</tbody>
</table>

Russian Prices Catching Up

In general, prices are typically lower in poor countries, particularly for nontradable services (such as haircuts). Given the very low dollar wage levels prevailing in Russia, prices in Russia are supposed to be well below those in comparable market economies. To what extent have domestic prices converged to international levels after price liberalization? In a comparison of Russia and France (figure 3), it appears that overall consumer prices in Russia rose from about 6-7 percent of the French level in July 1992 (immediately following exchange rate unification) to 20-22 percent in July 1994, with prices of services lagging behind goods. It is likely results would be similar in comparisons with other market economies. Thus, the gap between domestic prices in Russia and foreign prices has remained wide, though it narrowed rapidly between 1992 and 1994.

As part of Russia's structural transformation, the relative price of services can be expected to rise significantly in the years ahead, since cost-recovery ratios are still low for many of them. An
The remaining large gap between Russian and international price levels is that, even if tight financial policies and foreign competition were to contain price increases in the tradable goods sector, inflation could stay persistently higher in Russia than in Western Europe.

This article is based on the authors' paper, "Relative Price Convergence in Russia," IMF Working Paper, May 1995. The views expressed here are the authors' and do not necessarily represent those of the Fund.

Hungarian Finance Minister Lajos Bokros Explains His Package
"Garnering Public Support Is Indispensable"

Hungarian Finance Minister Lajos Bokros could not be described as the most popular politician in the present-day Hungary. His austerity program, announced on "Black Sunday," March 12, attacked head-on the thankless job of dismantling the socialist welfare state, radically downsizing the public sector, cutting expenditures, and increasing revenues. The aim is to stop the dangerous slide into deeper foreign debt and an ever-widening budget gap, after long years of delays. But the public considers the welfare system as part of their national heritage. Transition editor Richard Hirschler asked the minister, who accompanied Prime Minister Gyula Horn to the United States, about the visit and the economic challenges facing the Hungarian leadership.

Q. In Washington, the Hungarian delegation was received by both World Bank President James Wolfensohn and IMF Managing Director Michael Camdessus. How would you assess the outcome of these meetings?

A. World Bank President Wolfensohn seemed extremely interested in learning the details of Hungary's economic program, especially our initiatives to accelerate privatization, to extend it to public utilities and the oil, gas, and electric power industries, and to complete the process by 1997. He voiced support for our stabilization package and hinted that World Bank resources could be useful to help consolidate and privatize Hungary's financial sector, as well as to streamline the overextended public sector. The World Bank loans are closely linked to the outcome of our negotiations with the IMF over a possible standby credit. At present, no accord has been reached, but that may come in October, once we agree on some key figures in the 1996 budget. The Fund wants to contain the budget deficit at 3 percent of GDP; but we foresee a deficit of 3.5 to 4.0 percent. The numbers are not that far apart; much depends on how the calculations are made. We expect a $2.5-3.0 billion current account deficit, and the IMF would like us to match it with a corresponding amount of direct capital inflow, to prevent a further deepening of the foreign debt. That is fine; but again there are grey areas: how, for example, should we consider the asset transfers of multinationals to their Hungarian subsidiaries? We see these transfers as part of capital inflow, but the
IMF thinks otherwise. So both parties are now working on compromises.

Q. How would you summarize the economic dilemmas facing Hungary, and the basic thrust of the austerity package, popularly called the "Bokros Program"?

A. During the past 25 years Hungary has been unable to achieve economic growth without increasing the balance of payments deficit and the national debt. This is because the public sector is too large and inefficient; if there is economic growth, the public consumption expands even faster. Thus, the budget deficit soars, and the current account balance deteriorates. Restrictive measures are required, but they constrain economic growth. Last year the economy did get off the ground, though slowly, but once again the external balance deteriorated. In 1993 and 1994, annual exports increased by just 5 percent while imports grew by more than 35 percent. The 1994 current account deficit shot up to a record $3.9 billion. Over the past two years, gross debt grew by $7.5 billion, while foreign direct investment reached $3.8 billion. Hungary's $29 billion gross foreign debt remains the highest, per person, in Central and Eastern Europe. In the first three months of 1995, the budget deficit soared to 150 billion forints ($1.2 billion). Only one-third of that amount could be covered from domestic savings. Financing the budget deficit crowded out investment and hindered the development of business and industry. So we have to cut public spending and domestic consumption, and put the country on a path of sustainable, exports-led economic growth. The austerity package—which Parliament approved on May 23, amending no fewer than 21 laws—will have the immediate effect of cutting this year's budget deficit to 156 billion forints ($1.2 billion) from the originally planned 282 billion.

Q. What are the major changes in social policy?

A. A country as indebted as Hungary cannot afford to spend the equivalent of 27 percent of annual GDP on welfare and social services. It cannot afford universal child-care benefits, two years of maternity pay, and free higher education for all. The universal entitlement will have to go. We have to limit social assistance to those in need—about 3 million Hungarians live under or at the subsistence level. From now on, family allowances, child-care benefits, and maternity payments will depend on individual income and wealth, even though effectively, for some 80 percent of families, family allowance and child-care assistance.

Q. And how will you modernize and streamline the state administration?

A. Hungary's million public sector employees put a heavy burden on a country of just 10 million people. As part of our downsizing, before the end of this year various ministries and central budgetary agencies will see 19,000 positions cut by 1996, to be managed by the Treasury.

Unwrapping the Bokros Package

- The National Bank of Hungary (NB) devalued the forint by 9 percent as of March 13, and promised further monthly devaluations of 1.9 percent in May and June, and of 1.3 percent in July; a general import duty surcharge of 8 percent came into effect on March 20 and will remain in place until mid-1997. (The import duty surcharge alone will generate an extra 56 billion forints in revenue, with a further 25 billion forints coming from higher import prices and exchange rates.) Hungarian companies will no longer be obliged to exchange their hard-currency export revenues for forints, although they will still have to repatriate their revenues to Hungary.

- The family allowance will no longer be universal and automatic. But automatic eligibility will be maintained for families with three children or more and for those with a net per capita monthly income of less than 15,000 forints. Others will be means- and assets-tested. Child-care assistance is to be reduced to cover only those entitled to the family allowance. From now on, employers, rather than the social security organizations, will have to fund sick pay for the first 20 days. Beginning this fall, tuition fees will be introduced at universities and colleges.

- Wages are to be held down in government administration and state-owned companies. (The gross average monthly wage in 1994 was 33,000 forints, and despite the expected 28 percent inflation rate, will not rise above 40,000 forints this year, meaning an average real wage cut of 10 percent.) Government employment, including such public employees as teachers, and doctors will be reduced. Rules on severance payments and bonuses will be tightened. It is likely that the central budget contribution to local governments next year will be reduced by 20 percent. Fifty percent of surplus revenues accrued from the basic activities of public sector institutions will be allocated to the central budget. Most extrabudgetary funds will be abolished, support for specific projects will come from the central budget instead of from state funds. A unified financing system will be set up as of January 1, 1996, to replace such public employees as teachers, and doctors.

- The tax system will be modified as of January 1, 1996. Corporate tax will not be reduced, but companies will pay only 40 percent of social security contributions on income, down from 44 percent. Employees' share will increase to contributions of 12 percent of their pay, up from 10 percent. Several exemptions have been eliminated. (Contributions will be required on sick pay; and author fees, honoraria, and other intellectual products will be levied at a rate of 44 percent.) The tax-collection agency (APEH) and the customs and excise collection authority (VPOP) will have a common database and information system. According to plans, a single authority will collect customs duties, taxes, stamp duty, and social security contributions, and will introduce a tax-filing system, based on both income and property.
Privatizing Hungary's Energy

The Hungarian government has formulated plans to privatize the energy sector over the next three years:

- The government will sell 30 to 35 percent of MOL, the state oil and gas company, to strategic investors and reduce the state share to 25 percent plus one vote. The rest will be sold off to institutional investors or left in the hands of local authorities and compensation funds. (MOL closed last year with an after-tax loss of 1.2 billion forints on its preliminary balance sheet, due to losses on the wholesale natural gas market and higher-than-expected mining royalties.)

- MVM, the state electricity company, is to sell off 50 percent minus one vote of its national distribution center, but will retain full control of the Paks nuclear plant and the national grid. The government also plans to sell 100 percent, less one golden share, of the regional electricity companies and the non-nuclear power stations (both of which are under MVM), with 50 percent plus one share going to strategic investors.

- The regional gas supply companies are also to be sold off almost completely (100 percent less one golden share), with 50 percent plus one share to go to strategic investors.

But two key questions will need to be answered before privatization starts:

1. **How will the state keep household energy prices (which have been heavily subsidized for years) under control after privatization?**

   Gas and electricity prices rose by over 50 percent at the beginning of this year, but it is estimated that a further rise of around 100 percent is needed to bring them to world levels and to cover production and modernization costs. The latest price rises were accompanied by a 9 billion forint (73 million dollar) compensation package, and current political debate suggests that the government will wish to see household prices remain low.

   Many customers are unable to afford domestic heating bills despite the compensation package. The Budapest Electricity Works has announced that 10,000 families in the capital currently risk having their electricity supply switched off because of unpaid bills. Last year, consumers owed the Works 1.2 billion forints. The Works is now trying to recoup its debts, but, for political and social reasons, companies have until now been reluctant to disconnect customers.

2. **Which elements of the energy sector should remain in state ownership, and who should represent the state's interests?**

   The power sector unions want the state to retain a majority holding in MVM, which would retain control over its subsidiaries (i.e., the regional electricity companies and non-nuclear power plants). This proposal would give foreign investors portfolio rather than controlling stakes and thus represents a radical departure from last year's plan. There are now two energy sector union leaders on the MVM supervisory board, raising fears that they may exert undue influence over the privatization process. The union leaders have been pressing for employment guarantees, shares for employees, and consultation rights with new owners after privatization.

   The debate on the state's role in a partially privatized utility sector centers on such issues as control of Hungarian oil and gas fields; whether the state should keep a majority stake in Mineralimpex, the wholesale oil and gas trader, in order to regulate the wholesale markets; and whether or not Mineralimpex should be combined with the state oil and gas company.

Other unresolved issues include:

- The percentage of shares to be set aside for employees or to be released for privatization coupon holders.

- The kind of capital injection that is needed.

- The criteria for determining the type of investor to be preferred (such as strategic or portfolio investors) and the rights that should be accorded investors.

### Projected Revenues from Privatization

(billions of forints)

<table>
<thead>
<tr>
<th>Enterprise</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electricity works and supply companies</td>
<td>75</td>
</tr>
<tr>
<td>Gas supply companies</td>
<td>15</td>
</tr>
<tr>
<td>MOL, the state oil and gas company</td>
<td>39</td>
</tr>
<tr>
<td>Pharmaceutical manufacturers</td>
<td>10</td>
</tr>
<tr>
<td>National Saving Bank (OTP)</td>
<td>8</td>
</tr>
<tr>
<td>Other</td>
<td>5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>152</strong></td>
</tr>
</tbody>
</table>

Q. What is your privatization agenda?

Without touching on every detail, here are some of the major points:

- Hopefully, privatization of the "big fish,"—the gas, oil and electric power industries and the connected utilities, the Hungarian Telecommunications Company (MATAV; second tranche of privatization), and two major banks (the...
National Savings Bank and Budapest Bank)—together with a number of agrobusinesses and other manufacturing companies, can start in July. The first tender documents should be completed by midyear, with tenders announced, in order for the deals to be concluded before the end of the year. That would help realize our plan to collect roughly 150 billion forints as privatization revenue. [See table on privatization revenues.]

*The boards of the two privatization agencies, AVU (SPA, State Privatization Agency) and AVRt (State Asset Agency), will merge. The two organizations will function for a while side by side, and then the SPA will privatize itself out of business, as its last firms are sold off. The AVRt will remain the gatekeeper of public assets, and will play a key role in coordinating the sale of energy sector companies.

*Hungarian pension and insurance companies will be encouraged to enter the capital market in order to increase the volume of domestic shareholdings and the stability of the market.

Q. What are you expecting in 1996 and in the following years?

A. In 1996, without a doubt, there will be further belt-tightening. This is the price we have to pay for containing the budget and the current account deficit. We expect foreign direct investment to accelerate as privatization resumes and foreign investors regain confidence. If this happens, we could meet our target of $1.5 billion in foreign investment for the year. (Editor’s note: foreign direct investment was $1.1-$1.2 billion in 1994, down from $2.4 billion in 1993 and $1.6 billion in 1992. Some $200 million flowed into the country in the first quarter. The government also received $500 million from the sale of MATAV.) Our three-year economic program foresees a 4.2 percent economic growth by 1998, a $1.5 billion current account deficit, and a 15.5 percent inflation rate.

Q. You said earlier in an interview that as minister of finance half of your job is marketing: selling economic policies to the public. A recent opinion poll by Szonda Ipsos found that two-thirds of Hungarians were outraged at the reform package, while a mere 4 percent believed the reforms would improve the country’s finances in a big way ....

A. True, the program seemed to most Hungarians to come like a bolt of lightening out of a clear blue sky. But we had no other choice. The economic situation was deteriorating and (For example, just hours before the prime minister appointed me and my good friend, Gyorgy Suranyi [Suranyi is president of the national bank], Standard and Poor had revised its rating outlook for Hungary’s foreign debt downward, from BB+, with a stable outlook, to BB+, with a negative outlook, reflecting concerns about the direction economic policy was taking, privatization, the high budget deficit and low domestic savings. We couldn’t wait any longer; we didn’t have enough time to work out all the details, let alone consult the public or discuss possible alternatives. In fact, there were even some government members who were unaware of the package. Two ministers resigned immediately when the program became known. Besides, we didn’t want any leaks about the planned devaluation and import surcharge, to prevent speculation. Now we have a different situation. To further fine-tune our economic policy, public debate is absolutely necessary, including regular television discussions. We are open to criticism, ready to listen to policy alternatives, and willing to integrate sound proposals into our strategy. We are aware that without large-scale public support our program simply will not fly. Garnering public support is indispensable.

Camdessus: The March Measures Are Fine, but ...

Michel Camdessus, Managing Director of the International Monetary Fund, who on June 5 met with a top-brass delegation from Hungary led by the prime minister, welcomed the Hungarian government’s March stabilization package, calling it "courageous and substantive" in an IMF News Brief, dated June 6. At the same time he considered it only a first phase in a program "aimed at achieving a noninflationary growth path with external viability." Starting with a visit to Budapest in late June, the IMF staff will work closely with the Hungarian authorities on the next phase of this program, to be formulated in the context of the preparation of the 1996 budget. Managing Director Camdessus is prepared to recommend to the Executive Board that the IMF give financial support to the program, provided it realizes the following objectives:

- A significant reduction in inflation and maintenance of international competitiveness, through wage and monetary policies (application of the crawling-peg exchange rate).
- Structural reform of the public sector—that is, improved fiscal control mechanisms, more efficient public administration, broadening of revenue bases to reduce distortions in the tax system, and adjustments in the social security system to safeguard its viability while providing adequate assistance to those in need.
- Structural reform of enterprises and banks to curtail the role of the state and increase the responsiveness of the economy to market signals—this will require, renewed privatization efforts.
- An external current account balance, consistent with halting the increase in foreign debt, but without relying on exceptional inflows associated with privatization.
Laszlo Csaba: Capitalist Revolution in Eastern Europe

by Martin Schrenk

Scholars living in the once socialist, now postsocialist, countries are intimately familiar with the history and functioning of their economic system. That empirical evidence is extensively used in Laszlo Csaba's new book, The Capitalist Revolution in Eastern Europe: A Contribution to the Economic Theory of Systemic Change.

Taking a "second-generation" perspective on transition, the author abandons any illusion that by following a reasonable scenario, reforms can be accomplished quickly, and at predictable social and economic costs. He disagrees with any radical masterplans—"grand designs"—that lack historical and systemic insight. He also decries inappropriate comparisons, such as equating the "transformation" of postsocialist countries with "reform" in semi-industrialized capitalist countries. While in the latter, efforts focus on improving the prevailing system, in order to preserve it, "transformation" implies much more; it is, rather, a "modernization" that implies the destruction of the traditional economic and political order, and its replacement with multiparty democracy, a new set of coordination mechanisms, as well as openness to economic, technological, and cultural exchange with the outside world, reasonable monetary stability, and development of a vibrant private sector to sustain economic growth.

Csaba does not regard the misguided use of "reform" for "transformation" as just a quibble over terminology. In his view, "both sides" (presumably meaning both advisers and governments of transition countries) have underestimated the difficulties related to the multidimensional character of modernization. In applying theories and translating them into policy advice, advisers and decisionmakers should pay more attention, warns the author. The problem is not an overdose of sound macroeconomic policies, he continues, but that poorly digested, contestable, or fully untested macroeconomic theories were combined with total disrespect for the peculiar qualities of transforming economies. No wonder that these countries' first encounter with mainstream economics brought only meager results, he concludes.

He also makes clear that it is not the mainstream economics that should be blamed for the mistakes: "Mainstream economics does not call for confusing stabilization with institutional reform. It does not call for disregarding the environment in which it is applied, since it is not concerned with application at all." But Csaba also rejects "pragmatism" as an alternative approach. In his view, it lacks a "compass" with which to orient the countries as they move from one economic system to another.

Csaba argues that in the transformation process—which even in the most advanced Central European countries could take 15 to 20 years—balancing the budget should remain a long-term concern. But he warns against simplistic attempts to keep inflows and outflows in balance in each calendar year. He recognizes the dangers of inflation, and that price stability is the best way to protect the socially vulnerable, especially the elderly and disabled, to promote savings, and to make investment decisions simpler. But he emphasizes that while hyperinflation will prevent transformation, a moderate rate of inflation does not call for stabilization as the inevitable first stage of a transformation strategy: "the modernization strategy could not, but also need not, afford the luxury of a single digit inflation." But if the transition countries' fiscal imbalances will be eliminated only in the medium to long run, and if moderate inflation is there to stay, a stable exchange rate for a lengthy period is not sustainable, he asserts.

The author rejects the notion that universal privatization at maximum speed is self-evidently the most desirable approach. As long as the institutional prerequisites are not available, such as an efficient financial market and effective corporate governance under private ownership, full-speed privatization is not tempting, argues Csaba. He views voucher privatization as "populist" and suggests "equally cheap but fairer ways of paying one's electorate." Csaba disputes the assertion that managers of state-owned enterprises are inherently inept to run their firms efficiently. He sees anecdotal evidence that many managers, once they accept hard budget constraints as definitive, and recognize that privatization offers them long-run opportunities, do make the necessary adjustment. Consequently, he only mildly disapproves spontaneous privatization, appreciating its "evolutionary" potential for creating a vibrant private sector.

Beyond his forceful critique of mainstream views, Csaba offers, as an alternative, an "evolutionary" approach (in Hayek's and Popper's sense) based on "organic," "incremental" changes resulting from "spontaneous" decisions by autonomous agents. For the reader eagerly awaiting an alternative "vision" after the extensive critique of familiar blueprints, this message may appear disappointingly general. The author, however, would probably argue that any other
than such a low-key posture would be a relapse to "social engineering," deduced from a "theory of transformation"—the very approach that the proponents of the evolutionary paradigm reject. This would follow from his thesis that "shock-therapy and gradualism, although in pursuit of converse ideological agendas," both provide detailed top-down prescriptions for institutions, focus excessively on details, and suppress spontaneity—common characteristics of "social engineering."

Csaba’s prescription for arriving at a more operationally relevant methodology reflects his concept of "modernization" as the essence of transformation, as mentioned earlier. In his view, there is no room for a distinct economic "theory of transformation" with cross-country validity and endowed with predictive powers, from which "optimal" speed and sequence for specific countries can be deduced. Instead, he calls for a multidisciplinary approach that addresses the social and cultural environment of transformation, such as descriptive and comparative economics, institutional economics, political economy, history, law, and sociology. The yawning gap between abstract theories and utopian designs of transformation, and aimless muddling-through, needs to be filled by patient, multidisciplinary dialogue between scholars and practitioners, Csaba suggests.

This evolutionary approach assumes a sound relationship between a government and its people. Public trust should be based on a fairly simple but stable set of institutions and rules and on efficient conflict management. Stability of expectations is also important and requires credibility of policies and diminishing fears of policy reversal. This may be attained through laborious and time-consuming consensus building, in which the challenge is to persuade social partners and a large part of the public of the virtue of following sensible economic policies, instead of jumping at the promises of the latest wizards offering swift, painless economic cure-alls.

Csaba’s very explicit criticisms and rather vague proposals will probably be contested by many readers; similarly, his occasionally caustic or dismissive language will not meet with universal applause. He portrays as "quick fixes" comprehensive first-generation reform blueprints, and labels specific proposals as "ideological," "reductionist," or "naive." Some chapter subtitles promise more than the author delivers, such as "The Operationalization of Transformation in Functional Terms" or "Towards a Theory of Transformation." But the author makes no secret of his limited purpose: it is to "contribute to, rather than settle the international debate on this particular area of general economics." And indeed, this book will be rewarding reading for those who are not satisfied with the conventional wisdom and are looking for new answers to the formidable puzzles of transformation.


Martin Schrenk is Economist in the Transition Economy Division, the World Bank.

**Milestones of Transition**

[Contributions of Open Media Research Institute, Prague are appreciated.]

Polish Finance Minister Grzegorz Kolodko warned in early June that inflation would pick up unless his anti-inflation package—including duty-free import quotas for some foodstuffs, more intervention in the farm market, tighter budgetary discipline, and measures against raising prices by monopolists—is implemented. Inflation for the first half of this year is likely to be around 14.6 percent, as against a government target of 17 percent for the whole year. The economy grew by between 5.5 and 6.5 percent in the first quarter of the year compared with the same period in 1994. According to a poll of general election voting intentions published in the June 4 *Gazeta Wyborcza*, support for the Democratic Left Alliance (SLD) has risen to 25 percent, while that for the Freedom Union has fallen to 9 percent, and for the Peasants’ Party to 8 percent.

Poland’s national bank said the appreciation of the zloty may have a short-term negative effect on Polish exports, but that it should prove temporary as Polish importers and exporters learn to minimize currency risk. On May 16 the national bank widened to 7 percent the band within which the zloty exchange rate can fluctuate above or below its fixed mid-rate. Since then the national bank has continued to intervene on the domestic foreign-exchange market to halt the zloty's rapid appreciation against the dollar. Official hard currency reserves rose $1.6 billion in April to $9.1 billion, according to a national bank report.

Poland was awarded its first investment-grade credit rating (a Baa3) by Moody, the international rating agency. The rating, which is the first to be assigned to a country that has negotiated a debt forgiveness package with bank lenders, will pave the way for the country’s debut Eurobond offering. However, Stan-
standard & Poor's, the other large U.S. rating agency, and IBCA, the European agency, chose to assign only sub-investment grade ratings to Poland.

Latvia's largest commercial bank, Baltija Bank, where about 40 percent of all Latvian deposits are held, resumed partial banking operations on May 31. (The bank's president suspended operations on May 23, and its shares were transferred to the government two days later to prevent bankruptcy.) Two former heads of the Baltija Bank are charged with exchanging 60 percent of the bank’s credit resources, worth about 80 million lati ($156 million), for Russian state treasury bonds, redeemable in 2008, with 3 percent annual interest.

The banking crisis in Latvia has no direct implications for Lithuania; nonetheless, bankers and businessmen are watching their operations more closely, says Lithuanian Finance Minister Reinoldijus Sarkinas. Questions remain about three of the country’s biggest banks in which the government still holds 51 percent of shares. The World Bank has recommended further privatization of the sector. But the state plans to hold on to its 51 percent share, Sarkinas said: "In the future, it will come to a privatization."

The Czech government on June 7 decided to unilaterally abolish the clearing system that has governed trade payments with Slovakia since the two countries split. Thus, it is likely that as of October bilateral trade will be conducted in hard currency. Ending the clearing system, under which the Czechs have run up monthly deficits for more than a year, will be a further step toward making the Czech koruna convertible. The cancellation may lead to a decline in Slovak exports and hard currency reserves. (The Czech Republic remains Slovakia’s biggest trading partner, accounting for 37.1 percent of exports and 29.6 percent of imports in 1994.)

Foreign capital in the Czech economy exceeded $3 billion at the end of May and is producing strong inflationary pressures, Czech National Bank Governor Josef Tosovsky said on June 6. The economy cannot absorb the huge inflow of foreign capital—the bank’s hard currency reserves have risen from $6.2 billion to $9.5 billion. Much of the foreign capital is short-term speculative money. The Czech government is expected to approve a new hard currency law. The earliest date the koruna can become convertible is October 1995.

Slovakian Premier Vladimir Meciar announced on June 6 that under the new voucher privatization concept in Slovakia, the National Property Fund will distribute bonds worth 35 billion koruny, with each citizen receiving bonds worth 10,000 koruny. Citizens will be able to use bonds to buy shares in companies that are earmarked by the government and can also use them as downpayment on an apartment. The new measures will increase state control of the economy and prohibit private ownership of strategic industries, in effect spelling the end of coupon privatization, according to the Financial Times.

Average monthly income in Russia, measured in dollars, fell from $87 in November 1994 to $72 in March 1995, a spokesman for the Russian government’s Economic Reforms Center reported on May 16. According to the State Statistics Committee, the highest wage—1.47 million rubles (about $286)—was paid in the gas industry, and the lowest—147,000 rubles (about $29)—in agriculture. Average wages in the health care, education, and scientific research sectors has dropped below the subsistence minimum. The population’s average real income declined 6 percent compared with the same month in 1994. Between January and April some 30 percent of the population—44 million people—had monthly incomes below the subsistence minimum of 385,000 rubles ($45) a month.

Western official creditors and Japan agreed on June 2 to reschedule nearly $7 billion of Russian debt and debt servicing due in 1995. In addition, the group of 17 creditor countries affiliated with the Paris Club agreed to launch talks in the fall for "a comprehensive rescheduling" of Russian debt to official lenders (estimated at $36-$40 billion), provided some conditions are met, including continued adherence to the recently concluded IMF stabilization plan. Russia will pay the Paris Club countries some $1.2 billion in interest payments this year.

According to Russia’s Deputy Finance Vladimir Petrov, the government plans to write into its 1996 budget foreign loans worth $8.7 billion, with half of them from multinational lenders. He said this would include $4.8 billion in loans from international financial organizations. Russia may also borrow to pay off its $120 billion foreign debt, but only if it can make credit arrangements that will not increase its repayment burden over the next two years.

Several Western banks have recently begun issuing American Depository Receipts (ADRs) for Russian companies. ADRs may facilitate the inflow of needed foreign investment to Russia. However, while ADRs provide a vehicle for foreign portfolio investment, particularly from U.S. funds, they do not eliminate the fundamental deficiencies of the Russian securities market.

Russia’s foreign trade turnover reached $25.7 billion in the first quarter of 1995, an increase of 10.5 percent over the same period in 1994. Exports totaled $14.4 billion, while imports amounted to $11.3 billion. Trade turnover with Western countries reached $20.3 billion, with exports accounting for $11.5 billion and imports $8.8 billion.
Russia introduced new import customs duties on May 10. In an effort to protect national agricultural producers from competition with cheaper Western products, import duties on meat and meat products were raised from 8 percent to 15 percent, on poultry from 20 percent to 25 percent, on sausage from 8 percent to 20 percent, on butter from 15 percent to 20 percent, and on fish from 5 percent to 10 percent.

Russia produced 81 million tons of grain in 1994, down 18 percent from 1993, and the amount will fall still further this year. The government failed to ensure adequate supplies of fertilizer. Russia now has 285,000 private farms, but most are in bad shape: 20,000 failed last year, largely because of a lack of machinery.

Since 1991, the land area held by Russia’s state farms has shrunk from 124 million hectares to 34 million, while the cooperative sector’s holdings have increased from 85 million to 137 million and the private sector’s from 4 million to 23 million. State Committee on Land Chairman Nikolai Komov said on May 20 that the number of “land users” (zemlepolzovateli) has increased from 300,000 to 45 million. He added that despite “weak legislative guarantees,” there have been “significant structural changes” in land tenure.

Russia’s central bank has introduced a 100,000-ruble note, worth about $20. Previously, the 50,000-ruble note, introduced in 1993, was the largest in circulation.

The Uzbek government will no longer finance insolvent enterprises, President Islam Karimov told the republic’s cabinet of ministers on May 16. While noting that inflation has been steadily decreasing in 1995, he said managerial inertia is to blame for the country’s poor economic performance and its failure to privatize. Karimov also indicated that the only possible way to increase production in many cases is to turn state-owned businesses into joint stock companies.

Bulgarian Deputy Prime Minister and Minister for Economic Development Rumen Gecchev said on May 10 that the government’s major economic goals in 1995 are maintaining financial discipline and achieving 2.5 percent economic growth. The cabinet projects an increase in GDP averaging 4.5 percent a year during its term in office; it also intends to lower inflation from 121.9 percent in 1994 to 15 percent by 1998, and curb unemployment. Gecchev said that privatization, to be carried out in two stages, will start in January 1996 and end in late 1997. Some 150 enterprises will be selected for privatization. The Kozloduy nuclear reactor, the military-industrial complex, the Bulgarian Telecommunications Company, the Post Office, and one or two major banks are among those enterprises that will not be privatized, Gecchev said. The private sector’s share in GDP, which accounted for 30 percent in 1994, is projected to reach 55 to 60 percent by the end of 1996 and 70 to 75 percent in late 1997.

Illegal business activities in Bulgaria amounted to $9.5 billion in 1994, equivalent to the country’s GDP, according to a May 8 report in Trud. The trade union newspaper cited statistics of the Bulgarian National Bank. Illegal business includes drug trafficking, forged customs declarations, and trade with countries that are under an embargo. According to Trud, many restaurants, hotels, and casinos are front businesses created to justify profits to the revenue office.

Viet Nam cut its trade deficit in the first four months of 1995 to $80 million from $228 million in the same period last year. Exports rose 48.7 percent to $1.48 billion, during the period, and imports rose 27.4 percent to $1.56 billion.

Ukrainian authorities increased utility prices for individual consumers as of June 1. The cost of heating has doubled, while prices for water and sewage disposal have risen by 40 percent. The government announced recently that it intends gradually to raise utility rates, previously heavily subsidized, until they reach 60 percent of their real cost; on June 1, they covered only 30 percent of the real cost.

The European Bank for Reconstruction and Development (EBRD) has said that the bank will set up a capital fund with $60 million equity to buy and restructure Hungarian companies experiencing serious difficulties. EBRD President Jacques de Larosiere during a late-May visit to Hungary, confirmed the successful relations between the bank and the host country. The EBRD had invested $900 million in Hungary in a total of 31 projects, which amounts to 12 percent of the EBRD’s investments. The EBRD will continue to play a role in Hungary in the development of the financial sector, in privatization, and restructuring, and in the development of infrastructure and the capital market.

The EBRD had increased its disbursements to Eastern Europe and the former Soviet Union by 238 percent in the first quarter of 1995. The bank made investment commitments of $383 million in the period. First-quarter operating profit before provisions surged to $9.91 million, up from $2.16 million a year earlier.

China’s industrial output has grown to $18.81 billion, 15.4 percent higher than in April of 1994, according to figures from the State Statistics Bureau.

China will halve its new foreign borrowing this year to $5 billion in a drive to maintain tight curbs on international fund flows in the wake of the Mexican crisis, according to the deputy governor of the central bank. Zhu Xiaohua insisted that
the Chinese government would stand by Chinese state-owned banks that have borrowed abroad.

By the year 2005, China will be the world's second largest economy, will rank in the top half-dozen among trading economies, and will be the largest trading partner of each of its neighbors, according to a study by China experts at the Australian National University.

The 1994 grain harvest in China was the second biggest in the country's history, but was not enough to keep pace with rising demand, combined with a fourth year of greater than 10 percent economic growth. Beijing, caught by a grain shortfall of some 11 million metric tons from the previous year, turned to foreign markets to fill the gap and to hold back prices. In the first three months of the year, U.S. exporters shipped agricultural goods worth $984 million to China, just short of the 1994 total of $1.08 billion. Scott Reynolds, director of the U.S. Department of Agriculture's trading office, predicts a record year for U.S. exporters in 1995.

The Prague Stock Exchange (PSE), taking its next step toward continuous trading, will split into three separate sections this autumn. As of September 1, shares on the bourse will be placed into one of three categories:
- A main market (trading listed issues that have a free float of shares with a nominal value of at least $8 million and that have at least 20 percent of the issue publicly traded).
- A second-tier market (for bond trading, comprising issues that have a free float of $4 million or more and that have at least 15 percent of equity available for public trading).
- An unrestricted market to handle all remaining issues.

The PSE has struggled to digest the roughly 1,700 issues that came on the market subsequent to the two waves of privatization in 1993 and 1995. A lack of transparency has plagued the market, because most companies were not disclosing the full information that is needed for a healthy capital market.

**The Russian Economy—Stabilization at Last?**

A mood of optimism about the economy prevails in Moscow. Russia's economy is starting to stabilize. In the first four months of the year, GDP reached 275 trillion rubles ($55 billion) compared with planned levels of 200-260 trillion rubles ($40-$52 billion), and output fell by 5 percent instead of the anticipated 6-8 percent. Industrial output in May was unchanged compared with May 1994, and only 0.8 percent less than a month before. The steel, chemical, and petrochemical industries raised output by 10 percent in the first five months of the year over the same period in 1994. Intereenterprise debts were shrinking and wage arrears declining.

The budget deficit in the first four months of 1995 dropped to 3.3 percent of GDP instead of the expected 8 percent. According to a government budget report, first-quarter revenue rose to 32 trillion rubles ($6 billion), exceeding the planned levels—for the first time in five years—by 3.3 percent. Expenditures totaled 39.7 trillion rubles ($8 billion), 82 percent of the target figure.

First Deputy Prime Minister Anatoly Chubais, hailed the data saying that "the country's economic situation has radically changed, and recovery is under way." Chubais considers the ruble's month-long rise against the dollar a sign of stabilization, the result of the government's tough budget. (The ruble rose to a two-month high of 4,900 to the dollar in mid-June.) The ruble has begun to squeeze foreign currencies from the national market, and de-dollarization of the economy has begun, according to Chubais.

The mid-May projections of Credit Suisse First Boston also foresee a recovery in 1996. The Swiss-American bank sees GDP down 4 percent in 1995 (against 15 percent last year), and then up a further 1 percent in 1996, and envisages 60 percent consumer-price inflation in 1996. Last year inflation reached a high of 200 percent, then dropped to 170 percent for the period end-1994 to end-1995. Inflation is continuing to slow this year: the cumulative monthly consumer price index has decreased every month, beginning at 17.8 percent in January, and falling to below 8 percent in May.

Economics Minister Yevgeny Yasin warned, however, that expectations of an imminent upswing in the Russian economy might be unrealistic. He said that arresting the contraction in the economy has been a great achievement in view of cuts in government credits, stagnant state investment, and restrictive monetary policy. The economy's performance show that output can be produced without state backing.

The government submitted the draft 1996 budget to the Duma on June 18, and prepa-
World Bank/IMF Agenda

Social Fund Project Launched in Cambodia

The World Bank announced June 9 that its first Social Fund in the East Asia region will be set up in Cambodia, with $20 million in IDA funds, to bring schools, clinics, roads, and clean water to this country where life expectancy is a mere 52 years. (The social fund is not subject to recipient government control. It is transparent and demand-driven: communities can request money up to $250,000 for specific projects. The average project cost is about $25,000.) The fund will finance small-scale projects in the poorest areas, and will help local groups take ownership of assets.

$600 Million Rehab Loan to Russia

The World Bank on June 7 granted a second rehabilitation loan worth $600 million to Russia to help finance imports. The funds will support the government's macroeconomic stabilization program during 1995 and will finance structural reforms, including opening up trade, abolishing quotas and export licenses, reducing import tariffs, streamlining fuel export procedures, and abolishing restrictions on commercial land sales. The loan is for 17 years, including a 5-year grace period, with an interest rate of 7.09 percent.

Russia Upstages Mass Transit

Under a new $329 million World Bank loan, 14 Russian cities will get help upgrading and restructuring their public transport companies. The project, approved May 16, will finance urgently needed replacement vehicles and spare parts in the target cities. The cities will be able to buy more than 1,700 buses and trolleys and rehabilitate more than 1,500 vehicles already in service. The loan will also finance expert advice on improving urban transport policies throughout the country, as well as on restructuring the domestic bus manufacturing industry.

Russia Seeks New IMF Loan Facility

Russia's Deputy Economics Minister Sergei Vasiliev said negotiations are beginning with the IMF on a new loan facility. Russian officials hope that the loan will amount to $3 billion a year over three years beginning in 1996. Vasiliev said the first $1.2 billion tranche of last month's IMF $6.8 billion standby loan went to pay foreign creditors. He added that final plans for spending the rest of the standby financing are to be made later this year.

Oil Cleanup in Russia Turns Messy

Taxes, bureaucracy, and suspicion are hindering efforts to clean up the oil spill in Russia's Komi region as disaster looms, reports the Wall Street Journal Europe. "I think the government is trying," says a World Bank official in Moscow. "But every single ministry has its own turf to protect and they are not used to cooperating in a crisis." The World Bank and European Bank for Reconstruction and Development recently approved $125 million in loans to pay for the cleanup, but the Ministry of Finance is charging a 23 percent value added tax on Western equipment being imported to remove the oil.

World Bank Focuses on Ukraine

In support of efforts to resuscitate Ukraine's seed industry, the World Bank has approved (May 23) a $32 million loan. The project will develop private enterprises to produce and market seeds, improve regulation of the seed system and develop a research plan. Long-term goals will include liberalizing seed pricing, marketing, and trade and establishing private seed production. Earlier, the Bank had released $250 million to Ukraine—the second tranche of a $500 million rehabilitation loan—to finance critical imports and support the country's balance of payments. World Bank official Oleksander Kaliberda said the Bank is ready to expand its aid program to Ukraine. He noted that among the 19 projects currently under review for financing are a proposal for institutional development worth $44 million, for which the Bank could appropriate $27 million, and a project to rehabilitate hydroelectric power plants in Ukraine, with the Bank possibly providing a $115 million loan. He said that if Kiev continues to pursue economic reforms, there will be no reason for it not to qualify for $1 billion annually in World Bank assistance.

Help Pledged for Central Asian Nations

International donors and agencies, meeting in Paris in late May, offered Kazakhstan, Azerbaijan, and Kyrgyzstan further financial assistance to keep their wide-ranging reforms on track. *Kazakhstan* was pledged $1.22 billion for 1995, and a further $575 million for 1996. (In 1995, $400-$450 million in long-term loans are to come from the World Bank and Asian Development Bank. The IFC and the EBRD will grant a further $150 million in equity participation and loans. Export credit agencies indicated additional commitments in export-financing credits.) On June 9 the World Bank approved a $180 million structural adjustment loan to improve competition in the Kazakh agriculture and energy sectors, to expand foreign trade, and to strengthen the private and
the financial sectors and social services. Earlier, the IMF approved a 12-month standby credit of $290 million. 

*Azerbaijan* was pledged $430 million for 1995, and, preliminarily, $240 million for 1996. Inflation has fallen sharply (monthly inflation has been reduced to around 3 percent from 60 percent at the end of 1994), and the exchange rate has stabilized, but the lasting Nagorno-Karabach dispute worries donors. 

*Kyrgyzstan* was pledged $680 million for 1995-96. Donors commended the country for being at the forefront of stabilization and economic reform. Inflation is down to single digits and the currency is stable and convertible. Privatization is progressing well, enterprise restructuring is under way, financial discipline has been imposed on enterprises and banks, and land distribution and agricultural reform have been stepped up. There was concern about the budget and a monitoring period was agreed with the government. The budget deficit is expected to rise to 11 percent of GDP in 1995, from 8.4 percent in 1994. (Tax collection is currently a problem, pending implementation of the country’s first universal tax laws later this year.)

**World Bank Expands Single Currency Loan Program**

The World Bank has expanded its single currency loan program. The Bank will offer all its borrowers the choice of floating rate single currency loans, fixed rate single currency loans, and currency pool loans with a variable lending rate. Previously, all borrowers received loans in a basket of currencies. The new measure will allow borrowers to select any currency or composite currency for which there is sufficient borrower demand, and in which the World Bank can efficiently borrow from the market. It will also allow borrowers to select the interest rate basis that will apply to the loan. The Bank said each member country will be eligible for single currency loans for up to half of its planned annual lending program or $100 million equivalent, whichever is greater.

**IMF Drafts Standards on Financial Data**

IMF officials are drafting standards that will press member governments to publish faster and fuller financial accounts. The document will be submitted for consideration to members at the IMF Annual Meeting in October. IMF official Roger Nord said that eventually it will be made available to the public. The issue of openness will be raised at the June summit of the G-7 countries in Halifax. Nord said in an interview that there was no decision yet on whether the IMF would publish a report twice a year on how well some major countries had followed IMF advice. He said some countries were willing for the report to be made, but that others argued that they could not speak frankly to the IMF if such material were to be disclosed.

**IMF Approves $1.8 Billion for Algeria**

The IMF Board had approved a $1.8 billion three-year extended fund facility for Algeria to support an economic reform program started in 1994. The program aims to slash inflation and spur economic growth through rapid elimination of the budget deficit, full liberalization of prices from government control, and promotion of the private sector. Under the plan, economic growth is to accelerate to 5.3 percent from 1.1 percent in 1994-95; the year-end rate of inflation is to be reduced to 10.3 percent from 35.1 percent; and the budget deficit is to be cut to 1.3 percent of GDP from 2.8 percent.

**World Bank Assists China's Forestation and Rail Modernization**

China is using $500 million in World Bank loans for a range of afforestation projects, aimed at pushing back deserts that have swallowed up vast tracts of forest due to rampant tree-cutting over centuries. In another development, the World Bank has approved a $400 million loan to China to improve its congested railway system. The loan will cover 23 percent of the cost of the government's program to reorganize and refurbish the system, which carries more than half of the country's freight and much of its passenger traffic. The project involves electrifying a line more than 600 miles long, computerizing its telecommunication and information systems, developing container transports, and acquiring of more powerful locomotives.

**New IDA Credits for Viet Nam**

A $100 million IDA credit to Viet Nam will help modernize the country's irrigation system, which dates from French colonial times. Another IDA credit of $165 million will help finance the government's plans to improve power supply in southern and central Viet Nam; to provide new and rehabilitated generation, transmission and distribution equipment; and to upgrade agency training for better management and maintenance.

**MIGA First Guarantee in Viet Nam**

The Multilateral Investment Guarantee Agency (MIGA) issued its first Contract Guarantee in Viet Nam to the U.S. Citibank. Citibank invested $15 million to open a Hanoi branch. The MIGA guaranty of $13.5 million will protect against the risks of expropriation, transfer restrictions, civil disturbance, and war.

Since Viet Nam joined MIGA in October 1994, MIGA has received more than 30 applications for coverage of potential foreign investments in the country, totaling hundreds of millions of dollars. MIGA membership has increased to 128 with Ukraine and Mozambique among its most recent new members. In
the current fiscal year MIGA has facilitated foreign direct investments totaling over $1 billion in 18 developing countries.

Macedonia Receives $154 Million

The IMF on May 5 granted a $55 million loan to the FYR (former Yugoslav Republic) of Macedonia. An $85 million IDA credit approved May 16 will provide crucial balance of payment support for the government's planned reforms in its enterprise and banking sectors, along with social safety net programs to protect the most vulnerable people. The project will also help clear some of the country's debt. A second IDA credit of $14 million, approved on May 16, will provide services to laid-off workers and help them find new jobs.

Baltic Sea Cleanup

The World Bank will join the European Bank for Reconstruction and Development, the European Investment Bank, the Nordic Environmental Finance Corporation, and Nordic Investment Bank in financing seven projects, costing $240 million, to clean up the Baltic Sea. As announced on May 17, the projects will back the Baltic Sea Joint Environmental Program, an international effort to clean up and protect the Baltic Sea. The overall cost of the program will be about $1 billion a year over 20 years, to be covered by 14 countries (Belarus, Czech Republic, Denmark, Estonia, Finland, Germany, Latvia, Lithuania, Norway, Poland, Russia, Slovakia, Sweden, and Ukraine) with assistance from international lending institutions.

Of the seven Bank projects—two each for Latvia and Lithuania, and one each for Estonia, Poland and the Russia—four have already been approved. Their aim is to improve municipal water treatment services and to reduce pollutants discharged into the Baltic Sea or its major rivers.

Latvia Loan

The World Bank approved a $14 million loan to Latvia on May 23 to rehabilitate the district heating system in the City of Jelgava. Bank funds will be used to increase boiler efficiency, eliminate environmentally unsound coal-fired boilers, install heat meters, and improve maintenance of power generators.

IDA Credits: Infrastructure Rehabilitation in Angola ...

The World Bank's IDA will provide Angola with a $249 million credit to strengthen macroeconomic management and rehabilitate the infrastructure, said National Investment Director Ana Dias Lourenco. Other projects totaling $309 million have been identified.

Road Building in Albania ...

Albania's economy has continued to expand, boosted by international assistance and the emergence of the country's private sector, but the recovery has been tempered by the lack of adequate infrastructure. With help from a $15 million IDA credit approved May 25, Albania will promote agricultural development and improve road access to rural areas. The goal is to improve roads, using labor-intensive methods; provide equipment to maintain roads; and conduct an inventory of roads that fall under different administrative areas.

and Agro-Service Development in Madagascar

The agriculture sector in Madagascar has performed well below its potential because of lack of support-services for farmers, cooperatives, fisheries, and other producers. An IDA credit of $25 million, approved May 23, aims to increase productivity and reduce poverty in rural areas by speeding up delivery of extension services to farmers and improving the technical expertise of agricultural staff. (Agriculture accounts for 60 percent of Madagascar's exports.)

Uzbek Cotton Fields Fertilized by World Bank Money

The World Bank on May 26 approved a loan of $66 million to help Uzbekistan improve production in the vital cotton sector. Specific project goals include: supporting the private sector efforts to process and market about 25,000 tons of planting seed per year, improving pest controls, and providing equipment and training to introduce irrigation timing technology. The total project cost is estimated at $84.6 million.

IFC's Beer Investment

The World Bank Group's International Finance Corporation will invest $24.4 million in a recently privatized Tanzanian brewery. The $18.4 million loan and $6 million equity investment will help the company increase output and meet international health, safety and environmental standards.

Mozambique Privatizes

Mozambique agrees with the World Bank to privatize most of the country's big state-owned enterprises, including the telecommunications and energy sectors, within the next two to three years. Simon Bell of the World Bank's Mozambique office said that the country has so far sold off 14 of the 55 largest state-run firms. Mozambique has one of the most successful privatization programs in Africa, Bell is quoted as saying.
Conference Diary

For the Record

International Infrastructure Projects
June 8-9, 1995, Central Park South, New York, USA

Highlights of this conference included project financing in Asia, Latin America, and Russia and tapping the capital markets for infrastructure finance. Information: Conference Holdings, Burlington, MA 01803, USA, tel. 1-800-767-9499 or, outside the U.S., (617) 270-6200.

Poland 1995: Crossroad of Opportunities
June 19, 1995, New York, USA

A one-day conference presented and hosted by the U.S.-Poland Chamber of Commerce of Metropolitan New York. Topics included: Changing role of commercial banks in post-London Agreement Poland; Transition of the financial market for capital, institutional, and equity investments; Resources and operations of multilateral and U.S. organizations and the mass privatization program—emerging opportunities for investments. Information: U.S.-Poland Chamber of Commerce of Metropolitan New York, 812 N. Wood Avenue, Suite 204, Linden, New Jersey, 07036, USA, tel. (908) 486-9311, fax (908) 486-4084.

Forthcoming

Russia: A New Era for Business, Finance and Investment
July 6-7, 1995, Moscow, Russia

Conference sponsored by Euromoney and Bank Austria, Linklaters & Paines, focusing on sectoral opportunities in the Russian market; energy and infrastructure finance; development of capital markets; and privatization. Participants include both foreign investors and Russian corporations. Information: Conference Department, Euromoney Publications PLC, Nestor House, Playhouse Yard, London, EC4V 5EX, U.K., tel. (44171) 779-8366, fax (44171) 779-8835.

Hydropower Projects in Emerging Markets
September 11-13, 1995, New York, USA

Conference will analyze international hydropower deals, with emphasis on how to develop an efficient structure, help manage multiple sources of risk, and bring together partners. Discussions will touch upon criteria that determine the greatest profit opportunities for hydropower project development: tapping new and alternative funding sources; determining the ownership structure for a hydropower project; implementing the optimal strategies for managing currency; bundling smaller hydro projects for total package financing; and identifying the best models in hydro privatization and revitalization.

Peep Show

From the Hungarian magazine Uritok

Information: Conference Holdings, Inc., 70 Blanchard Road, Suite 4800, Burlington, MA 01803, USA, tel. 1-800-767-9499 or, outside the U.S., (617) 270-6200.

Cleanup of Manufactured Gas Plants
September 19-21, 1995, Prague, Czech Republic

International symposium and trade fair, sponsored by the U.S. Environmental Protection Agency, U.S. Department of Energy, Electric Power Research Institute, Czech Technical University, Gas Research Institute, SGS Environment, Umweltbundesamt, NATO's Committee on the Challenges of Modern Society, Edison Electric Institute, Technical University of Budapest, Florida State University, Woodward-Clyde, and EPP Publications. The symposium focuses on: Site characterization and investigation; Monitoring and field screening technologies; Soil remediation technologies; Groundwater remediation technologies; and Waste reuse, recycling, and minimization. Information: MGP '95 Symposium, Florida State University, 2035 East Paul Dirac
Social Relations and Social Policy under Conditions of Market Economy: Russia and World Experience
September 24-27, 1995, Moscow, Russia

Sponsored by the Institute for Employment Studies and Socio-Economic Research Association. Topics to be discussed include: Types of social policy; Redistribution of power and property; Social guarantees and social responsibility; the Social orientation of an economy and criteria of economic expediency; Psychological aspects of forming a market economy in Russia; Confrontation in the sphere of social-labor relations and problems of public consensus; Social stratification in countries with a market economy; and Prognosis for the social structure of Russian society.

Information: Dr. Dulnara Sorocoumova, conference coordinator, Institute for Employment Studies, Malaya Lubyanka Str. 16, 10100, Moscow, Russia, tel./fax (095) 928-8319, (Email: comlab.vega.msk.su.)

Transforming Economies and Societies: Towards an Institutional Theory of Economic Change
October 19-21, 1995, Cracow, Poland

Organized by the European Association for Evolutionary Political Economy (EAEPE) and the Cracow Academy of Economics. Keynote speakers include: Professor D. Mario Nuti, London Business School, United Kingdom; Professor Grzegorz W. Kolodko, Deputy Prime Minister of the Polish Government and Minister of Finance; Professor Carlo Poni, University of Bologna, Italy; and Professor Philip Mirowski, University of Notre Dame.

The conference will promote dialogue between decisionmakers and business and government leaders from Central and Eastern Europe and Western industrial countries, presenting information about the economic transformation in Central and Eastern Europe, and stimulation of entrepreneurial activity. The key question: How can marketing concepts be adapted for the cultivation of markets in economies undergoing transition?

Information: Professor Dr. Reiner Springer, Wirtschaftsuniversitat, Wien Althanstr. 51, 1090 Wien, Austria, tel. 43-1-313 36/4371, fax 43-1-313 36/751, (Email: springer@isis.wu-wien.ac.at), or Professor Dr. Petr Chadraba, Kellstadt Center for Marketing Analysis and Planning, DePaul University, 1 East Jackson Boulevard, Chicago, Illinois 60604, USA, tel. (312) 362-6200, fax (312) 362-5647, (Email: pcha_drab@wp.post.depaul.edu.)

March 1-2, 1996, Trento, Italy

The European Association for Comparative Economic Studies will hold its sixth Trento workshop in cooperation with the Department of Economics of the University of Trento, Italy. The workshop will focus on defining the rules governing private supply; creating more suitable organizational forms of the for-profit firm in order to handle the problem of information asymmetry; promoting the voluntary supply of services of collective interest by fiscal means; and adopting a policy designed to develop private supply, whether for profit or otherwise.

Papers are called for in the following areas: theoretical analysis of the privatization of welfare systems; concrete models of welfare system privatization; analysis of policies promoting private supply; size, evolution, and features of the nonprofit sector and implications for policies for the privatization of welfare systems; and the consequences of welfare privatization on public spending, the level of welfare, and employment. Analyses of selected micro case studies are particularly welcome. Authors must be members of EACES and submit a twopage abstract in triplicate by September 16, 1995. Information: Bruno Dallago, Department of Economics, University of Trento, Via Inama 1, 38100 Trento, Italy, tel. (39461) 882-211, fax (39461) 882-222.
New Books and Working Papers

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

World Bank Publications

To receive ordering and price information for publications of the World Bank, write: World Bank, P.O. Box 7247-8619, Philadelphia, PA 19170-8619, USA, tel. (202) 473-1155, fax (202) 676-0581; or visit the World Bank bookstores, in the United States, 701-18th Street, N.W., Washington, D.C. or in France, 66 avenue d'Iéna, 75116, Paris. (Email: books@worldbank.org) (Internet address: http://www.worldbank.org/.)


Policy Research Working Papers


In Bulgaria, social transfers provide 24 percent of per capita household income. This is comparable to the share in other postsocialist European countries, but more than 40 percent higher than the share in OECD countries. Bulgaria's safety net needs better targeting. Comprehensive reform is needed, focusing on pensions, unemployment benefits, child allowance, and social assistance.

Dimitri Vittas and Roland Michelitsch, Pension Funds in Central Europe and Russia: Their Prospects and Potential Role in Corporate Governance, PRWP no. 1459, May 1995, 50 p.

Social pension systems in most countries in Eastern Europe and the former Soviet Union face severe financial pressure; the aging populations are facing a complete breakdown of the system. Restructuring and downsizing of the present system will leave adequate but affordable—thus sustainable—benefits and will allow for the creation and growth of private pension funds.

The shortcomings of company-based benefit plans suggest that transitional economies should opt in the longer run for contribution plans that are based on individual, fully funded capitalization accounts. Such schemes could operate with variable contribution rates, reset each year in accord with the salary growth of each worker, the cumulative investment return on his/her account, and the targeted pension benefit. Once private pension funds are established, long-term financial resources should accumulate rapidly. The funds can then play a major role in modernizing securities markets, stimulating innovation, fostering better accounting and auditing standards, and promoting greater disclosure of information.

The private pension funds could also greatly improve corporate governance and the monitoring thereof. Their "voice" in corporate affairs could be exercised more effectively through collective bodies, allowing them to create more robust structures of corporate governance and to lower monitoring costs. To order: World Bank, Priscilla Infante, Room G8-118, tel. (202) 473-7642.

IMF Publications


This paper examines the extent to which wage structures have adjusted during the economic transitions in the Czech Republic. Since 1988, returns to schooling have increased, driven by weakening returns to vocational education and sharply increased returns to university education. These changes are led by developments in the private sector and retarded by the sluggish response of state enterprises. This general pattern of changing returns emerges in other transition economies as well. As to differences between wage policies in the private and state sectors during the transition, the private sector appears to establish steeper career wage profiles and is more likely than the state sector to use past unemployment experience as an indication of a productivity deficit.

Wage structures in market economies are not free of distortions. The reconstitution of East European labor unions into genuine collective bargaining organizations has the potential for introducing one source of such distortion into the wage structures of economies in transition. Union representation is largely confined to the state sector. Unions in the Czech Republic have had no impact on relative wages in either the state or private sectors.


The Baltic countries began their stabilization and reform process in earnest in mid-1992. During the first two and a half years of reform, these countries have made significant progress in macroeconomic stabilization. Financial policies were tight, inflation was brought down, and by 1994, the output decline had bottomed out and recovery was under way. The paper argues that in light of the Baltic experience, the credibility of stabilization policies has been of greater importance than the choice of the exchange rate regime per se. Moreover, the cost of disinflation in terms of lost output was limited and short-lived.


C.E.E.P.N. Publications


To order: Central and Eastern European Privatization Network, P.O. Box 18, 61109 Ljubljana, Slovenia, tel. (38661) 168-3396, fax (38661) 346-660.

CASE Publications, Warsaw


To order: Center for Social and Economic Research, 00-585 Warszawa, ul. Bagatela 14, Warsaw, Poland, tel./fax (48-2) 628-6581.

CEPR Discussion Papers


Economic development in Eastern Germany is not uniform. The building and construction industry is booming but the manufacturing industry is stagnating. This paper argues that severe distortions in relative factor prices are the cause of the dichotomous development. These distortions result from excessive wage increases and investment support large enough to make the cost of capital...
negative for East German industry. The support for investment should be abandoned and a political compromise should be sought, to reduce the planned wage rises. The compromise could include an investment-wage agreement for insider workers and a distribution of the stock of public housing, to prevent workers from suffering wealth losses. It would be a Pareto improvement, avoiding the large welfare loss incurred by the policies currently pursued.


**DAE Working Papers**


**IRIS Publications**

Georges Korsun and Peter Murrell, *The Effects of History, Ownership, and Pre-Privatization Restructuring on Post-Privatization Governance*, Working Paper no. 147, January 1995. To order: *IRIS Center, 2105 Morrill Hall, University of Maryland, College Park, Maryland 20742, USA, tel. (301) 405-3110, fax (301) 405-3020, (Email: info@iris.econ.umd.edu).*

**The Mario Einaudi Center for International Studies Working Papers**


**I.C.E.G. Publications**


**Other Publications**

Privatization—Dirty Dancing
generate higher tax revenues in Russia.
To order: Geonomics, 14 Hillcrest Avenue, Middlebury, Vermont 05753, USA, tel. (802) 388-9619, fax (802) 388-9627.


To order: Institute of Economics, Estonian Academy of Sciences, tel. (372) 454-162, fax (372) 630-8851, (Email: mail@sekr.tami.ee).

Newsletters


SIGMA Public Management Forum, a quarterly newsletter of the OECD/CCET and EC/PHARE, for public administration practitioners in Central and Eastern Europe. To order: Public Management Forum, SIGMA-OECD Information Services, 2 rue Andre-Pascal, 75775 Paris Cedex 16, France, tel. (331) 4524-7900/4524-1311, fax (331) 4524-1300.

Wirtschaft im Wandel, published by Institut fur Wirtschaftsforschung Halle. To order: Professor Dr. Rudiger Pohl, Institut für Wirtschaftsforschung Halle, Delitzscher Strasse 118, 06116 Halle, tel. (0345) 7753 701, fax (0345) 7753 820.

What this much-higher-than-forecast nominal GDP implies for fiscal and monetary policy remains to be seen. But it is virtually certain that with the "shadow" economy growing robustly and now accounting for as much as a third of GDP, tax avoidance will continue to mean that higher tax rates do not necessarily
Bibliography of Selected Articles

Postsocialist Economies


CIS and the Baltics


Partial Success


Reddaway, P. Cancel the IMF Loan To Russia. Wall Street Journal (Europe), March 9, 1995.

Sokolov, I. Investment Crisis [in Russia]. Problems of Economic Transi-

Mr. Secretary, we managed to halt inflation—this morning, for fifteen minutes.

From the Hungarian magazine Hocipo
Bibliography of Selected Articles continued


China


Viet Nam


Central and Eastern Europe


Playing the Tax Game. The Budapest Sun (Hungary), June 1-7, 1995, p. 4.