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TRANSITION

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The World Bank's New Approach to Good Governance: Promises and Risks

by Johannes Linn

The World Bank has always recognized that economic institutions in borrowing countries should function more efficiently, more openly, and with greater accountability. What is new is the much greater recognition of bad governance. It is clear that misgovernance—distorted fiscal policies, unregulated banks, poorly defined property rights, discretionary business regulations, to name just a few of its forms—benefits a few privileged groups, at great expense to society at large. What hinders good governance is often the power of the vested interests that have a stake in the status quo and therefore resist changes.

Evidence suggests that a state with transparent and effective institutions is associated with:

- Higher income growth, national wealth, and social achievements.
- Institutionalized democratic competi-

tion and meritocratic government.

- Policies and a legal framework that are not “captured” by vested interests.
- A civil society and free media whose independent voice enhances the accountability of the government.

There is also clear evidence of the severely negative impact of ethnic fragmentation and ethnic tensions on economic development. Ethnically frag-

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Investment with a High Return: Supporting Economics Education and Research in Transition Countries

Minutes of a High-Powered Meeting at the World Bank

On May 22 a distinguished crowd gathered at World Bank's headquarters for a conference chaired by World Bank President James Wolfensohn and George Soros. Senior representatives of wealthy foundations—Aga Khan, Carnegie, Citigroup, Eurasia, ExxonMobil, Friedrich Ebert, Hewlett, Kress, MacArthur, Starr—met leading professors from institutions in Budapest, Kiev, Moscow, and Prague, institutions that are “centers of excellence” educating a new generation of economists. A third group was also present, the World Bank's team—the “catalysts.” The discussion centered on support for these schools of new economic thinking and the establishment of new ones. At the meeting several foundations pledged contributions or matching funds or expressed interest in providing financial and intellectual support for future projects. The following shortened transcript of the meeting captures some of the highlights of the discussion.

JAMES WOLFENSOHN (PRESIDENT, WORLD BANK): Capacity building is at the center of the development process in transition economies. And one of the most successful examples is the building of centers of excellence to ensure

that opportunities to study modern economics are available to local citizens to enrich their knowledge and participation. But capacity building is a continuing responsibility. The World Bank is pleased to be a part of this effort. But we also

recognize that it requires partnership between the Bank and other donors to be able to do more, both financially and intellectually. The Bank will continue to

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mented countries (and regions within countries) tend to provide fewer and poorer quality public goods, such as education. In contrast, institutions that guarantee minority rights and provide opportunities to resolve conflicts have been shown to offset the side effects of polarized societies.

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New Priorities Require New Approaches

The World Bank's recent focus on good governance means a much deeper appreciation of the complementarities of reforms across different realms—political, economic, social, and regional. Although since its very inception the Bank has been in the business of improving governance, this heightened recognition has had a profound influence both on what it does and how it does it. Consequently, the Bank is:

- **Supporting reform of public sector management.** Innovative adjustment loans to Albania and Latvia—supporting strengthened governance—have addressed the roles and responsibilities of government ministries and agencies, the developing conflict of interest, legislation and asset disclosure rules, and enhancement of the judicial system.

- **Supporting increased fiscal transparency.** Introducing a Treasury system in the Russian Federation has provided the basis for timely audits of fiscal accounts. Similar programs have been developed in Hungary and Kazakhstan and are under discussion in other countries in the region. In Albania the Medium-Term Expenditure Framework has facilitated a more open budget process, revealed links of government policies to budget outlays, and provided the public with better access to relevant information.

- **Dealing with the scourge of corruption.** Corruption is often the nourishment that sustains nontransparent institutions and inefficient policies. Bosnia and Herzegovina, Kazakhstan, Kyrgyzstan, Poland, Romania, and Slovakia recently received World Bank assistance for diagnosing problems of corruption and developing strategies for reform. Governance and anticorruption workshops were conducted in a number of countries, including Bosnia and Herzegovina, Poland, and Romania.

- **Building local capacity and fostering community-driven development.**

The Local Initiatives Project in Bosnia and Herzegovina gives low-income micro-entrepreneurs access to credit, through NGOs that serve as microfinance institutions. Half of the loans approved have gone to women and a fifth to returning refugees or displaced persons.

- **Monitoring and evaluating the impact of reform,** both to encourage greater accountability among the Bank's counterparts and to enhance safeguards in the Bank's lending activities. In operations that aim at reducing red tape, bribes, and other extra costs of doing business, the Bank has started directly surveying local firms to monitor impact.

- **Investigating the impact of state capture and political institutions on the quality of governance, economic growth, and poverty alleviation.** A recent report, *Anti-corruption in Transition*, investigates for the first time the patterns, levels, and causes of corruption and provides ideas and recommendations for designing and implementing effective anti-corruption strategies. Another major new Bank report, *Transition after a Decade*, highlights the critical role of new businesses as engines of growth in transition economies.

In developing Country Assistance Strategies, the Bank consults extensively with member-state governments as well as civil society, the private sector, local governments, and legislators. Posting information in national languages on the Web provides excellent opportunities for public access and lively discussions.

Project development and monitoring now involve a wide range of stakeholders, especially for projects that include community-driven development components. Broad-based consultations are conducted not just within the country but also with other donors. The Bank recognizes that reforms can be truly effective

and sustainable in the long-term only through country ownership and hopes that the Bank-assisted institutional reforms will become integral parts of government policies and gain public acceptance. Ultimately, of course, involvement of society in developing and implementing reform must be driven by the countries' own institutions and political processes.

Yet with all these changes, the Bank can only go part of the way toward removing obstacles to good governance. Its statutes limit involvement in domestic political affairs—and rightly so.

Risk of Reform Overload

Viewing reforms as interrelated, across sectors, entails some serious risks:

- First, by trying to address the roots of poor governance, the Bank may overload the reform agenda and overstretch both its own limited capacities and those of its counterparts.
- Second, even the most committed reformers might shy away from undertaking a huge mass of comprehensive and simultaneous reforms, including fiscal relations, civil service, pensions, education and health, banking sector, regulatory institutions, and so on.
- Third, overloading the reform agenda can undermine the credibility of genuinely reform-minded governments. Can they be blamed for the slow process of institutional development that took decades to achieve in other countries?
- Fourth, can the Bank really transfer the highest standards of knowledge in so many areas, simultaneously in many countries?

Selectivity, Flexibility, Gradualism

After grappling with these questions for quite a while, we became more selec-

tive, relying more on our partners and implementing projects with potential demonstration effects. Our approach to adjustment operations has become more gradual, and we have become more flexible in defining conditionality.

Clearer division of labor across different multilateral institutions and bilateral donors is also important. It is encouraging to see a broad consensus on issues of good governance among multilateral institutions and bilateral donors. But it is also important that each institution focus on its comparative strength. If each institution tries to tackle the same problems undermining good governance, the risks of overloading the agenda and overstretching capacities increase substantially.

Investment with High Returns continued from page 1

fund the New Economic School (NES) at the rate of \$250,000 a year for at least the next three years. We also want to help with the establishment of a Ph.D. program in economics at the Budapest-based Central European University (CEU). And we are eager to cooperate on the research programs of the Economics Education and Research Consortium EERC) and, as one of the founding partners, to continue to support that consortium.

GEORGE SOROS (SOROS FOUNDATIONS): I believe the NES has established its credentials, and the CEU has done likewise. And the Kiev—Mohyla Academy, which is supported by the EERC, as well as possible candidates such as the American University in the Kyrgyz Republic or the Kazakhstan Institute of Management, Economics, and Strategic Research, are islands of enlightenment in a rather dismal sea. These institutes are tremendously important in their areas. Having brought them into existence, we have a responsibility to help them achieve sustainability. Sustainability has four major components:

Our clients will be best served by establishing a clear focus in their relations with each multilateral and bilateral agency. Such a focus will allow them to set concrete and achievable goals for each part of the reform agenda—and to designate responsibility and capacity to various development institutions and bilateral donors to meet the goals within their particular sphere of competence.

Johannes Linn is the World Bank's Vice President for the Europe and Central Asia Region. This article is based on the speech he presented at the Conference on "Good Governance and Transparency in the Transition Countries," held in Prague, May 15, 2001.

- **First, the students themselves will have to contribute.** We have been pioneering a student loan scheme. We are already working with ABN AMRO Bank, which—in cooperation with the EBRD [the European Bank for Reconstruction and Development]—worked out a student loan scheme for business schools in Hungary. We should be able to apply the same scheme for NES. The chief economist of the EBRD has already expressed support.

- **Second, we need to rely more on local teaching,** which is important for sustainability as well as capacity building. Hiring local professors costs less than hiring Western professors. The NES has now hired its first crop of teachers who graduated from that school. That's very important to its sustainability. And the CEU is now graduating students who will be able to move into teaching in their alma mater.

- **Third, we need local support from the business community and the alumni.** The NES now has a local board to support it.

• **Fourth, the schools will need international support for at least the next three to five years** to be able to plan ahead. It would be desirable to make multiyear commitments and ensure good donor coordination. The amounts of money needed are not very large. The NES needs a commitment of about \$1.5 million a year for the next 3–5 years from international donors, after which it can depend on local support. If those of you here commit \$250,000, I will continue my support of \$350,000 a year for the next five years. And if we can get student loans kicking in, we'll be well on the way to \$1.5 million. For the CEU, I have created an endowment of \$20 million. But the university will need to call on other sources of support in order to grow. I'm encouraged by the cooperation with the World Bank Institute, and the promise of combining its general knowledge with the knowledge of CEU that comes from having students from all over the region. That should create a very productive environment.

NICHOLAS STERN (CHIEF ECONOMIST AND SENIOR VICE PRESIDENT,

WORLD BANK): Many citizens in the transition economies suffered great deprivations during the past 10 years. What started off with great idealism and enthusiasm has turned into a difficult experience, one we all share responsibility for in some measure. Some things we didn't understand very well, and sometimes we acted in ways that were short-sighted. But some things we did understand, and in those areas we acted in ways that were farsighted. The establishment of the institutions that we are discussing today is a clear example. These schools and the students they train are the real hope for the region. Graduates are participating in government and policymaking in their countries—a solid achievement. Now we need to find a way to help bring these institutions to the point of self-sustaining growth.

The need is as strong as it ever was—perhaps stronger, because we now have a better understanding of the importance of sound policymaking, including institutions and governance, in taking a coun-

try through a transition that has turned out to be longer and more difficult than we thought it would be. Today we understand even more deeply the importance of good economics in making good policy. So, to build on the real achievements of these schools, we need to support their move to self-sustaining growth.

No academic institution can rely on just one source of funding. It needs a broad range of support. If you get enough people involved, if you have students paying tuition, and if private and public sources are contributing as well, then an institution has a chance to survive. And that's why it's so important to get a group like this together.

WILLIAM BADER (VISITING RESEARCH FELLOW, WORLD BANK; AND FORMER ASSISTANT SECRETARY OF STATE FOR EDUCATIONAL AND CULTURAL AFFAIRS, U.S. DEPARTMENT OF STATE): In my role as the moderator, I would like to begin by stressing the importance of building private-public alliances. Such alliances

A Study on Strengthening Economics Education in Transition Economies

Strengthening economics education and supporting qualified economists who can teach economics at all levels and carry out high-quality research and policy analysis are still important issues in many transition economies. As *Transition* reported two years ago (“An Assessment of Higher Education in Transition Economies,” April 1999, vol. 10, no. 2), the Eurasia, Soros, and Starr Foundations and the World Bank sponsored a comprehensive study that assessed the state of economics education and research in 24 transition economies. It found that the need to build new indigenous capacity for teaching and research in market-based economics is particularly critical in the Caucasus, Central Asia, and Southeastern Europe. Given the financial and human capital constraints and the small size of some of the countries, a regional rather than a national approach is considered preferable. In the short term it is vital to start training substantial numbers of economics professors, policymakers, and others at high-quality

regional centers such as the economics department at the Central European University in Budapest, the Center for Economics Research and Graduate Education in Prague, the Economics Education and Research Consortium in Kiev and Moscow, and the New Economic School in Moscow.

The study helped to identify potential host countries and institutions for future regional centers of excellence in those three regions. Since its publication, progress has been made in designing regional graduate economics centers in the three regions. A steering committee has been created to coordinate project design, implementation, and fund-raising. Draft implementation plans have been written for all three regions and distributed to potential donors in Europe and the United States. And much effort has gone into building a partnership among governments, private foundations, international corporations, and international financial institutions.

contribute immensely to the quality and financial sustainability of the new education and research institutions that we will focus on during this meeting. After a decade of trial and error in the transition economies we now know without question that the long and arduous journey to market economies requires—indeed, demands—the development of indigenous institutional capacity to create and evaluate economic policies. This meeting features two world-class models of institutional success: the New Economic School and the Central European University.

GUR OFER (COORDINATOR, NEW ECONOMIC SCHOOL): The mission of the NES is to create and sustain a first-rate Russian graduate school of economics that focuses on teaching, research, and outreach to the community and on training a new generation of professional economists for Russia. When the NES started in 1992, visiting professors made up 80 percent of the faculty, and Russian professors represented only 20 percent. This year the ratio has been reversed, without any deterioration in teaching quality. As the proportions of international and national faculty shifted, the cost of teaching, which was very high at the beginning, fell considerably. It has not yet reached Russian salary levels, though, which is important for sustainability.

We are completing our ninth year of teaching modern economics in Russia. About 150 graduates are working in Moscow—in public service, in the central bank, in the Ministry of Finance, in international financial institutions, and in the private sector. We established a research center in 1995. We conduct workshops in economics throughout the country through partnerships with the University of Voronezh, the University of Ekaterinburg, and the University of Vladivostok. (See article about the NES's outreach program on page 8, *The Editor*.)

We plan to expand our education program. We also hope to establish a Ph.D. program, possibly in cooperation with the CEU, and a policy analysis unit focusing on current issues in Russia. Our vision is to create a "Russian House of Economics," a physical and institutional home for the several new economics institutions: the NES, which is engaged mainly in teaching; the Center for Economic and Financial Research (CEFIR), a research institute (headed by Erik Berglöf) with which we have close collaborative ties; and the EERC, which will disseminate the work of these other two institutions across Russia and other countries of the former Soviet Union.

About half our yearly expenditure of \$1.5 million goes to teaching, a little more than a quarter to research, and a little bit less than a quarter to outreach and dissemination. Currently we're being supported by MacArthur, Eurasia, the Open Society Institute, and others. We're also concentrating more on cost recovery. We seek your help in building an endowment as we also increase fund-raising in Russia and create a student loan fund. We believe that the idea that George Soros advanced today, that of a consortium of donors, is a sound one, and we hope that this forum will agree.

FABRIZIO CORICELLI (HEAD OF PH.D. PROGRAM, CENTRAL EUROPEAN UNIVERSITY): Broadening the funding base will not only permit greater stability and a longer-term perspective, it will also offer the CEU the opportunity to receive assessments of the quality and organization of its programs from a larger group of observers. When we started the Ph.D. program in 2000, we were constrained by the budget. A Ph.D. program requires a longer-term perspective, with a tenure track to attract top-quality professors and a solid research base. The CEU started in 1991 in Prague with a one-year master's program. In 1994 we moved to a two-year program to reduce the intensity of the program and to

broaden the curriculum. We also realized that a two-year program would give students the skills needed to return to their countries as high-level professionals. But many students have gone to top U.S. universities to complete their studies. This is obviously a favorable signal about the quality of the program, but it also shows the limits of a master's-only program, since most students attending U.S. and other Western programs tend to remain there. We decided, therefore, that it was important to commit to a Ph.D. program in order to prepare future academics and high-level professionals for the region.

BORIS PLESKOVIC (RESEARCH ADMINISTRATOR, WORLD BANK): The 1999 study (see box on page 4) found that the quality of economics education is especially low in three regions—the Caucasus, Central Asia, and Southeastern Europe (see box 1). Over the longer term we should establish regional centers there. That would concentrate our money and other resources and will have greater impact. And it is also a useful remedy against brain drain: if students can enroll in learning institutions in their own regions, they tend to stay there and contribute to the future development of their countries.

- **In the Caucasus** (Armenia, Azerbaijan, and Georgia) public funding has fallen sharply in the wake of armed conflict, but private institutions of higher education have proliferated in response to the great demand for higher education. The Eurasia Foundation and the EERC are designing a master's-level teaching program in economics. In their opinion, local universities must be involved, as the program would serve regional needs. In the summer of 2000 a planning forum in Tbilisi, Georgia, discussed the issue with rectors and economics deans from six universities—two each in Armenia, Azerbaijan, and Georgia. The groundwork is continuing.

- **The five republics in Central Asia** (Kazakhstan, the Kyrgyz Republic,

Tajikistan, Turkmenistan, and Uzbekistan) have already implemented some Western-style reforms of higher education. As in the Caucasus, the number of private institutions has increased in response to both the decline in public funding and the increase in demand for higher education. The exact location of a regional center will be determined through a regionwide competition, but the American University of the Kyrgyz Republic and the Kazakhstan Institute of Management, Economics, and Strategic Research are strong candidates for a regional graduate school of economics. The one selected will have an enhanced economics program with a

curriculum that better reflects the needs of the region and with expanded outreach activities to increase student and faculty representation from all five republics.

• **In Southeastern Europe** (Albania, Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia, Slovenia, and the Federal Republic of Yugoslavia) the major impediment to education reform is the maintenance of the status quo—the continued dominance of professors educated under socialism, the lack of scope and academic rigor in existing programs, and the lack of high-quality economics instruction and research. The country selected to host a regional

economics center will be politically stable and have a good geographic location and good infrastructure to attract students from other countries in the region.

HORTON BEEBE-CENTER (VICE PRESIDENT, EURASIA FOUNDATION): The EERC was created to promote the development of skilled local economists in Russia and Ukraine who can teach, conduct economic analysis, and formulate sound economic policy. Its ultimate goal is to build sustainable domestic institutions and a vibrant academic community. The consortium has been highly successful as a multilateral effort in pursuing this objective.

NES, EERC, CEFIR: A Triumvirate in Russia, Sowing the Seeds of Modern Economics

The New Economic School of Moscow (NES), the Economics Education and Research Consortium (EERC), and the Center for Economic and Financial Research (CEFIR) are committed to helping Russia and the other members of the Commonwealth of Independent States (CIS) develop all aspects of modern economics—education, academic research, policy analysis, and the training of professionals—and to reversing the brain drain that has characterized the transition period.

The New Economic School (<http://www.nes.ru>) was established in 1992 as the first nonstate graduate school of modern economics in Russia. Its main goal is to prepare a new generation of academic and professional economists through its master's program, taught by leading Western and Russian economists. So far, the NES has awarded master's degrees to more than 250 students. Half these graduates have remained in Russia and assumed positions as professional economists; the other half are continuing their studies in leading Ph.D. programs abroad.

The Economics Education and Research Consortium (<http://www.eerc.ru>) has created a coast-to-coast network of young economists in Russia who participate in twice-yearly research workshops, an annual conference, a series of advanced training seminars, and a research grant program. In Ukraine the EERC has established an international-quality, English-language master's program in economics and will create a similar research and outreach center this year. And

with funding from the World Bank's Global Development Network, the EERC is expanding its research network to include other CIS countries.

The Center for Economic and Financial Research (<http://www.cefir.ru>) is an independent think tank that provides economic policy advice to the Russian government. CEFIR members worked with the Putin administration's new economic program. The CEFIR research group was initially brought together through support from the European Union, under the RECEP project managed by the Stockholm Institute of Transition Economics (SITE, Stockholm School of Economics). Faculty members include top graduates from the NES and are among the first Western-trained Ph.D.'s who have returned to Russia (from Harvard University, Manchester University, and the Massachusetts Institute of Technology). Through its international network—which includes the Centre for Economic Policy Research, the William Davidson Institute, and SITE—CEFIR is developing a program for continued training. CEFIR's forthcoming journal, *Monitoring the Russian Economy*, will fill an important niche by combining the dissemination of high-quality research through short summary articles with the monitoring of micro- and macroeconomic activity.

Together, the NES, the EERC, and CEFIR form the foundation of the "**Russian House of Economics**," which strives to create a critical mass of modern economic knowledge—and of knowledgeable economists—in order to improve policymaking at all levels of Russian government.

The EERC consists of two core programs. The program in Russia focuses on professional capacity building, mostly through research grants and technical training. The program in Ukraine focuses on master's-level training in economics. About two-thirds of the program graduates are already employed in the public sector in Ukraine, including key parliamentary committees, the prime minister's office, the central bank, and other important institutions. Now we face the challenge of making the EERC sustainable. Funding remains vulnerable, and we are working to establish new revenue sources. In Ukraine we are looking into student loan programs. In Russia we are looking at outside sources of research grants. More donor coordination is essential to sustainability—now that the EERC, the NES, the CEU, and other programs have proven their value.

ERIK BERGLÖF (DIRECTOR, STOCKHOLM INSTITUTE OF TRANSITION ECONOMICS): Financial sustainability for these centers will come only after they have achieved acceptance and created a critical mass of well-trained economists in the transition economy in which they're located. The threshold they have to reach is much higher than I originally thought—and also much more important—because the forces aligned against such efforts are stronger than I had anticipated. Therefore, the think tank feature of these institutions—the policy support they can provide—is extremely important. It indicates that we're teaching not just an academic discipline but also a set of tools, a way of thinking that can be incredibly powerful when it gets into the policy process. Thus we need to broaden our activities to include policy support as well as teaching, research, and outreach. Another way to broaden our base is to work not only with the government but with business too. And we also need to appeal to the people who received their training in the West and have come back to work in the pri-

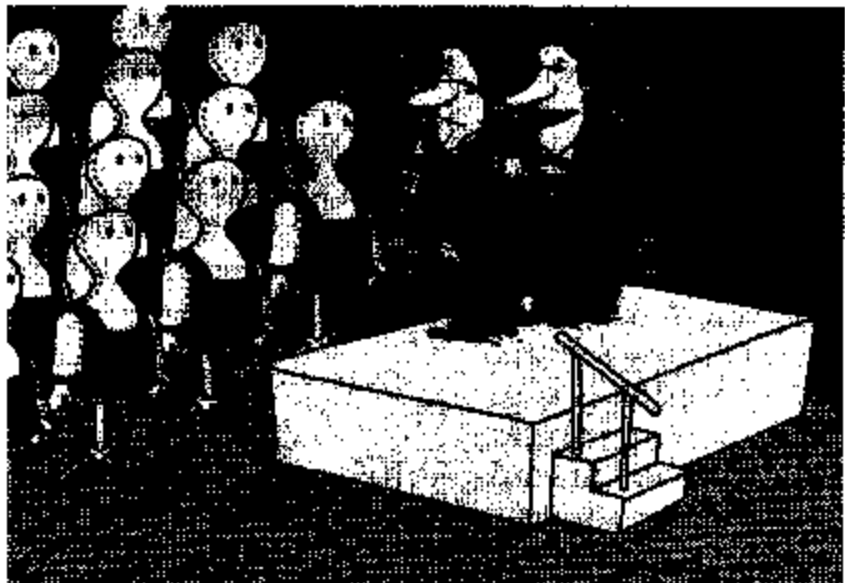
vate sector. They are a great untapped resource. There are a number of exciting areas of research in the intersection of law and economics and political science. In Russia today, the environment is not very conducive for a political scientist or lawyer trained in the West who wants to be involved in research. We can try to open things up a bit. And we need to empower those young people who are coming back after receiving training in the West.

MARCELO SELOWSKY (CHIEF ECONOMIST FOR EUROPE AND CENTRAL ASIA, WORLD BANK): Many of you have mentioned the high rate of return to investments in these centers of excellence. These returns accrue not only to the countries involved but also to Europe and to the OECD countries in general. It can be very difficult for countries to commit to reform programs if they don't have a team of trained economists who evaluate the policy options, identify the tradeoffs,

and begin to depoliticize some of the economic discussion. And this capacity is fundamental for integrating these countries with Europe.

In Russia, Ukraine, and elsewhere it is still very easy to make protectionist arguments that have repercussions for European foreign direct investment and other relations with these countries. Russia still gets only one-tenth the foreign investment that Poland gets. If there aren't a certain number of well-trained economists who can explain to the population why it shouldn't fear foreign direct investment, reform can hardly take hold. More than in any other group of countries, among the transition economies lack of knowledge is a greater constraint to reform than lack of political will. Therefore, the high returns to these investments in education benefit not just the countries directly involved, but also the West, especially Europe.

PR is the Most Important



“That was almost perfect, now let's try again. When you announce the immediate layoff of all 8,000 employees have a little more sadness in your voice.”

From the Hungarian Economic Daily *Világazdság*

Outreach of the New Economic School: Regional Capacity Building in Russia

by Sergei Guriev

The Russian Federation began its transition to a market economy with virtually no tradition of education and research in modern economics, as the numerous economics departments were dominated by ideologically biased Marxist political economy programs. One of the main challenges of Russia's economic transition has been building capacity in economics.

Since the transition began, many attempts have been made to improve the quality of education in economics. One of these efforts is the New Economic School's Outreach Program, launched in 1998. The New Economic School (NES) was established in 1992 as the first nonstate international graduate economics program in the Russian Federation. When the program was started, most of the courses were taught by visiting professors from the West. The strategic goal, however, was to build a sustainable modern economics department. To do so, NES began bringing back Russian economists with Ph.D.s from top universities in the West.

Once it was clear that, together with the Center for Economic and Financial Research (CEFIR), a Moscow-based research institute, NES had achieved a minimum critical mass of well-trained

economists, it began to disseminate expertise to universities in Russia's regions. In 1998, through a generous grant from the MacArthur Foundation, NES launched its Outreach Program. The main goal of the program is to work with economics faculties across the country to help them upgrade skills and transform their teaching.

Obstacles to Teaching Advanced Economics

Such an effort was long overdue. Both the returns to investment in training trainers and the losses associated with failing to do so are huge. A perfect example of an institutional trap, the economics profession in Russia had slipped into a self-sustained equilibrium in which the old political economy school kept reproducing itself. The old guard is on its way out, but it has trained a younger genera-

tion of academic economists. Although these students have not inherited the older generation's ideological bias, they have not acquired the analytical tools of modern economics (usually disdainfully referred to as "theoretical" or even "mathematical" economics).

The implications of this failure have an effect far beyond academia. Without these tools, economics training is limited to introductory courses in micro-economics and macroeconomics, which are too basic to be applicable to Russia's complex economic problems. More advanced courses and the tools needed to study and analyze Russian economic reforms remain by and large unavailable. Hence "Western" economics is thought of as being too simplistic to be of use in real Russian life—a view that helps create distrust of economic policies based on "Western" economics and of economic reform in general.

Accomplishments of the NES Outreach Program since Fall 1998

- **30 one-week workshops attended by 400 participants** from more than 100 universities, held in Ekaterinburg, Irkutsk, Kislovodsk, Kostroma, Moscow, Nizhny Novgorod, Novosibirsk, Perm, St. Petersburg, Tomsk, Vladivostok, and Voronezh. Subjects taught included introductory and intermediate econometrics (including panel data, binary choice, and time series); intermediate and advanced microeconomics (including general equilibrium theory and contract theory); intermediate and advanced macroeconomics (including growth and new Keynesian models); financial economics (asset pricing); labor economics; and public economics.
- **Two Summer Schools**
- **Visiting Scholar Program**, in which 25 provincial faculty visited NES for half a semester to take courses and conduct research.
- **Academic Partnership Program**, which has established long-term partnerships with the Department of Economics of Voronezh State University, Ural State University Department of Economics, Far Eastern State University.

The poor state of economics education is also exacerbated by the separation of education and research inherited from the Soviet era. Under the Soviet system, research was concentrated in the Academy of Science; university professors in the social sciences were not motivated to do research (the situation was somewhat better in mathematics and the natural sciences). This lack of integration between teaching and research represents another barrier to introducing advanced courses into economics curricula.

Another problem is the growing gap between Moscow (and to some extent St. Petersburg) and provincial universities. While these metropolises are managing to reverse the brain drain and establish solid institutions in economics research and training, there have been almost no success stories elsewhere in the country.

Successful Partnerships

The NES Outreach Program was conceived as an ambitious operation, and it has been growing since its inception. The first major outreach activities were one-week long workshops and two- to three-week summer school sessions. Thirty of the best economics faculty from the regions participated in each workshop, taught by NES faculty. The workshops have been very popular, with tough competition for participation in each. During the workshop participants spent all their time in the classroom, with many doing homework into the evening.

In 1999 NES became one of three resource centers in the pilot stage of the regional capacity-building effort undertaken by the Open Society Institute (OSI), the organization funded by philanthropist George Soros. OSI launched a program to upgrade provincial departments of social sciences. Instead of supporting individual faculty, the project aimed at building institutions of modern education and research in Russia's provinces.

Within this project, NES has formed three long-term partnerships with departments of economics in Voronezh, Ekaterinburg, and Vladivostok. Each partnership is a two- or three-year project that includes comprehensive modernization of the provincial department. In addition to workshops and mini-courses, NES has helped its partners revise their curricula, upgrade their libraries, launch joint research projects, and bring provincial faculty to NES as visiting scholars. The visiting scholars spend half a semester at NES, where they take courses, work in the library, and discuss their research and course programs with NES faculty. So far NES has hosted about 20 visitors from partner universities. The visiting scholars program has proven so successful that NES has opened it to faculty from institutions outside the partnership program.

NES would not be able to carry out its Outreach Program alone. Fortunately, it has already graduated almost 300 economists, more than 100 of whom continued their education in top Ph.D. programs abroad. Some of these economists have returned to the Russian Federation to become the first tenure-track faculty at NES and CEFIR; they are the main resource of the Outreach Program. Others have assumed academic appointments in the United States and European universities. NES regularly

brings these scholars to Russian provinces for short periods of time.

Measuring Achievements

So what has NES Outreach achieved, and how far has it yet to go? Is there a light at the end of the tunnel? One good test of success would be reaching the point at which provincial departments are able to reverse the brain drain, at least to the level achieved in Moscow. It is true that Moscow is a special case and that what is feasible there may be impossible in other Russian cities. But a decade ago no one believed that Moscow would be able to reverse the brain drain.

It has taken NES almost 10 years and a strong vision to build its very small but growing faculty, and it will take another 10 years before it becomes a full-fledged department of economics. But we now have a much better understanding of how to build modern academic institutions in contemporary Russia. We may well have cause for cautious optimism that the first Russian regional economics departments will emerge as early as a few years from now.

Sergei Guriev is assistant professor at the New Economic School and the Center for Economic and Financial Research in Moscow. More information about CEFIR can be found at <http://www.cefir.org/>.



Centre for Economic and Financial Research, 117418 Russia, Moscow, Nakhimovsky pr., 47, office 720, phone +7 095 105-5002, fax 105-5003, e-mail: cefir@cefir.ru

China's Great Financial Challenge

by Henk van Gemert

Over the past 20 years China's financial system has gradually evolved from the traditional monobank system of the prereform period to the diversified, multi-tiered system of today. New institutions have been set up, new laws prepared, and new channels of financial intermediation established. While the emergence of this financial system is a great achievement in China's transition, financial "deepening" in China has been incomplete and unbalanced, for several reasons:

- First, the reform took an institutional rather than a functional approach. It

Financial Reform in China: Bridging the Gap between Plan and Market

Financial Reform in China: Bridging the Gap between Plan and Market, *written as a joint project by 10 Chinese experts brought together by the editor, Henk van Gemert, addresses key issues facing China's financial system today. The volume analyzes three major goals:*

- Modernizing the macroeconomic management regime, including the monetary policy, exchange rate policy, and opening-up external liberalization policies.
- Improving the efficiency and effectiveness of financial intermediation, including restructuring and commercializing banks, deepening and widening capital markets, further developing nonbank financial services (such as insurance and securities), and establishing an adequate regulatory framework.
- Removing obstacles between the financial system and its main customers, notably the big state-owned enterprises, the nonstate industrial sector (particularly small and medium-size enterprises), and the agricultural sector.

sought to establish and perfect a new financial infrastructure—in terms of formal institutions and laws—without much attention to whether the system functions effectively and efficiently or whether the people have adopted accountability and commercial behavior.

- Second, throughout the reform period the Chinese government has wanted to use the financial system as a powerful instrument, available on demand, to both drive the economy in the desired direction and achieve the political objectives of industrial and macroeconomic development. The long-term goal of creating an independent, market-driven financial system has often had to be sacrificed to short-term political considerations.

- Third, the reform has bowed to vested interests, avoiding and postponing steps considered too radical and painful. Financial deepening has coexisted with financial repression. Market forces have been introduced, but state ownership and state intervention have exposed the sys-

tem to weak competition and persistent moral hazard problems. Banking and finance have become key sectors, but most markets are underdeveloped, operating costs are high, and informal finance is common. Banks have become more independent, but most public savings go to state-owned enterprises, while the private sector lacks adequate financing. Supervisory bodies have been set up, but the system is still opaque, and implementation and enforcement of the new regulation inadequate.

Recently, as the economy began to feel the pinch of financial constraints, the Chinese leadership decided to accelerate the reform. Moreover, it was recognized that China would have to take more radical steps to prepare for entry into today's competitive global environment upon joining the World Trade Organization (WTO). Indeed, the idea of China "joining the world" has already started to serve as a catalyst for further reforms.

The author with the Chinese team of contributors



Table 1 presents a selection of the major tasks China faces in the short and medium term—at both the macroeconomic and the sectoral levels. Most measures include functional or behavioral changes, which by their nature take a long time. It may be another 10 years before the coun-

try can enter the final stages of its transition toward a fully fledged market economy. China's great financial challenge is to continue its comprehensive, ambitious reforms—in particular, steadily improving financial efficiency, financial discipline, and monetary management.

*The author is a professor at Tilburg University. This article is based on a book that he recently edited, *Financial Reform in China: Bridging the Gap between Plan and Market*, Maastricht: Shaker Publishing, 2001, 247 pp.*

A Proposed Financial Reform Agenda for China

	Short-term measures (1-4 years)	Medium-term measures (4-10 years)
Monetary policy	Liberalizing interest rates for bank deposits and bank loans. Improving indirect policy tools. Abolishing directed (political) lending.	Adopting a fully market-based strategy of demand management. Exploiting new channels of monetary transmission. Adopting policies of greater independence and accountability.
External liberalization	Further simplifying the foreign exchange administration. Allowing more exchange rate flexibility. Starting a gradual removal of capital controls. Permitting foreign banks and other financial institutions to enter China, in accordance with the WTO agreement.	Adopting a fully flexible exchange rate regime. Continuing the gradual and cautious removal of capital controls and ultimately, if preconditions are met, adopting full capital account convertibility. Allowing foreign banks and other financial institutions to compete on a level playing field with domestic banks.
Regulation and supervision	Implementing the newly approved regulations for banks and other financial intermediaries. Strengthening prudential supervision. Clarifying and harmonizing operational standards, provision requirements, and accounting rules. Developing a new law for closure and bankruptcy of financial institutions. Introducing safety nets such as a deposit insurance scheme and lender-of-last-resort facilities.	Finishing the process of replacing direct state intervention and state protection with a market-oriented regulatory framework. Reconsidering the segmentation of banking, investment, and insurance.
Human resources	Education! Encouraging retraining and professional upgrading activities. Improving management models.	Education!
Banking	Continuing the commercialization process by allowing more competition and accepting diversified ownership structures. Improving the quality of banks' assets through debt restructuring and debt transfer. Increasing operational efficiency while reducing overstaffing and overbranching.	Finishing the process of cleaning up banks' balance sheets and introducing uniform capital adequacy ratios based on internationally accepted standards. Giving up majority state ownership.
Financial services	Adjusting the number of rural and urban credit cooperatives through mergers and liquidations. Screening and rectifying the numbers and business scope of local trust and investment corporations. Modernizing the payment system. Supporting new financial products while dealing carefully with associated risks.	Streamlining the structure of the financial services industry. Expanding the supply and improving the quality of products.
Direct finance	Continuing to develop securities markets by simplifying trading procedures, improving information disclosure procedures, and upgrading the legal framework.	Liberalizing asset prices and allowing the stock market to reflect borrowers' financial conditions and to execute corporate control.
Economic activity	Continuing the reform of state-owned enterprises while accepting diversified ownership and taking over social responsibilities. Removing financial barriers for the nonstate	Finishing the restructuring and privatization of state-owned enterprises. Continuing the establishment of a social

The Transformation of China's Banks and Capital Markets

For the first time since the private sector began to reappear in the late 1970s, private businesses have access to public capital. Enterprises that are free of foreign ownership, have three years of profitability, and hold at least 30 million yuan (about \$3.6 million) in assets can now turn to the country's underwriters with the hope of going public. China's senior leaders have recognized that a capital-backed private sector could be the country's best hope for economic survival after it joins the World Trade Organization (WTO), when global competition is expected to squeeze China's state-owned enterprises. Growing private companies can absorb excess labor, generate taxes, and help save China's economy from domination by foreign firms.

Truly private companies, majority owned by individuals, still account for less than 20 percent of China's economic output and for only about 50 million of the jobs held by its 1.4 billion people. But that's changing fast. Many town and village enterprises are emerging under individual ownership, and they constitute the largest class of capital-hungry private enterprises in China today.

Meanwhile, a smaller, more potent class of entrepreneurs is forming—Internet-related start-ups, networking companies, software companies, and high-technology equipment manufacturers.

Allowing Private Access to Public Capital

Until late last year the state authorities decided who could list stock on the country's two exchanges, Shanghai and Shenzhen, and rarely granted the privilege to private companies over state-owned firms. But that has changed, first in the "B-share market"—where shares of Chinese enterprises are denominated in foreign currency and only foreign investors and domestic securities companies were allowed to invest—and now in the much larger "A-share market." Here, shares are denominated in yuan and reserved exclusively for domestic investors.

The B-share market was established in December 1991. The market faltered, undermined in part by the attractiveness of the Hong Kong Stock Exchange as a place to list quality state-owned enterprises, in part by divestment by foreign companies that became disenchanted with the quality of the companies listed there and with the market's poor liquidity. Only 15 percent of the B-share market's capitalization is thought to remain foreign owned. By the end of 2000 the A-share market's tradable capitalization reached \$192 billion, while that of the B-share market was no more than \$5–7 billion.

The B-share market has recently undergone a rapid revival, however, aided by the government's announcement in February that local investors would be allowed to buy B-shares. Domestic investors have since bought heavily on this market.

By June the number of B-share accounts could total half a million—twice the number before the February announcement—and the market could attract a net inflow of \$2.5 billion.

There's plenty of capital available. In March 2001 Chinese residents had around \$78 billion of hard currency deposited in state banks (and probably at least as much outside bank accounts). In addition, state-owned enterprises held foreign exchange deposits worth \$48 billion. Serious institutional investors—mutual funds and pension funds—would give the now volatile markets depth and a longer-term perspective. Those investors, though now state owned, will eventually demand better governance of the companies they invest in, and fewer government limits on their growth. (Right now they cannot invest in the B-share market.) The likely result will be a stronger, more flexible economy. As the private sector grows, it will inevitably become a powerful political constituency.

Competing with Foreign Banks

China's accession to the WTO will increase the pressure on the banking sector. Within five years of accession, under the agreements concluded with the United States and the European Union, the domestic banking sector will be substantially opened to direct foreign competition: foreign banks will be allowed access to local currency business, and the still rudimentary domestic sector will be exposed to the sophisticated marketing and risk assessment skills of international banks.

China's banking system consists of 4 state-owned commercial banks established in the late 1980s, 3 policy banks set up in 1994 to channel long-term funds to favored areas, 10 national joint-stock commercial banks, around 90 city-based commercial banks, and about 3,000 urban and 42,000 rural credit cooperatives. Some 160 foreign banks have branches or representative offices, but their activities are restricted and their share of the market is tiny.

The four state-owned commercial banks—the Bank of China, the Agricultural Bank of China, the Industrial and Commercial Bank of China, and the China Construction Bank—control an

overwhelming share of the market. In late 2000 they accounted for 66.5 percent of loans outstanding and 70.9 percent of deposits. They also dominate in terms of branches and employees—employing nearly 2 million people in about 103,000 branches across China.

Shoring Up Commercial Banks

The government has in recent years taken several steps to shore up the four state-owned commercial banks, which have suffered from heavy burdens of nonperforming loans. Many firms in the state sector are unable to service debts as a result of general inefficiencies, difficult markets, and increased competition. In 1998 the state injected additional capital of 270 billion renminbi (\$32 billion) into the four banks. In 1999 four asset management companies were set up to acquire—and, if possible, dispose of—their nonperforming loans. The transfer of bad assets to asset management companies has so far been restricted chiefly

to debts contracted before 1995, when the current Commercial Bank Law was passed. That means that 1.4 trillion renminbi in assets from the four commercial banks—about 20 percent of their combined outstanding loans—has been transferred to the asset management companies. In addition, 580 state-owned enterprises agreed to swap another 340 billion renminbi for equity. Financial sector reforms since 1997 have strengthened the banks' balance sheets, and a more rigorous supervisory structure is being put in place.

Once foreign banks settle in China, they will be allowed to set up joint ventures with Chinese partners, and wholly owned foreign banks will be able to operate after five years. This prospect adds to the urgency of further reforms in China's financial sector.

Based on a New York Times article by Craig S. Smith and reports of Oxford Analytica

Building Support for Policy Change by Improving Governance in China: The Case of Shunde

by Yang Yao

The lack of proper state governance is the most important factor hindering economic performance after privatization in many transition economies. Tangible “self-restructuring” of the government can lend credibility and thus public support for implementing policies, as the experience of one Chinese city, Shunde, shows.

The important role played by radical government reform is clearly demonstrated in the privatization program implemented in Shunde in the 1990s. Located in the Pearl River Delta in China's Guangdong province, Shunde is a new city of about 1.2 million people. Its economy produces every kind of home appliance except television.

During the 1980s Shunde was renowned for its development of township and village enterprises. In the 1990s the pitfalls of public ownership became apparent. The most serious problem was that township and village enterprises, like their state-owned enterprise counterparts in the city, had accumulated huge debts, which the local government was obligated to repay. To

solve the problem, several local governments opted to privatize the enterprises.

Gaining Public Trust through Governance Reform

Shunde was among several pioneer cities that started privatizing as early as 1992. By 1999 only a handful of its public firms, mostly in the energy and utility sector, remained in government hands. Privatization eventually spread across the country: by the end of 1998, more than 80 percent of the public firms at or under the county level had been privatized

Because the best incentive for local governments to carry out privatization was to stop assuming the liability of more

nonperforming loans, privatization could have been easily seen by the public only as a way for the government to get rid of its financial obligations. Without genuine governance reform, people would have had the idea that the government would compensate its loss of the privileges associated with enterprise ownership by putting a more aggressive “grabbing hand” into the firms. Thus governance reform is necessary to initiate privatization, and investment is required after privatization. Shunde's local government has done both.

The central goal of Shunde's governance reform was to transform the role of the government from a player to an arbitrator in the economy. This transformation involves not only changes observable to

the public, but more important, intangible changes, such as anti-corruption supervision inside the government, the improved morale and integrity of public servants, enhanced government regulation and administration, and ultimately, a greater commitment by the government to the rule of law.

Improving Effectiveness by Shrinking

The government signaled its intentions through radical structural changes. First, it cut the size of its administra-

tive staff by nearly 40 percent, from 1,400 to less than 900. This much smaller government size has been maintained since the reform was initiated in 1993. As a result, the Shunde government did not need to do anything when a nationwide government reform program aiming at downsizing 15 percent of governments at all levels was launched in 1998. Second, policymakers reduced the number of government departments from 49 to 29. As a result, many functional departments simply vanished. For example, there were 14 bu-

reaus in charge of agriculture before the reform, now there are only 4. Several agencies in charge of industry were merged into one, whose role was transformed from managing to providing administrative support and services. To increase the transparency, the Shunde government publishes a monthly bulletin containing information on government regulations and activities.

A comparison of Shunde and other cities in China reveals much about the relation between governance reform and

The Entrepreneur and the Politician

Policymakers considering state governance reform face two main challenges. First, in many cases improvements in state governance are intangible or are not immediately verifiable by the citizenry. Second, having been deceived by their totalitarian regimes for decades and left unsatisfied by the unfulfilled promises put forward by recent reform programs, citizens in transition economies are skeptical about the intentions of any state-initiated programs. The government thus has to make credible commitments in order to convince the citizenry that establishing the rule of law is desirable for the government itself.

Consider an economy consisting of a firm, a politician (representing the government), and an entrepreneur (representing the private sector). The politician has a limited tenure of two periods. Initially, the government owns the firm, but it delegates its management to the entrepreneur, who receives a fixed wage. The entrepreneur derives utility only from his income; the politician derives utility from government income (now the profit of the firm) and the number of his or her subordinates (that is, the size of the government, which gives the politician a sense of power). A large government, however, entails deadweight loss to the firm's output. In addition, the entrepreneur, who is paid a fixed wage, puts limited efforts into management, so the firm loses money.

In the first period, the politician decides whether to privatize the firm and whether to reform state governance. If it succeeds, privatization shifts ownership to the entrepreneur, who then puts all his efforts into managing the firm, causing the firm's output to rise for the same size of the government. Government income comes from a tax levied on the firm's output. In effect, the tax includes regular taxes, unwarranted

fees, extra transaction costs, and any other kinds of cost borne by the entrepreneur as a result of poor state governance.

Privatization is a dominant strategy for the politician because government income becomes positive after privatization while the politician is able to enjoy the same level of power. The state governance reform is defined as a less predatory government, one that exacts a smaller tax on the firm. The reform is necessary to induce the entrepreneur to invest in or even buy the firm. The politician, however, may be of two types, the "L type," which is more predatory in tax collection and has more desire for power, or the "H type," which is less predatory in tax collection and has less desire for power. Reform of state governance occurs when the politician chooses to be an H type.

The entrepreneur cannot verify whether the reform is actually carried out, because it is intangible and the tax is realized only after the entrepreneur buys the firm and produces. We assume that if the higher tax rate is realized, investment is not profitable for the entrepreneur. But the fact that the reform cannot be verified gives politicians an incentive to cheat: they may promise state governance reform and then impose a high tax rate after the entrepreneur has purchased the firm and begins producing. Because of this possibility, the entrepreneur can rightly be skeptical of the politician's promise of reform, even if the politician really intends to implement it. To convince the entrepreneur that the state governance reform is the politician's time-consistent action, the politician has to send a credible signal to show his or her intention to reform. One such signal is reducing the size of the government.

privatization. Most firms in Shunde were privatized by management or employee buy-out; in contrast, in many cities privatization meant nothing more than changing the firm's name. In southern Jiangsu province, internal disputes within privatized firms were reportedly common because of the forced nature of the privatization process; in some localities many firms were simply dissolved and degenerated into family workshops. The lack of political and government assurance was cited as a key factor leading to these dismal results.

Shunde's governance reform has not only resulted in thorough and genuine privatization, it has also begun to bring favorable reactions from the private sector. This is shown by a 1999 survey on 338 private entrepreneurs in six Chinese cities, including Shunde. To the question "how many major law, regulation, or policy changes occurred in the last three years that affected your business?" the average answer in Shunde was 0.36, while the average for all six cities was 2.54. These results suggest that the policy environment is much more predictable in Shunde than in other cities.

In addition, more people in Shunde trust the courts: 40.6 percent of firms in Shunde—but just 30.7 percent of firms in the larger sample—were willing to seek justice in court. In terms of administrative irregularities, Shunde stood tall: no arbitrary fee collection was reported in Shunde, whereas it was one of the most complained about issues in several other cities.

As for government services, Shunde had the lowest number of power cuts and the smallest average losses reported by firms. The wait for telephone installation was also much shorter in Shunde than elsewhere (6.3 days versus 22.5 days in Beijing). In addition, none of the firms in Shunde complained about the quality of phone services, while the percentage

of firms filing complaints in Chengdu, Mianyang, and Deyang were 22 percent, 31 percent, and 23 percent, respectively. In terms of water supply and drainage, Shunde ranked high or medium.

Clues to Shunde's Success

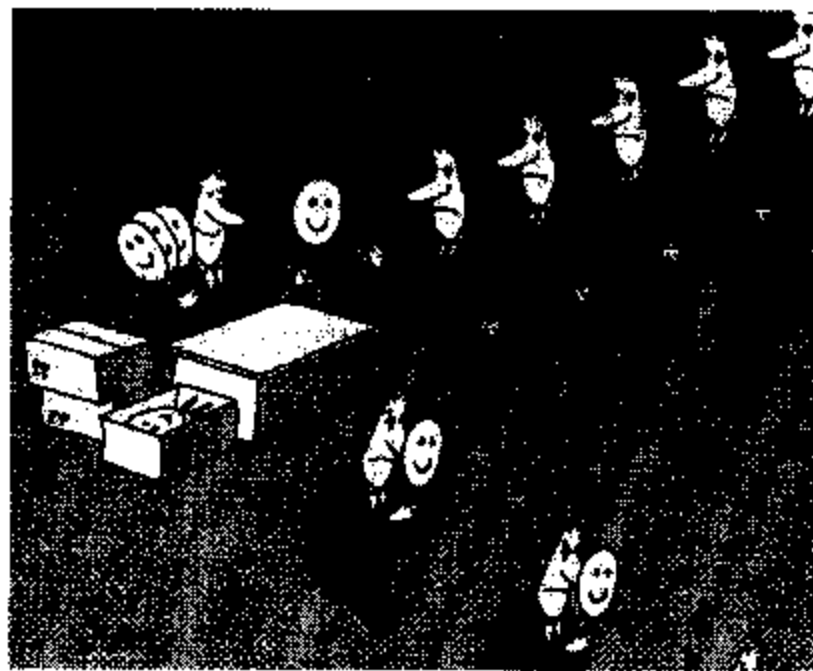
What factors have contributed to the success of Shunde's governance reform? The size of the economy and the time horizon of the politicians are two key factors. In the economic arena, the city's electronics industry has maintained a technological edge within China. In the political arena, the mayor of the city is deeply committed to the local economy, having turned down several promotion opportunities.

Transition from a command economy to a private property-based economy involves not merely the establishment of private property rights but also the transformation of the governance of the state, where the guardians of private property rights reside. Adoption of private property rights is relatively easy

compared with the transformation of state governance, which involves political, social, and cultural obstacles. The problem is how to first convince politicians that they should downsize and streamline the government and then how to convince the public of their genuine intention to do so. It is therefore vital to establish a "political free market" that encourages political parties to maintain a program regardless of who is in office, or open political debates, which create confidence among the citizenry that there is a consensus on key issues. External constraints (such as the legislative body) enforcing verified government choices are helpful to ensure state governance reform and high economic performance.

Yang Yao is associate professor at the China Center for Economic Research at Beijing University. His email address is yyao@ccer.pku.edu.cn. This article was adapted from his paper, "Government Commitment and Privatization," (September 2000).

Keep Smiling!



From the Hungarian Economic Daily *Világgazdaság*



SITE

Stockholm Institute of Transition Economics
STOCKHOLM SCHOOL OF ECONOMICS

Nice Try? The Uncertain Future of the Nice Treaty

by Richard E. Baldwin, Erik Berglöf, Francesco Giavazzi, and Mika Widgren

Ireland's rejection of the Nice Treaty in June could mean the end of the agreement. No tears should be shed, however. While in principle the treaty opened the European Union's (EU) doors to enlargement, in reality the proposed reforms could hardly have satisfied the needs of an organization with more than 27 members. In fact, the treaty would have made EU decisionmaking less rather than more effective. The treaty also failed to deal with the issue of safeguarding the operational efficiency of the European Central Bank. What should be done to keep the enlargement process on track?

The Nice Summit, held last December, aimed to remove obstacles to Eastern enlargement imposed by the Amsterdam Treaty and to ensure that the operation of EU institutions remains efficient and legitimate, even after its membership nearly doubles in size. The summit met the first objective, but it failed almost completely to achieve the second.

Failings of the Nice Treaty

The Amsterdam Treaty left open three issues, which it explicitly required be settled before enlargement: the size and composition of the European Commission, extension of qualified majority voting (the number of votes needed to pass or block an EU decision) in the EU's council of Ministers, and reform of the Council voting rules. The latest report in the *Monitoring European Integration* series published by the Centre for Economic Policy Research (CEPR) argues that the Nice Summit failed on many fronts.

- **Reform of the European Commission.** Decisionmakers at Nice adopted a temporary, makeshift reform—temporary because it applies only from 2005 to the date when the 27th member joins, makeshift because a long-term solution was not established. According to the Nice Treaty, beginning in 2005 each member state will get one commissioner. Once the number of member states reaches 27, the council will have to unanimously agree to reduce the number of commissioners to fewer than 27. The tough decisions were thus postponed.

- **Increase in qualified majority.** According to a nonbinding declaration, the qualified majority in the Council of Ministers will be increased from 71.3 percent to 73.4 percent of the votes. The increase will take place in stages, until all applicant states have joined the EU.

- **Reform of decisionmaking by the Council of Ministers.**

The Nice Treaty's reform of decisionmaking by the Council of Ministers actually made things worse. EU leaders adopted an extremely complicated system that would have made it more difficult for the enlarged EU to act. Power tilts toward large nations. Poland and Spain were each given 27 votes in the council, 2 fewer than the four largest countries. Romanian, with a population of 22.5 million, was offered 14 votes. The Netherlands, with a population of 15.5 million, was offered 13.

- **Maintenance of the effectiveness of the European Central Bank.**

Nice was supposed to implement institutional reforms needed to prepare for enlargement. Enlarging an unreformed European Central Bank to include 5 or 12 new members would turn this critical policymaking body into a large, unwieldy group that would have trouble making difficult decisions in a timely manner. The treaty, however, failed to deal with the problem, instead encouraging the European Central Bank and the commission to propose solutions.

- **Establishment of dates for enlargement.** Enlargement is a process, not an event, and there is a strong possibility that the first enlargement wave may seriously delay subsequent waves, slowing reform momentum in applicant nations. To redress this problem, the EU should have set "entrance exam dates" for evaluating which nations are fit to join the organization. It missed an opportunity to commit members to dates.

The Nice Treaty would significantly alter the way the EU functions. By making the decisionmaking process of the Council more cumbersome, the treaty would slow European integration, which relies on legislation and thus the council's ability to act. Further integration is likely to rely more on member states' initiatives, perhaps channeled into new enhanced co-

operation arrangements. ("Enhanced cooperation" means faster and easier integration in certain areas, such as the visa regime or the Economic and Monetary Union, which created the Euro common currency. Accession into the EU does not automatically entail inclusion in these arrangements, for which candidates must meet other conditions.) The commission has a crucial role in enhanced cooperation arrangements, for if these arrangements become more common, the Commission's influence may expand.

Enlargement at Stake

Institutional reforms can wait; Eastern enlargement should not. The European ideal was born in the devastation caused by intolerance and destructive nationalism. The East-West division of Europe is the last remaining element of this pre-1945 world, and only Eastern enlargement can remove it. Enlargement would fulfil the aspirations of 100 million Europeans who chose freedom, democracy, and markets, and it would ensure political and economic stability in Europe. Enlargement is quite simply a historical imperative. Council voting weights will be a historical footnote.

Killing the Nice Treaty would recreate the situation that led to the Nice mess in the first place. The Amsterdam Treaty made EU reform a precondition for enlargement. This sequencing was at least part of the reason why Nice became the longest meeting (five days and nights) in the history of the EU's intergovernmental conferences and still failed to achieve its goals. If reform is a precondition for enlargement, interests that are lukewarm to enlargement are granted leverage. Had enlargement instead been locked in first—as it had intended to be at the Nice Summit—such "hostage taking" would have been less effective, and the new members would be able to make their own suggestions, rendering the agreed upon reforms more sustainable.

Repairing the Damage

Different views have been put forth to account for the Nice blunder. In one view, EU leaders did not realize the serious negative consequences of their actions, which resulted from ill-prepared late-night debates. The council's new voting allocation, for example, was never discussed during the conference. The pragmatic and able leaders sitting in the council of the EU15 may have failed to realize the dramatic efficiency consequences of their decisions for the EU27, which may have seemed a distant and abstract concept.

In another view, the EU leaders got what they bargained for—a crippled legislative process that strips the commission and parliament of the power to set the agenda. Future European

integration will be guided by intergovernmental initiatives, with the large members inevitably becoming stronger players, more commensurate with their economic and demographic importance.

For some members, integration has gone as far as domestic voters allowed them to go: the key European institutions are seriously constrained, and decisions are made mainly by the governments. Other members never accepted the notion that a dozen or more small nations—nations with populations the size of large cities—should have a major say in how to run a Europe that produces a third of world output and is home to almost 500 million people.

The question of which view is correct matters greatly for what comes next. If the failures of Nice represent an oversight, then there is ample time for emergency repairs, which could be implemented at the 2004 Summit. If the Nice Treaty was willful, it may take a high-profile crisis or crises in the enlarged EU (a deadlock in the 2006 finance negotiations that threatens to leave the EU without a budget, a deadlock over reforming the Common Agricultural Policy or the Structural Funds) to mobilize the resolve necessary to reform the Nice reforms. Either way, the Nice Treaty was no better than a nice try.

Richard E. Baldwin is professor at the Graduate Institute of International Studies, Geneva. Erik Berglöf is director at the Stockholm School of Economics. Francesco Giavazzi is professor at Bocconi University, Milan. Mika Widgren is professor at the Turku School of Economics and Business Administration and the Yrjö Jahnsson Foundation, Helsinki. This article is based on the latest Monitoring European Integration series, published by the Centre for Economic Policy Research, on the progress of economic integration in Europe.

Accession Countries Running Hurdles



From the Hungarian Economic Daily *Világazdság*

Rebuilding the Ravaged Balkans: Europe Needs New Development Policy

by George Petrakos

As profound changes shape the new Europe, the Balkans are experiencing the least progress in all sectors. While average per capita GNP in the countries of Central Europe has reached about 20–30 percent of that in the European Union and is tending toward convergence, per capita GNP in the Balkans is less than 10 percent of the European Union's, and the gap is widening.

Researchers and practitioners analyzing the origins of the Balkan region's lag have found several explanations:

- **Hesitant restructuring.** Early interpretations linked the weak recovery with governments' reluctance or inability to implement serious restructuring policies. Countries that applied the "appropriate policies"—stabilizing, liberalizing, and privatizing in a timely manner—were the first to recover economically after 1993. They were able to limit the belt tightening policies to a relatively short period, making them less painful and more socially acceptable. And they were able to balance the unavoidable social costs with broad economic progress, improving their chances of succeeding. In contrast, most Balkan countries, confronting many more obstacles and difficulties than Central Europe has, have been unable to implement reform policies effectively and persistently. Most of the Balkan countries are in recession. Reforms, at least in the short term, will be very costly for an important part of their population.

- **Adverse initial conditions.** Because of historical circumstances, the economic situations of the Balkan countries were less favorable than those of such Central European countries as the former Czechoslovakia, Hungary, and Poland. Most Balkan economies had been dominated by primary industries (mining, energy production) and had practically no prior experience with a market system. Their prewar, precapitalist system had been replaced by central planning. Then,

with the collapse of the Soviet-style system, these countries—overdependent on the Soviet-led Comecon trading bloc (except for the former Yugoslavia)—suddenly became exposed to a global environment. Without historical knowledge or experience of a market economy, they were supposed to build new organizations and new institutions—in the midst of pervasive abuse of power and rampant corruption. These economies are being pressed hard to integrate into the global economy, and as a result their modernization has been a more violent and destructive process.

- **Armed conflicts and ethnic wars.** Devastating ethnic conflicts have ravaged the Balkans since 1989, destroying production networks, human resources, and much of the physical and social infrastructure. Trade, investment, international tourism, and capital inflows were all badly hit, and the region was destabilized. The Balkan economies lost about 25 percent of their GNP between 1989 and 1997, further widening the development gap with the rest of Europe (excluding the countries of the Commonwealth of Independent States).

- **Unfavorable geographic location.** Balkan countries do not share borders with the developed countries of Western Europe, as do some countries of Central Europe (the Czech Republic, Hungary, Poland, Slovakia, and Slovenia). Lacking swift access to the economic centers of Western Europe, the Balkan economies have to reckon with much higher transportation costs. (The greater

part of the Balkans is more than 1,000 kilometers from the economic center of the European Union, and the transportation infrastructure is poorly developed.) Several Balkan countries have only other Balkan countries as their neighbors. For a variety of reasons, however, trade among Balkan countries is especially limited. Even in the age of the Internet, geographic proximity to the developed centers of the West facilitates the flow of information, the spread of knowledge and technology, the movement and interaction of people, the adoption of successful economic and social organizational models, and an understanding of the operation of important institutions and mechanisms. Thus the countries of Central Europe have clear advantages over the Balkans. (Using geographic location to justify failures is wrong, however, as the economic success of small and relatively distant countries such as Cyprus and Israel demonstrates.)

If we assume that the current tendencies separating the Balkans from the European Union will be reversed in the near future, how likely is it that the Balkans will close the gap with the developed countries of Europe? It has been estimated that it will take about 100 years for the average Balkan country to reach 75 percent of the development level of the European Union, assuming that its annual growth rate exceeds the EU average by more than 2–3 percentage points. If we take into account the accession of the countries of Central Europe, and thus reduce the average per capita GNP of the European Union by

20 percent, it would still take 80 years to close the gap—roughly four generations!

Such a long economic division in Europe, combined with the free market system, could have a serious impact on the demographic structures, population balance, and labor markets of all European countries. The population of the Balkan countries exceeds 50 million, the vast majority of whom live below the poverty line. Policies that would allow these people to live and work with dignity in their own countries would obviously be more effective economically and more humane over the long run than any policies banning their movement into Western Europe.

The EU should therefore redesign its development policy, first and foremost in relation to the Balkans. The postwar reconstruction of Europe required an overall plan that depended on external aid (the Marshall Plan) and extensive interventionist policies lasting more than two decades. The Balkan countries have similarly seen a good part of their social, technological, and productive infrastructure decimated by wars and conflicts, and another part destroyed by the collapse of the previous system. This destruction has been hastened by the opening of markets and the exposure of an outdated production system to the inexorable forces of international competition. The unification of the new Europe requires statesmanship. It will serve

its purpose if it contributes to the idea of a Europe without exclusions or exceptions, a Europe that offers decent prospects and a positive role for all its people.

The author is an associate professor at University of Thessaly Head and director of the Department of Planning and Regional Development, South and East European Development Center (petrakos@uth.gr). This article is based on his paper "The Balkans in the New European Economic Space: Prospects of Adjustment and Policies of Development," presented at the First International Conference on "Restructuring Stability and Development in Southeastern Europe," held in Volos, Greece, on 1-3 June 2001.

How to Fix the Balkans? A Conference in Volos, Greece

by Jennifer Vito

The hosts of the Balkans conference in Volos, Greece, didn't have to go far to find just the right place for the meeting. The South and East European Development Center of the University of Thessaly lies right on the Aegean Sea, in the middle of the picturesque city of Volos and at the foot of the majestic Mount Pelion. Just as in Greek mythology Jason and the Argonauts set sail from Volos to find the magical Eldorado, the 100 or so participants in the Volos conference hoped to find the way to the yearned-for stability and prosperity in the Balkan region.

The conference looked at what had contributed to the disappointing post-1989 performance of the Balkan region, often characterized by unfavorable structural adjustments and weak growth performance, and discussed policies that could reverse the trends. The participants grappled with many unanswered questions: Why is the Balkan countries' performance so different from that of Central Europe? Are domestic policies or unfavorable initial conditions responsible for their poor performance? What approach is expected from the European Union and other international organizations?

Evgeni Peev, in his paper "Ownership and Control Structures in the Transition to Crony Capitalism: The Case of Bulgaria," gave a detailed analysis of Bulgaria's recent problems: lack of institutional constraints on discretionary managerial behavior, and a rent-seeking culture characterized by economic agents who are quasi-state officials, quasi-owners, and quasi-managers with a short-term existence. New owners of priva-

tized enterprises have been interested not in maximizing profits but in stripping assets and exporting capital.

Generating perhaps the most heated discussion was Costis Hadjimichalis's paper "European Political Integration after Kosovo: A Damaged Project?" Focusing on the events in the Balkans in the 1990s, the author emphasized that the war in Kosovo summoned the spirit of imperialism at a time that the European Union was trying to expand toward Eastern Europe. He rejected the notion that the concept of the nation-state has become a hollow one.

Charlambos Tsardanidis, in his paper "New Regionalism in South-Eastern Europe: Problems and Prospects—The Case of the South-Eastern European Cooperation Process (SEECP)," tried to answer this question: Will regional cooperation schemes, specifically the South-Eastern European Cooperation Process, be able to get rid of the past inward-looking, import-substituting and protectionist policies and adopt a more dynamic outward-looking, export-oriented approach connecting the European Union with the Black Sea and Caspian Sea regions? The author listed the weaknesses that will prevent this cooperation from developing into a (sub)regional integration arrangement: mutual trade is marginal, the pull of the European Union is overwhelming, and a predominant state that could draw the others into a regional arrangement is lacking. But, the author concluded, the SEECP can function as a useful forum for discussion.

Lithuanian Women Bear the Brunt of Transition

by Anne Marie Spevacek

Despite massive changes in the Lithuanian economy since 1991, male-biased attitudes remain embedded in institutional and social thinking, placing a heavy burden on Lithuanian women, many of whom juggle the role of primary family caregiver with that of full-time worker outside the home. Coupled with discrimination in the workplace, sexism greatly inhibits women's ability to achieve equal status in society.

Lithuania's economy underwent massive restructuring between 1990 and 1997, when the number of people employed in state enterprises fell from 1.3 million to about 0.5 million while the number of private sector employees doubled to 1.2 million. About 58 percent of state sector employees are women, while men represent about three-quarters of private sector employees. One explanation for the difference is that spheres of activity traditionally dominated by men, such as construction and engineering, have undergone almost complete privatization. Privatization has reduced employment opportunities for women, many of whom find it difficult to find work in the private sector, due in part to discrimination and lack of contacts. This pattern of employment appears to be the norm throughout the transition economies. In the Czech Republic, for instance, 74 percent of working women are employed in the state sector. This "feminization" of the public sector has also occurred in Africa and Latin America.

Vertical segmentation is especially prominent in occupations in which both men and women work. In education, for instance, most secondary school teachers are women while the majority of higher-level (and higher-paid) positions, such as professors, headmasters, and administrators, are filled by men (91.5 percent of university professors are men). These gender differences were evident throughout the Soviet period, despite the official claim that women were equal in the workplace.

Gender differences in wages stem partly from the fact that fewer women work in

higher-paying jobs. But even in the same job, Lithuanian women on average earn only about 77 percent of what men earn. This pattern is seen throughout the transition economies.

Discrimination in hiring is a serious problem for women in Lithuania. The phenomenon reflects traditional attitudes that relegate the role of women to the family, as well as the popular belief among employers that female workers are more expensive because of labor laws protecting mothers. A high number of job advertisements in the nation's daily newspaper, *Lietuvos Rytas*, specify the gender of the worker being sought. Job advertisements for men often describe management positions, while advertisements targeted at women usually indicate age and appearance requirements. Job advertisements in Poland reveal the same pattern.

Although women account for 52.8 percent of Lithuania's population, they do not play a large role in politics or administration. In 1997 only 22 percent of municipal council positions were held by women—a figure that declined after the municipal elections held in early 2000. Nationally, women occupy just 15 of 141 parliamentary seats, or 10.6 percent of the total. The majority of Lithuanian decision- and policymakers are men, relegating women politicians and government representatives to a lower status and rendering them relatively powerless.

But there are also encouraging signs. The Law on Equal Opportunities that entered into force in March 1999 is working to ensure the implementation of equal rights

of women and men guaranteed in the Constitution. Lithuanians who believe they have been discriminated against in the workplace may submit a complaint to Lithuania's Equal Opportunities Ombudsman, located in Vilnius, who may then submit proposals to state and government institutions in order to enforce equal rights.

The government, together with NGOs, drafted and put in practice an Action Plan for the Advancement of Women in Lithuania. This plan covers protection of women's human rights, women's socio-economic position, health, education, family planning, women in politics and administration, abuse and violence against women and girls, women and the mass media, and the statistical system and gender differences.

To combat discrimination against women in the labor market, it is imperative that the government enforce the laws already in place. An affirmative action policy that reaches down to every municipal center could guarantee ample employment of women. "Equal pay for jobs of comparable worth" was a rallying cry that brought forth the Equal Pay Act of 1963 in the United States. If such a policy were enacted in Lithuania, women's high educational status and skills would enable them to achieve the equitable pay they deserve.

Anne Marie Spevacek is a research analyst specializing in economic growth at the Academy for Educational Development in Washington, D.C. This article is based on her paper, "Gender Dimensions of Economic Transformation: Impacts of Transition on Lithuanian Women."



THE WILLIAM DAVIDSON INSTITUTE
AT THE UNIVERSITY OF MICHIGAN BUSINESS SCHOOL

Latest from the Davidson Institute's Publication Profiles

The Secrets of China's Business Groups

by Lisa A. Keister (Oxford University Press, 2000)

The way in which firms in the People's Republic of China conduct business was fundamentally altered during the 1980s. As a result of industrial reform, firms became increasingly able to determine how and with whom they conduct business. From methods of production to decisions about hiring and firing workers, Chinese business organizations became less dependent on central authority and consequently began to behave more like capitalist firms.

Yet the new Chinese organizations did not emerge as isolated economic entities. Rather, with the encouragement of the state, they formed federations, known as *qiye jituan* (business groups) and began to conduct business from within these interfirm networks. The elaborate structure of interfirm relations that developed within the groups bears a strong resemblance to the Japanese *keiretsu*, and, as they do in Japan, corporate alliances began to dominate the Chinese economic landscape.

Despite their central position in economic reform and in the Chinese economy more generally, however, we know almost nothing about the way the groups formed or the manner in which they were organized. Moreover, while research on busi-

ness groups speculates that groups with certain structural characteristics facilitate economic development by improving the financial performance of the groups' member firms, this research has produced little empirical evidence that such a relation exists.

The objective of this book is to fill these gaps. The book provides an account of the emergence of business groups in China and details their organizational structure. It contributes to our understanding of the function of these groups by isolating and examining the relation between various aspects of group structure and the financial performance of member firms. It is based on extensive firsthand research in China (conducted by the author in 1995 and 1996), including interviews with many of the largest business groups. The book includes ethnographic accounts of the process of business group formation as well as statistical analyses of the impact of these interfirm networks on firm outcomes such as profitability and productivity (output per worker).

Lisa Keister is a professor of economics at Ohio State University, in Columbus, Ohio, and a Research Fellow at the William Davidson Institute.

Competition and Enterprise Performance in Transition Economies

by Wendy Carlin, Steven Fries, Mark Schaffer, and Paul Seabright

What determines the success with which firms in transition economies respond to the demands of the new market environment? Where do the most important gains in productivity come from? In this article, we report the results of a large cross-country survey of firms in 25 countries that shows the relative influence of competition, ownership, and features of firms' external environment (including the presence of soft budget constraints) on their restructuring actions and subsequent sales and productivity performance. The results show convincingly that competition matters—in an intriguing and complex way.

When the process of transition began, there was widespread agreement that liberalization—the power of firms to set prices, choose what to produce, and invest as they thought fit—was a necessary condition for significant improvement in the productivity of the economy as a whole. But beyond that there was little consensus as to the nature of the industrial transformation to be expected.

Some findings led observers to expect that the main gains from reform would come from a redirection of resources across sectors of the economy, from those in which value-added was

low (or even negative) to those in which value-added was high. Others thought the main gains would come from changes in corporate governance, specifically from the privatization of state-owned enterprises and the elimination of state subsidies. Yet others thought that the essential ingredient was competition, which could not be ensured merely by privatization, since many state-owned enterprises were effectively monopolists. What else was required to ensure competition was also much disputed: many countries set up competition agencies to try to establish competitive conditions directly; skeptics argued that the only important consideration was trade liberalization, which would import competition from abroad. Entry by new firms was viewed as an important component of the economic transformation, but there was great uncertainty about its likely quantitative contribution to improved performance.

Recently, attention has been drawn to the importance of the overall environment for market transactions, which may affect all firms in an economy, albeit not necessarily in a uniform way. This environment comprises a range of factors associated with the functioning of the state—from tax systems to regulatory hurdles to official corruption, organized criminality, and the uncertain enforcement of business contracts and property rights—that influence the profitability and predictability of economic activity. Without a sound business environment, it is argued, new investment and improved productivity are unlikely to emerge from abandoning central planning, liberalizing prices and trade, changing ownership, and cutting state support.

What have 10 years of transition taught us about the relative importance of these different factors? This article uses the results of a large survey of firms across transition economies, undertaken by the European Bank for Reconstruction and Development and the World Bank, to investigate this issue. The main results, presented below, are striking. When interpreting the results, it is important to recall that the average growth of firms' sales and productivity was close to zero, and only slightly more than 40 percent of firms reported positive sales growth over the preceding three years.

• ***The nature of competition in the product market has important effects on the performance of firms.*** Sales and productivity growth were higher in firms facing one to three competitors in the market for their main product than in firms that faced no competition or competition from more than three firms. Firms facing one to three competitors reported growth that was 10–13 percent higher than that of other firms. Firms reporting more than three competitors had higher sales growth than monopolists, although not significantly so.

• ***Controlling for other factors, there is no significant relation between privatization and performance.*** State-owned firms and privatized firms that had been owned by the state show no significant differences in sales or productivity growth. New private firms, in contrast, have significantly higher sales growth and lower productivity growth. It is, of course, impossible to tell how much of the positive relation between new entry and sales growth is due to survivor bias, that is, the fact that the only new firms observed are the successful ones. The weaker productivity growth of new entrants is likely to indicate that such firms have been attracting labor faster than their sales have been growing. Unfortunately, the data are not available that would allow the productivity level of new entrants to be compared with that of incumbent firms.

• ***Soft budget constraints seem to have a negative impact on sales growth.*** The business environment has a somewhat positive impact. There is no systematic relation between sector or urbanization and performance.

• ***State-owned firms are less likely to engage in new product restructuring.*** Privatized and new firms behave similarly in this regard.

• ***Although the number of competitors is not a significant determinant of the decision to innovate, there are nevertheless important competition effects.*** Market power, as measured by the 10 percent test, is an important positive determinant of new product development, but so is pressure from foreign competitors and customers (pressure from domestic competitors is insignificant). Domestic and foreign competition appear to be only imperfect substitutes. Soft budget constraints are a significant disincentive to new product restructuring in most specifications. The quality of the business environment is not significantly related to innovation.

• ***State-owned firms are much more likely than other firms to have engaged in defensive restructuring.*** We cannot exclude the possibility that this result may reflect the fact that privatized firms undertook defensive restructuring earlier in the reform process (that is, before the sample period). Although the number of competitors is insignificant, firms with market power, as measured by the 10 percent test, are significantly less likely to have engaged in defensive restructuring. The effects of size and service sector are similar to those for new product restructuring.

• ***Controlling for these other factors, soft budget constraints tend to be associated with more defensive restructuring.*** This result suggests that we may be having some difficulty identifying precisely how soft budget constraints work:

they may allow poorly performing firms to survive, but defensive restructuring may be part of the price the state extracts for its continued support.

An important finding of the study is that competition appears much more important than the effect of ownership per se in influencing performance. Together with competitive pressure, especially from foreign suppliers, the presence of some market power strongly and robustly enhances sales, productivity, and new product restructuring. New product restructuring is in turn an important contributor to firm performance, so the nonmonotonic character of competition (“some market power but not too much”) appears to have both direct and indirect effects. These findings are consistent with the presence of a Schumpeterian-type competitive process at work in the transition economies, albeit one accompanied by considerable disruption and turbulence. This evidence suggests that the presence of two or three seriously competing firms generates competitive behavior. Moreover, transition is an investment-intensive process, and the descriptive evidence from the survey indicates the presence of financing constraints. In the presence of competitive pressure, retained profits are thus important for financing the restructuring that helps firms succeed. The presence of soft budget constraints appears to have

a broadly negative impact and a favorable business environment a broadly positive impact on firm performance.

Turning to policy implications, our findings strongly reinforce the message that unchallenged monopoly is a drain on performance. It is certainly more important to ensure that monopolists face at least some challenge than to try to referee the necessarily confused process of rivalry among the few. As the importance of competition becomes more apparent, so do the difficulties in bringing about such a process effectively. But our results help illuminate the many ingredients needed for the competitive process to work.

Wendy Carlin is a professor of economics at University College London and a Research Fellow at the William Davidson Institute and CEPR. Steven Fries is an economist at the European Bank for Reconstruction and Development. Mark Schaffer is a professor of economics at Heriot-Watt University [give city and country] and a Research Fellow at the William Davidson Institute and CEPR. Paul Seabright is a professor of economics at IDEI (Université de Toulouse-1) and a Fellow of CEPR. This article is the summary of the authors' study, published as WDI Working Paper No. 37.

Report from the Field

For the past eight years, the William Davidson Institute has sponsored a Fellowship in Business Journalism. Every year, one or two mid-career journalists from transition and emerging market economies come to the University of Michigan in Ann Arbor to study topics that will improve their ability to report on business, economics, and related public policy issues. Starting with this issue of the Transition Newsletter, we include an article by one of these correspondents from the field.

In the Labyrinth

by Catalin Dimofte

No, the title doesn't refer to a novel by Jorge Luis Borges. The article is about running a small business in Romania—or trying to run a small business, to be more precise.

According to the recently released report “Red Tape Analysis: Regulation and Bureaucracy in Romania,” doing business in Romania takes a lot of determination and even bravery, let alone money and patience. The opening paragraph sets the tone:

Small and medium-sized enterprises (SMEs) in Romania must comply with numerous bureaucratic procedures and operate in a confusing and unpredictable regulatory and legal environment. The costs of compliance in terms of time and money are extremely burdensome for SMEs and affect the resources available to devote to business activity and growth.

The report was drafted by the Center for Institutional Reform and the Informal Sector (IRIS), a group affiliated with the University of Maryland, under a project wholly funded by USAID. A team of about 10 full-time staffers accomplished in one year what innumerable Romanian committees appointed by the government or Parliament failed to do in a decade. Countless inquiries and angry official statements have stressed that bureaucracy plagues the business environment; anticorruption crusades have been launched. For any person who has lived for more than a couple of weeks in Romania, it is no secret that all have failed miserably and that bureaucracy and its offspring, corruption, reign supreme.

The IRIS report is the first quantitative assessment of the subject ever drafted in Romania. The findings of the report are

truly impressive—in the negative sense of the word. From the very beginning of a company's existence, the entrepreneur has to deal with the full might of Romania's oppressive, cumbersome, slow, and inefficient bureaucracy.

"Typical SRL" Goes to War

Say you want to incorporate a new company, called Typical SRL. To begin with, you should heed U.S. Ambassador Jim Rosapepe's warnings on the issue: "In the United States, it takes one day to register a new company. In Romania it takes between 49 and 102 days. In the United States a small business needs seven forms, weighing 30 grams. In Romania it needs 83, weighing half a kilogram."

In addition to the plethora of certificates, approvals, authorizations, and so on, all Typical's efforts and paperwork will have to be duplicated—once for the Trade Registry and twice for the Finance Ministry, for tax purposes. Even established firms have to interact frequently with the Trade Registry, for reasons ranging from capital increase to statute changes to common things like changes in address. On average, Typical would interact at least once a year with the Trade Registry, spending \$100–\$150 on fees and 4–7 days of employee time for the associated paperwork, waiting another 14–29 days before the whole process is completed. There is an abundance of anecdotal evidence about people who have surrendered to this wall of bureaucracy. A fellow journalist was telling me the other day how his efforts to set up a small company failed. "It ended almost before it began," he said. "I was asked to produce some sort of evidence that my would-be company has headquarters. Since basically the entire company was supposed to be me typing on my computer hooked on to the Internet, I said my apartment would be the headquarters. But then I was asked to get a written, stamped, and notarized approval from the residents association saying that my work would not disturb the other residents in the apartment block. That was the end of it. There are over 40 apartments in that block of flats, and I had no chance of persuading each and every one of them. For the time being, probably until global income tax becomes operational, I guess I'll have to resign myself to evading tax." But troubles are just beginning for Typical SRL. Depending on the type of business, further authorizations, approvals, permits, or operating licenses from various ministries or agencies are necessary. At this point, Typical's owner/manager gets the preliminary approval, the *aviz de principiu*, needed for the registration process. In some cases, these approvals are mere sheets of paper whose main roles are to make public servants look busy. In others, they are a serious business, protecting a state monopoly. In all cases, they are one of the many entry barriers the private entrepreneur has to surmount.

Upside Down

One of the most important sources of strength and resilience of the Romanian bureaucracy is the reversed agenda of priorities of the central administration. In a normal situation, when a public problem occurs, an existing organization deals with it or a new institution is created to do so. More often than not, things work a lot differently in Romania, where they start with Mr. X, a political chieftain seeking a top position within the Executive Branch. If such a position is not free, Mr. X convinces the government or the Parliament to create a new ministry, agency, office, or committee—and to appoint himself as head of the new organization. Of course, the bigger the ego of Mr. X, the bigger the organization must be, ideally with local branches throughout the country.

At lower levels, things are about the same, except that the problem is solved "in the family," at a ministry or local level. A fringe benefit of the system is that all those employees and their families secure a hefty crop of votes for their benefactor at the next elections. The only problem is financing the organization. That's easy, though—a new tax or business service is invented and the rest of society has to support another layer of bureaucracy. This is how and why a large share of the 24 or so "special funds" were born—to finance a group of bureaucrats and only subsequently to solve a real economic or social problem.

Take tourism, for instance. According to the IRIS report, if one seeks a management position in a tourism business, "it is necessary to be a graduate of the Tourism Management Faculty at the university or to have a related special subject, training in Tourism Management, a certificate for foreign languages, and proven work experience in tourism." This applies to private entrepreneurs as well as state organizations. Throughout the past decade, Romania had a government body in charge of tourism. It distinguished itself from other ministries or agencies by being very prolific, breeding a multitude of smaller agencies, authorization and classification offices, and so on. All these measures and regulations might mean well, but the road to hell is paved with good intentions. Has Romanian tourism progressed an inch due to this oversized bureau-

MICHIGAN JOURNALISM FELLOWS		
Year	Name	Publication
1993-94	Vladimir Matejovský	Mlada Fronta Dnes, Prague (First Year)
1994-95	Jane Dobejš	The Warsaw Journalism Center
1995-96	Catalin Dinuște	Adevărul Economic, Romania
1995-96	Laurențiu Ilie	Buzna, Romania
1996-97	Jin Weiye	Shanghai Television Station, China
1997-98	Sanja Modrac	Tjednik, Croatia
1997-98	Jan Mihalacik	Respekt, Prague
1998-99	Bogdan Zukowski	Pressence Reporter, Warsaw, Poland
1998-99	Weiying Liu	China Daily, PRC
1999-00	Maria Teresa Gomez	Vozes S/A, Brazil
1999-00	Maria Elena Oti Cambou	Pressence Reporter, Cuba
2000-01	Lentija Zlamalova	Mlada Fronta Dnes, Prague

cracy and regulatory system? The few foreign tourists who come to Romania each year complain most about the poor services and conditions and decide to vacation the following year in Turkey or Greece.

If Typical is an importer or exporter, it will find the Ministry of Commerce particularly proud of the speed with which it releases import-export licenses: two to three days usually, at a cost of just a few dollars. But Typical will then discover that it needs on average another one to four authorizations and licenses from this ministry, and it will have to spend \$150–\$250 and wait 10–17 days to get them. Unlike other ministries, the Ministry of Commerce claims to approve nearly all applications it receives. So why, one might ask, is there any need for the authorizations and licenses in the first place? Nobody within the ministry seems to know.

In the Gardens of Oblivion

All those formalities accomplished, Typical will now proceed to a new battleground—dealing with the local authorities. If successful, in the end it will win its “Operation Approval.” If we are to keep the analogy with warfare, this stage is trench warfare. There are two large categories of approvals at this level—those released by the territorial branches of the central authorities and those required from the local authorities, people such as the fire brigade. This seems to be the battle that decides the war. “Many surveyed firms complained about this particular set of requirements and said that they began operating before receiving the Operation Approval and simply pay any fines or penalties imposed by the authorities afterwards,” IRIS reports.

To better understand what is going on, consider the story of an entrepreneur who tried to build and open a small hotel. He lost his war, surrendering to the overwhelmingly superior forces of the natural gas company. “The main natural gas pipeline was three meters from the hotel. Initially, I had to obtain a preliminary approval from the municipality, fire brigade, and gas company confirming that my construction did not jeopardize their pipe. Then, after the construction was completed, I had to obtain from the gas people another preliminary approval that they agree in principle to hook me up to the network. I also had to produce a project on the basis of which they would allocate me a certain quota of natural gas—a completely irrelevant thing, as long as what you pay is what you get and consume. They had to approve that project to make the connection. After two months of waiting I lost patience, gave up, sold everything, and walked away.” The entrepreneur did not mention what it took to get the authorizations for the construction itself. In 1999 it would have cost \$250–\$650, 20–40 days of employee time, and 58–85 days of waiting to ob-

tain just one of them, the Urbanism Certificate. Overall, the full process can take years.

Situations like these generate what are euphemistically called “unofficial fees,” a more sophisticated and eloquent term for bribery. Typical should be prepared to apply for three to five authorizations/licenses from the local authorities, spend \$500–\$1,700 (of which unofficial fees can account for up to 65 percent), waste 14–26 days of employee time for the necessary paperwork, and wait on average 45–71 days. Approvals from the public utilities cost \$300–700 and require a waiting time of 25–44 days on average. On top of that, once Typical is in business, it will have to face a steady flow of inspections from just about everyone, costing the firm another \$150–\$800 a year. Since the majority of the 533 pieces of legislation relevant to business are somewhat ambiguous, that leaves plenty of decisions open to the discretion and arbitrary judgment of the inspectors—hence the good old unofficial fees.

The Tax Conundrum

In many cases, paying taxes in Romania is frustrating beyond imagination. According to the IRIS report, if Typical had been operational in 1999, it would have had to spend 18–29 days of employee time preparing the paperwork necessary for the national taxes and another 2–6 days to comply with local taxes. Inspections from the central and local fiscal authorities (6–9 per year on average) would have required another 13–32 days of employee time and \$350–\$1,300 in expenses.

The true extent of the nightmare is illustrated by an episode cited in the report, which describes the experience of a taxpayer trying to pay a local tax. “Any business in Bucharest with a sign on the exterior of a building is required to pay an annual ‘plaque tax.’ The firm had no idea where to pay this tax. The taxpayer went to the Financial Administration of Sector 2, but it had moved. She was sent from there to another address, but when she got there she found that that office had also moved. At the third branch of the Financial Administration of Sector 2, she found out she had to go to a remote part of Bucharest to pay the tax. She was told over the phone what documents were necessary and where the tax had to be paid, but the source did not know the account number into which the money was to be deposited. When she arrived at the obscure location (both hard to reach and hard to find), she was told that she was not in the right place—only individuals pay there, not companies. She was then sent to the mayor’s office in Sector 2, where individuals supposedly pay the plaque tax. She went to this location and was told that she was in the right place, but payment was not made there. She found the account number and the amount she had to pay and then

finally, the next day, was able to make the bank transfer. The amount of the tax was 80,000 lei (\$5 then), and it took two full days to pay.”

By and large, the report says, 10 percent of a company's personnel are hired to fill in forms. All necessary documents need to be completed several times, as different institutions ask for the same information. Overall one has the image of a parasitic public administration, suffocating and sucking blood from its host without killing it. As most public servants are poorly paid, it has become unavoidable and almost socially acceptable that

they extract bribes. But then, why would that be surprising in a country in which the Byzantine heritage is still very strong, all political parties are playing dumb when it comes to their fundraising techniques, and where government officials whose reported taxable income does not exceed \$4,000 a year own two, three, or four luxury cars and \$500,000 villas?

Catalin Dimofte was a William Davidson Institute Fellow in Business Journalism in 1995/96. He is currently a business journalist in Romania. This article is reprinted from the Romanian English-language magazine Vivid.

WDI Conference Diary

For the Record

Banking in Emerging Markets

June 15–17, 2001, University of Michigan, Ann Arbor

The William Davidson Institute and the *Journal of Financial Intermediation* co-sponsored a symposium on banking in emerging markets. The conference was organized by Prof. Anjan V. Thakor, professor of banking and finance at the University of Michigan and the Davidson Institute Area Director for Finance. Patrick Bolton, Princeton University, was the Program Chairperson. The symposium's keynote speaker was Dr. Michael Moskow, the President and CEO of the Federal Reserve Bank of Chicago.

Finance in Emerging and Transition Economies

June 27–29, 2001, Hong Kong University of Science and Technology

The Third International Conference on International Finance will focus on the evolution of financial markets and corporate finance practices in emerging and transition economies. The conference committee is composed of Prof. Enrico Perotti (University of Amsterdam), Dr. Anna Meyendorff (William Davidson In-

stitute), Prof. K. C. Chan (Hong Kong University of Science and Technology), and Prof. Sheridan Titman (University of Texas, Austin).

Information: Email: ameyen@umich.edu, Web site: www.wdi.bus.umich.edu.

Forthcoming

North Korea in the World Economy

August 27–28, 2001, Washington, DC

This conference will bring together economists, policy analysts, government officials, and policymakers from the international community to exchange perspectives on the development and globalization of the North Korean economy. Organized by Prof. Han Kim of the University of Michigan Business School, the conference is cosponsored by the Korea-America Economic Association and the William Davidson Institute. Featured speakers will be Prof. Ken Lieberthal, professor at the University of Michigan Business School and a Research Fellow at the William Davidson Institute, and U.S. Senator Joseph Biden. Another highlight of the conference will be a panel made up of K. A. Namkung (Atlantic Council); Ambassador Li Gun (U.N. Mission, Democratic People's Republic of Korea); Leon Sigal

(Social Science Research Center and John Merrill (U.S. State Department), who will consider where we go from here.

Information: Yesook Merrill, Senior Economist and Assistant Director, General Accounting Office. Email: MerrillY@gao.gov, Web site: www.wdi.bus.umich.edu.

Impacts of Cross-Border Business Interactions on Social Institutions

September 7–9, 2001, Aspen, Colorado

The Aspen Institute's Initiative for Social Innovation through Business and the William Davidson Institute at the University of Michigan Business School are bringing together a select group of leading researchers and exceptional scholars to participate in this symposium. While it has long been argued that interactions among economies profoundly affect economic development, the importance of international economic linkages to the development of institutions, both social and economic, is not well understood. This conference will serve as a venue for the focused exchange of ideas on this emerging research agenda, with special emphasis on the impacts in developing economies. The conference is being organized by Prof. Bernie Yeung, Foreign Investment Area Director for the William Davidson Institute. Participation is by invitation only.

Information: Email: byeung@stern.nyu.edu, Web site: www.wdi.bus.umich.edu.

India's Economic Development: Past and Future

September 21–23, 2001, University of Michigan, Ann Arbor

The William Davidson Institute is launching an important India initiative. This conference will provide more momentum and visibility to India-related research in North America by bringing together business scholars and economists whose empirical work can shed light on emerging patterns in the Indian economy and political system. Topics to be discussed include the newly emerging information

technology sector; the relative effect of privatization; the structure of firms, including business groups; financial sector reforms; the role of credit; and rural development. Nandini Gupta of the William Davidson Institute is organizing the conference.

Information: Email: nandinig@umich.edu, Web site: www.wdi.bus.umich.edu.

Corporate Governance, Stakeholder Accountability, and Sustainable Peace

November 2–4, 2001, University of Michigan, Ann Arbor

This conference will bring together a select group of academics, researchers, business executives, and NGO leaders

to examine the provocative issue of whether corporate governance affects sustainable peace in a region. Presentations will focus on the concepts of peace, corporate purposes and governance, workers' rights and social justice, corruption and stability in a technological age, and the business of peace. Organized by Tim Fort, professor at the University of Michigan Business School and the William Davidson Institute's Area Director for Corporate Governance, the conference is sponsored by the William Davidson Institute and the Aspen Institute's Initiative for Social Innovation through Business.

Information: Email: timfort@umich.edu, Web site: www.wdi.bus.umich.edu.

Recent Working Papers of the William Davidson Institute

www.wdi.bus.umich.edu

Garner, Thesia, and Katherine Terrell. **Some Explanations for Changes in the Distribution of Household Income in Slovakia: 1988 and 1996.** Working Paper No. 377, May 2001.

Carlin, Wendy, Steven Fries, Mark Schaffer, and Paul Seabright. **Competition and Enterprise Performance in Transition Economies: Evidence from a Cross-Country Survey.** Working Paper No. 376, May 2001.

Huang, Yasheng. **Why More is Actually Less: New Interpretations of China's Labor-Intensive FDI.** Working Paper No. 375, May 2001.

Huang, Yasheng. **Economic Fragmentation and FDI in China.** Working Paper No. 374, May 2001.

Vecernik, Jiri. **Earnings Disparities in the Czech Republic: Evidence of the Past Decade and Cross-National Comparison.** Working Paper No. 373, May 2001.

Fidrmuc, Jan. **Economic Reform, Democracy, and Growth During Post-Communist Transition.** Working Paper No. 372, March 2001.

Konings, Jozef, and Alan Murphy. **Do Multinational Enterprises Substitute Parent Jobs for Foreign Ones? Evidence from Firm-Level Panel Data.** Working Paper No. 371, April 2001.

Vecernik, Jiri. **From Needs to the Market: Changing Inequality of Household Income in the Czech Transition.** Working Paper No. 370, April 2001.

Grosfeld, Irena, and Thierry Tresselt. **Competition and Corporate Governance: Substitutes or Complements? Evidence from the Warsaw Stock Exchange.** Working Paper No. 369, March 2001.

Altomonte, Carlo, and Laura Resmini. **Multinational Corporations as Catalyst for Industrial Development: The**

Case of Poland. Working Paper No. 368, February 2001.

Bai, Chong-En, David D. Li, Zhigang Tao, and Yijiang Wang. **A Multi-Task Theory of the State Enterprise Reform.** Working Paper No. 367, March 2001.

Perotti, Enrico C., Luc Laeven, and Pieter van Oijen. **Confidence Building in Emerging Stock Markets.** Working Paper No. 366, December 2000.

Chang, Chun, Brian McCall, and Yijiang Wang. **Incentive Contracting versus Ownership Reforms: Evidence from China's Township and Village Enterprises.** Working Paper No. 365, November 2000.

Duffy, Fiona, and Patrick Paul Walsh. **Individual Pay and Outside Options: Evidence from the Polish Labor Force Survey.** Working Paper No. 364, March 2000.



Local Government
and Public Service
Reform Initiative



Open Society Institute

Good Governance Requires Respect for Ethnic Diversity

Setting up new political institutions and reforming public administration are important features of the transition process in postcommunist countries. In many countries both central and local governments have to deal with multiethnic communities during this process. Governments must be ready to protect the rights of minorities and encourage their involvement in democratic state-building. This is the way to achieve political stability, a basic condition for effective transition to a market economy and the rule of law.

Postcommunist countries established various forms of legal and institutional frameworks for protecting minorities. But it has become increasingly clear that securing the broader inclusion of minorities at various government levels requires a participatory system of governance. Local authorities are important agents, because it is they who implement multiethnic policies close to those affected. Their task is to design policies that are responsive to ethnic diversity, through representation of or direct involvement by minorities. But effective implementation is often hindered by central government control, skewed administration of law, insufficient technical expertise, and inadequate resources. These barriers should be overcome as soon as possible and legal and institutional re-

forms supplemented to create a political culture that embraces multiethnicity in public administration.

The Managing Multiethnic Communities Project (MMCP) is an in-house policy research project of LGI. The project addresses the needs of governments by developing various resources and programs to improve their capacity for accommodating ethnic diversity, promoting participation in public life, and providing equal access to public goods and services provided by the state.

For more information, visit the MMCP Web site, at <http://lgi.osi.hu/ethnic>, or contact Petra Kovacs, at kovacsp@osi.hu.

Recent Publications of LGI's Managing Multiethnic Communities Project (MMCP)

Diversity in Action: Local Public Management of Multiethnic Communities

edited by Anna-Mária Biró and Petra Kovács

This edited volume offers both theoretical and policy-oriented perspectives on local management of ethnically heterogeneous communities in Bulgaria, the Czech Republic, Hungary, Poland, Romania, Slovakia, and Ukraine (an earlier LGI publication covered the former Yugoslavia; a book on the newly independent states is forthcoming). Institutional arrangements and policy responses to a variety of issues—including tensions between central and local authorities, participation of national minorities in local governments, use of minority languages in public administration, financial guarantees for cultural autonomy, financial and political support for minority

education, and access of minorities to local public services—have varied widely in the seven countries studied. This book presents a set of innovative approaches and policies that attempt to address these issues, supplementing the country analyses with case studies of innovative practices used in the region. The volume highlights such issues as minority access to public services and media outlets, public participation by minorities at the local level, and protection of minorities' linguistic rights. To ensure a multiethnic perspective, the editors have included comments and recommendations from experts from various minority groups. Policy recommendations

intended to render public administration reform efforts sensitive to multiethnic issues are presented at the end of each chapter.

The seven countries covered in the volume share commonalities that make them suitable for comparative research. All are postcommunist countries going through a period of political, economic, and social transition; and all have gone through peaceful transition processes and opted for accession to the European Union and integration into the Euro-Atlantic structures; all are historically multiethnic and have undertaken significant institutional reforms, including public administration reform.

Innovative Local Practices

The book is divided into two parts. The first part deals with the political, legal, and administrative environment of managing multiethnic communities. The chapter on political science examines the basic concepts of state, ethnicity, and civil society and the conditions for their effective functioning, particularly given globalization. Related issues, such as legitimacy, state integrity and state collapse, citizenship, ethnicity and cultural reproduction, multiethnicity, and multiculturalism, are reassessed critically, using comparative examples from Western and Eastern Europe. The question of postcommunism and the special role of ethnicity in these states is also addressed.

The chapter on public administration presents an overview of institutional reforms carried out in the past 10 years at both the central and local levels. Two major competing constitutional arrangements, parliamentarism and presidentialism, are described and analyzed.

The second part of the book focuses on the historic legacy, legislation, and institutional structures, reviewing the major political debates over minority protection and public administration reform, with special reference to local government-related issues. Innovative local practices are detailed. The chapters on individual countries apply a multidisciplinary approach, combining policy analysis with demographic and sociological surveys, rights-based assessments with inquiries from a public policy perspective.

Several chapters examine the characteristics of multiethnicity, the legal and political position of minorities, and representation and participation of minorities in public administration and local government.

Minority Policies Differ across Countries

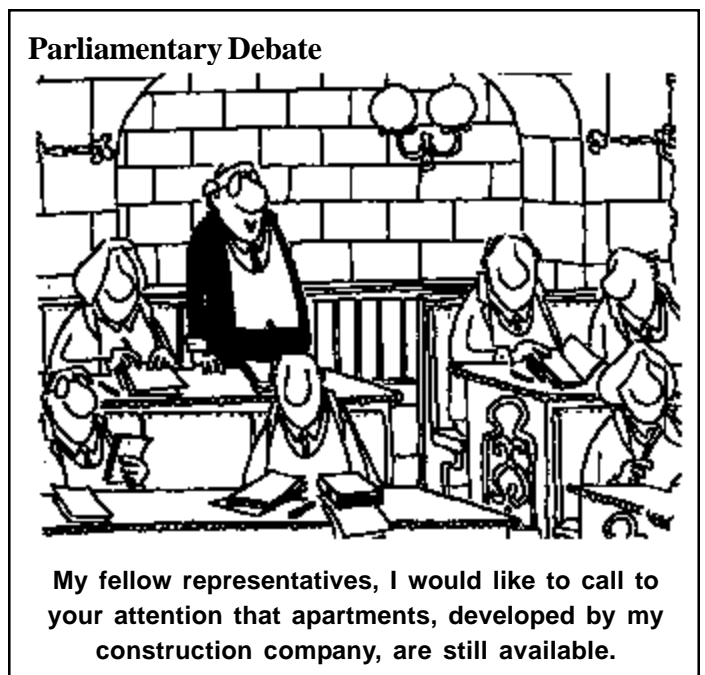
Several types of minority policies are identified. Key factors determining the design of these policies include the number

and size of minorities, their geographical location and pre-communist history, institutional memory, the level of skill and organization of their elite, and the availability of local and external resources (intellectual and material). Various minority groups in a given country may have very different aspirations, claims, and needs, depending on their levels of social and political integration.

Each country chapter includes an in-depth analysis of the legislative and institutional framework serving the protection of minorities and highlights the differences between *de jure* and *de facto* provisions of legal and institutional guarantees. With the exception of Hungary, the countries analyzed do not recognize minorities at the constitutional level. Instead, constitutional guarantees protect the dominant nation and the language of the dominant group, while minorities must be content with some *de facto* provisions at the local level. Conflicts and inconsistencies between international law and domestic legislation are also discussed.

In the emerging democracies of Central and Eastern Europe, new civil (nonprofit) organizations have emerged to participate in the design and implementation of public policy. The civil sector can fill gaps in government policy and practice and work in partnership with local government to meet minority needs.

The online version of *Diversity in Action* can be viewed on LGI's Managing Multiethnic Communities Project's Web site: <http://www.osi.hu/lgi/ethnic>.



From the Hungarian Daily *Népszabadság*

Bibliography on Ethnic Relations in Eastern Europe

The second edition of the *Bibliography on Ethnic Relations in Eastern Europe*, edited by Margit Feischmidt, includes chapters on ethnicity, nationalism, ethnic conflict, conflict resolution, institutions, political participation of minorities, and new initiatives in managing multiethnic coexistence. The volume describes work with regional and possibly theoretical significance published in English, German, Russian, and other languages. The material has been compiled mainly by local contributors. Other major sources include the library of the Central European University in Budapest, *Sociological Abstracts*, and various bibliographies.

Studies, articles, and working papers are listed thematically (one category, for example, is called "Theories Related to Ethnicity and Nationalism in Eastern Europe") and by keyword. Entries include bibliographic data, keywords, a summary of content, and the main arguments.

The volume also includes indexes by author/editor, theme, and geographic region (organized by region, country, and ethnic minority), as well as an index of journals. Regional categories include Central Europe (the Czech Republic, Hungary, Poland, Slovakia); Southeast Europe (Albania, Bosnia-

Herzegovina, Bulgaria, Croatia, Macedonia FYR, Romania, Yugoslavia FR); the Baltics (Estonia, Latvia, Lithuania); the Commonwealth of Independent States (the former Soviet Union without the Baltic states); the Western Republics of the Commonwealth of Independent States (Belarus, Moldova, the Russian Federation, Ukraine); the Transcaucasus (Armenia, Azerbaijan, Georgia); and Central Asia (Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, Uzbekistan). Small multiethnic regions (such as Kosovo and Transylvania) are included in the ethnic minority index.

The online version of the bibliography can be viewed on LGI's Managing Multiethnic Communities Project's Web Site: <http://www.osi.hu/lgi/ethnic>.

To order: Both of these volumes are distributed primarily to libraries, research institutes, universities, and international organizations working in the region. If you wish to receive a copy of either volume, please contact kovacsp@osi.hu. Please indicate "Order Diversity in Action" or "Order Bibliography on Ethnic Relations" in the subject line and provide your mailing address (name, institution, address, city, state, country, zip code) in the body of your message.

What Is COMIR?

by Snjezana Bokulic

The Consortium of Minority Resources (COMIR) is an Internet-based network of leading organizations dealing with minority rights and ethnic relations in the OSCE region. Founded in Budapest, Hungary, in February 2000, COMIR seeks to become a central source of information on issues of multiethnic policy, ethnic and national minority rights, and minority protection. COMIR's mission is to provide up-to-date online information to NGOs, minorities, policymakers, public officials, scholars, and the media at the international, national, and local levels. COMIR's Web site (www.comir.net) provides up-to-date information, reports, case studies, legal documents, and other publications on European ethnic minorities and related topics. COMIR also offers a range of services to international organizations, governments, and policymakers, providing them with information, reports, research, and expertise.

The Consortium coordinates information resources available on member organizations' Web sites. It also monitors and reports on behavioral norms and legislation related to minorities and multiethnic policies that have been approved and implemented at the national and regional (European) level. Information is coordinated by the LGI Managing Multiethnic Communities Project, which maintains the COMIR Database (<http://lgi.osi.hu/comir/db>). The COMIR Database will serve as a clearinghouse of information on minority and multiethnic

policy issues, servicing various clients in their requests for the latest information, reports, and research results. Information is disseminated through the Web sites and mailing lists of member organization, as well as by the European Centre for Minority Issues'.

COM IR and its member organizations are also engaged in other projects. Through a program of advocacy and rights training, mentoring, and counseling of minority activists,

the Minority Rights Group International and the Center for Documentation and Information on Minorities in Europe-Southeast Europe (CDIME-SE) are engaged in capacity building. CDIME-SE also aims to facilitate dialogue between the state and NGOs by developing a database. Member organizations have created a database of minority-related national

legislation in the postcommunist states and developed a new information system on minority rights.

Snjezana Bokulic is the coordinator of COMIR. For more information on COMIR, check its Web Site, at www.comir.net, or contact COMIR, at comirnews@yahoo.com.

LGI Announcements

Call for LGI Research Interns

Interested in working in a diverse, challenging, and exciting environment on topics related to local public policy development, decentralization, public service reform, and multiethnic community management? Would you like to contribute to LGI research and publications and participate in projects on Central and Eastern Europe, Southeast Europe, and Central Asia?

LGI may be the place for you! We are currently accepting applications for our newly established research internship program. Interns will work at the LGI office, located in the Budapest headquarters of the Open Society Institute. The internship cycle will begin in the late summer and last for four months (August 21-December 21, 2001).

Qualifications: Interns must be native English speakers with excellent writing, research, and communication skills and must hold at least a B.A. degree (M.A. desirable) in an area related to public policy or political science. Interns should be knowledgeable about Central and Eastern Europe, Southeastern Europe, or Central Asia; able to work independently; and computer literate. Familiarity with online research and a commitment to working in the region are a plus.

To apply: Applications must include a resume, a cover letter explaining the applicant's qualifications and reason for applying for the internship, the names and contact information (e-mail and telephone numbers) of two references familiar with the applicant's academic or written work, and a writing sample no longer than five pages in length. The deadline for 2002 is November 15, 2001.

LGI is unable to provide compensation for its interns and encourages prospective applicants to seek outside sources of funding. For more information on the LGI Research Internship program, please contact Petra Kovacs, at kovacsp@osi.hu.

Searching for Experts in Central and Eastern Europe or the Former Soviet Union? Looking for Employment Opportunities?

The LGI Experts Database is a rapidly growing registry of public policy and public administration experts willing to work on projects in Central and Eastern Europe and the former Soviet Union. To find out more about this useful tool, please visit the LGI Web site, at <http://lgi.osi.hu/experts>.

Local Government Internet Forum

LGI-Forum is an electronic meeting place for discussing local government problems, policies, and practices in a multidisciplinary manner. The Forum initiates and facilitates discussion on current practices in local government, disseminates academic and policy-oriented research, and promotes best practices.

Membership in the LGI-Forum is open to professionals, practitioners, and scholars interested in local government reform in transition economies and developing countries (primarily, but not exclusively, in Europe). To sign up, visit the Forum's Web site, at <http://lgi.osi.hu/forum>. To suggest topics for discussion, please email the Forum, at lgiforum@osi.hu. For more information, contact *Adrian Evtuhovici*, Project Manager, at evtuhovici@osi.hu.

LGI Policy Fellowship Program: Call for Fellows

The primary goal of the LGI Policy Fellowship program is to support policy research and design recommendations on the interaction of development models in various areas of government and public services. Fellows are encouraged to initiate

research and work on policy with national and local government officials and advisers.

Each year LGI supports joint or compatible research and policy development studies on three or four broad topics. The goal of the program is to create long-standing horizontal professional contacts and improve knowledge on specific Central and Eastern European development models.

LGI is currently calling for fellows for the 2001/2002 LGI Policy Fellowship Program, which runs from October 2001 through July 2002. Fellowship topics are:

- Municipal Creditworthiness, Fiscal Distress, and Debt Adjustment in Transition Countries
- Improvement of Fiscal Equalization Techniques in Countries with Several Tiers of Government
- Performance Measurement in Public Service Provision
- Decentralization of Water Management: Public Service Reform in Central Asia and the Caucasus

The deadline for submitting applications is July 20, 2001. Late applications will not be considered. For further details see <http://lgi.osi.hu/fellowship> or contact *Petra Kovacs*, at kovacsp@osi.hu.



Bank of Finland
Institute for Economies in Transition

The Bank of Finland Institute for Economies in Transition (BOFIT) conducts high-level research on transition economics and monitors economic developments in Russia and the Baltic states. Its research focuses on issues relating to macroeconomic performance, the public sector, and financial markets in transition economies. The institute publishes two research-oriented discussion paper series and regular economic reviews.

Putin's Second Year and Beyond—Seeking the Engine of Change

by Pekka Sutela

Vladimir Putin's second year as president of Russia has started with mixed feelings among observers. While 2000 was arguably Russia's best year in macroeconomic terms since 1913, recorded growth on a seasonally adjusted month-to-month basis has been zero since October. Investment, crucial for sustainable growth, seems to have begun to chill even earlier. If Russia maintains its current production level, annual growth will

be about 3 percent this year. In the light of this estimate, the official forecast of 4 percent is not that demanding. But some analysts have already cut their predictions of annual growth by 1–2 percentage points, implying a decline in month-to-month levels.

While it is still too early to predict an imminent recession or crisis, the real appreciation of the ruble together with

an expected slowing of world demand will likely force a narrowing of the current account surplus and increase fiscal strains on the economy. Russia will still have to service its foreign debts to retain credibility and creditworthiness, but money will be unavailable for maintaining short-term aggregate demand. Moreover, some of the recent systemic improvement is at risk, as barter may again pick up and arrears may grow.

Inflation remains a primary concern. Half this year's inflation target was reached in just three months. Although the recent money supply, which has declined slightly, presents no problem, there is considerable pressure to increase administrative prices. The electricity giant RAO UES is rumored to want a fourfold increase in domestic prices over the next couple of years. The company argues that otherwise there will be no money for the investment needed to maintain an adequate electricity supply. Such price increases will likely be blocked, but the pressure will persist, along with similar pressures on other prices. Indeed, many companies are talking about major wage increases.

The authorities have outlined a wide-ranging, highly ambitious plan for structural reform. It involves continued tax reform with an emphasis on enterprise taxation, as well as reforms in non-agricultural land, the public sector, the budget, banking, pensions, and, perhaps most important, natural monopolies, including natural gas, electrical power, and the railways. Many other parts of the policy agenda, such as reform of the court system, will also have direct impacts on narrower economic issues.

Last year was not a lost year for reform, but much more could and should have been done. The agenda for 2001 will burden decisionmaking and administrative capabilities to their utmost. While Russia has seldom suffered a lack of programs or intentions, there has been a lack of strategic thinking and implementation. The next few months may prove decisive. Many of the more liberal economic thinkers have already expressed disappointment and lowered expectations. The credibility needed to maintain momentum probably demands visible change this spring. Elections are also drawing nearer, and Russia's international environment is not changing for the better.

During the past 15 years Russia has ended up in what an institutional economist would call a "bad institutional equilibrium." There are many ways for systems to shift from one equilibrium to another. The probability of another top-down revolution is clearly much less than some hoped in early 2000. Change in Russia has often come from an external shock, such as the Crimean War. Such a shock—beyond an eventual decline in export prices—is fortunately not foreseeable, and any likely consequences are unclear.

A perspective of change is often linked to overlapping generations. The members of the new elite that emerged in the Yeltsin era are typically young, often just at the start of their careers, and intent on holding onto power for a long time to come. Russia's even younger "genera-

tion Y" may not be sufficiently unified or self-conscious to pose an alternative.

That probably leaves adoption of a European development perspective as the most certain bet for an engine of change. President Putin championed it in an online chat in March. The lack of credibility of this alternative may be reflected in the fact that almost nobody in Russia or other CIS states paid any attention. That Russia will aim to become a true European nation still strikes most as improbable.

The author is head of BOFIT. This is a slightly abbreviated version of his article "Putin's Second Year—and Beyond," published in BOFIT's Russian Economy: The Month in Review, May 2, 2001.

Russia Could Progress Faster through Liberalization

By Jouko Rautava

Despite the recent recovery of the Russian economy, the investment climate remains notoriously bad. This is in part due to unfinished institution building, but also in part to excessive regulations and bureaucracy. For example, some 400–500 kinds of commercial activity require a license. Given the steps in each permit process, the actual number of licensing requirements is closer to 2,500. In Western countries the number of commercial activities that must be licensed is probably between 30 and 90. The situation in Russia is even worse when it comes to product certificates or inspections by authorities.

Excessive regulations together with poor institutions have made the business environment exceptionally cumbersome. That raises a natural question: What are the costs of the lack of clear rules and transparency?

Russia's Costly Peculiarities

In a new PricewaterhouseCoopers survey, "The Opacity Index" (<http://www.opacityindex.com>), the authors estimate the extra costs arising from the lack of clear rules and internationally accepted practices relating to investment in 35 countries in the second half of 2000.

The index combines opacity ratings for five areas that affect capital markets—corruption, the legal system, macroeconomic and fiscal policies, accounting, and the regulatory regime. The effects of opacity are then treated as a surtax on investment. Opacity appears to be very costly for Russia. The costs of problems with corruption, legislation, and regulations are equivalent to an additional 43 percent corporate income tax compared with the burden on investments in Singapore, whose business environment

was judged to be the most transparent among the 35 countries surveyed.

Naturally, Singapore is less comparable to Russia than other transition economies in Europe, such as the Czech Republic, Hungary, Lithuania, Poland, and Romania—candidate countries for the European Union that are also included in the opacity report. Even compared with these countries, Russia's more opaque business environment translates into an additional 10–25 percent surtax on investments. Such a cost margin obviously has a major effect on investment flows to Eastern Europe.

According to the survey, Russia is likely to lose at least \$7 billion in foreign direct investment annually because of opacity. In 2000 inflows of foreign direct investment into Russia amounted to less than \$3 billion. The survey's findings offer interesting insights into Russia's current investment "strategy": because of ad hoc tax holidays and other negotiable concessions, the business environment has become even more opaque and, consequently, has attracted even less investment.

Institution Building Takes Time

Russia needs better institutions and more liberalization to make its business environment more transparent and business friendly and to lower the indirect costs of opacity. The relatively good working relationship between Putin's government and the Duma has opened new possibilities for progress in structural reforms. Indeed, the situation is probably better than many critics claim, given the recent advances in several major legislative initiatives in the government and the Duma.

Nevertheless, institution building is slow. Consider tax reform. After years of preparation part one of the new tax code was introduced in 1999, and part two was partly implemented at the beginning of 2001. The remaining parts are scheduled

for implementation at the beginning of next year. Thus even in a favorable political climate like today's, a reasonable assumption is that it takes at least five years to push through major reform packages (such as for banking, agriculture, the land code, and competition policy).

Liberalization Could Bring Quicker Results

The government has an important strategic "asset" for rapidly improving the investment climate, however—liberalization. Stroke-of-the-pen measures could help Russia reduce its regulatory burden without requiring time-consuming drafting of laws or significant administrative capacity. Russian authorities have forwarded a package for reducing bureaucracy to the Duma for evaluation, but so far real progress has been limited. Indeed, there have even been reversals, as indicated by recent problems with customs procedures and new product certificates and by the increase in bureaucrats.

Given Russia's history of reform, it may be difficult to convince the business community that the authorities are serious about regulatory reform. Thus Russia might benefit from adopting a clear, credible framework for liberalization. The European Union could serve as a benchmark, with every government plan and action directly compared with the situation in the EU. Moreover, the EU and the OECD have long experience in regulatory reforms, so a great mass of material is available in this area. The EU may not be the ideal model for regulatory reform, but it can certainly provide a credible benchmark for Russia. Incidentally, the lack of such a benchmark or policy target is one of the main reasons that Russia is lagging behind the EU candidate countries.

The author is an economist at BOFIT. This is a slightly abbreviated version of his article "Faster Progress through Liberalization," published in BOFIT's Russian Economy: The Month in Review, June 5, 2001.

New BOFIT Discussion Papers

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

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

This paper analyzes trade between Central and Eastern European countries and the European Union during 1993–98. Central and Eastern European countries have developed their comparative advantages in quite different directions. Some have developed a comparative advantage in industries requiring much skilled labor, while others have moved in the opposite direc-

tion. This difference is reflected in degrees of capital intensity.

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

The author reviews issues relating to the quasi-fiscal operations of central banks in a sample of countries in Central and Eastern Europe and the former Soviet Union. Transparency in fiscal and monetary accounts is at risk if the central bank undertakes quasi-fiscal operations while the government provides less than full coverage of fiscal operations. The lack of transparency in the fiscal accounts of transition economies warrants serious concern.

BOFIT Scholarships

The Bank of Finland Institute for Economies in Transition welcomes applications for posts in its Visiting Researchers Programme. Scholarships for two to six months are available for 2002 for high-level research projects in areas pertinent to the institute's research objectives. The application deadline for the 2002 program is June 15, 2001.

Visiting scholars are expected to conduct research based on a mutually agreed research plan. Articles stemming from the research are expected to be included in the BOFIT Discussion Papers Series and may be published elsewhere as well. Visiting scholars are also expected to give a lecture in the institute's seminar series on their research topic and to interact with other researchers engaged in projects in the same area.

BOFIT offers an active but relaxed research environment, excellent library facilities, and support from other research facilities. Remuneration will be commensurate with the visiting scholar's research experience.

Those interested in applying are invited to send a brief research proposal; a CV detailing the applicant's academic and research background, with the names of two or three references; and a copy of an earlier paper selected by the applicant, to the Bank of Finland, Institute for Economies in Transition, PO Box 160, Helsinki, Finland, fax: +358-9-183-2294, email: bofit@bof.fi. Applications should reach BOFIT no later than June 15, 2001.

Information: Pekka Sutela, head of institute, tel.: +358-9-183-2297, email: Pekka.Sutela@bof.fi, or Jukka Pirttilä, research supervisor, tel.: +358-9-183-2986, email Jukka.Pirttila@bof.fi.

World Bank\IMF\EBRD Agenda

Changing of the Guard at World Bank Institute

The World Bank Institute will have a new vice president. It has been announced that the institute's present head, Vinod Thomas, an Indian national, will become country director in Brazil on October 1. Frannie Leautier, currently director in the Office of the President, will replace Thomas. Leautier, a Tanzanian national, will be the first African woman to become a vice president at the Bank. She will assume her new position on October 1.

IMF to Gain New First Deputy and New Directors

IMF Managing Director Horst Köhler has proposed the appointment of Anne O. Krueger, a distinguished international economist at Stanford University and a former vice president of the World Bank, to the position of first deputy managing director. She would succeed Stanley Fischer, who earlier announced his decision to leave the IMF. The move comes less than two months after U.S. President George W. Bush said he was nominating Krueger to his Council of Economic Advisers. That nomination will be withdrawn. "Her appointment will send signals," says Robert Litan of the Brookings Institution. "One is that the administration is committed to a continued IMF, because she has spoken out on the need for an IMF. Second, she brings a thorough knowledge of trade and development issues to the Fund. She's extremely familiar with the economic situation of developing countries." The appointment of Krueger, which would be to a five-year term, requires executive board approval.

Timothy Geithner, formerly the undersecretary for international affairs at the U.S. Treasury and currently a senior fellow for international economics at the Council of Foreign Relations, is to be-

come director of the Policy Development and Review Department, succeeding Jack Boorman. As the *Washington Post* points out, "Geithner's position is widely viewed as the Fund's third most powerful because of the role this department plays in overseeing the Fund's approaches to individual countries." Harvard University economist Kenneth S. Rogoff, an authority on international economics, is to become economic counsellor and director of the IMF's Research Department, succeeding Michael Mussa. Gerd Häusler, formerly chairman of Dresdner Bank AG's investment banking arm and a member of the banking group's managing board, is to become counsellor and director of the newly created International Capital Markets Department. The appointments are expected to take effect over the course of the summer.

World Bank Co-Chairs Federal Republic of Yugoslavia's Donor Meeting ...

The World Bank and the European Commission will co-chair a June 29 donors' event in Brussels, where Yugoslav authorities will present economic policy goals and planned reforms. The Bank will present a detailed report to potential donors on the Federal Republic of Yugoslavia's economic and financial requirements. "Based on the report on the economic situation and investment and financial requirements, we would like to see at the donor conference a commitment by donors to \$1.2 billion worth of new projects and programs to initiate in 2001," said Johannes Linn, vice president of the Bank's Europe and Central Asia Region, during a recent visit to Belgrade. Yugoslav officials say the money is needed to rebuild infrastructure (particularly the power grid), reshape the banking system, and support the transition to a market economy. "Prospects for continued recovery of the economy are good. We expect the

economy to grow 5 percent this year," Linn added. The World Bank is particularly interested in building a proper social safety net to minimize problems bound to be felt by the poorest citizens.

... and Estimates Its Financial Needs ...

The Federal Republic of Yugoslavia will need to find \$20.5 billion in external financing over the next five years if its economy is to recover from a decade of underinvestment, international isolation, and war, the World Bank recently estimated. Of that total, \$4.6 billion will have to be provided by donor governments and international financial institutions. In a report on the country's economic prospects, the World Bank recommended large-scale privatization, cuts in government subsidies, increases in utility tariffs, and widespread investment in infrastructure to restore the economy. (The Federal Republic of Yugoslavia's membership in the World Bank was re-established on May 8. A plan has been approved for clearing the country's arrears, totaling \$1.7 billion, and granting temporary, exceptional IDA eligibility. Up to \$540 million in IDA lending could be made available over a three-year period. The World Bank hopes to raise an additional \$4 billion from donors in the next three to four years.)

... while the IMF Provides a \$249 Million Standby Credit

In support of the Federal Republic of Yugoslavia's economic program, on June 12 the IMF approved a standby credit of \$249 million. The first installment (\$62 million) can be drawn on immediately; the remaining three installments (\$62 million each) could become available once quarterly reviews of the program are concluded. The IMF's standby agreement clears the way for other international funds to flow into Belgrade, including project-specific financing from the World Bank and the European Investment Bank. The standby agreement

also allows Belgrade to move forward in talks on debt restructuring, the most critical economic issue it faces. The country owes some \$5 billion to Western governments in the Paris Club and another \$7 billion to commercial lenders in the London Club. The most optimistic forecasts predict a GDP of \$11 billion for the Federal Republic of Yugoslavia this year.

World Bank Withholds Lending in Lithuania and Latvia ...

The World Bank has put on hold a second \$50 million installment of a structural adjustment loan to Lithuania because of the slow pace of its agricultural reform and delays in restructuring the state-owned electricity utility Lietuvos Energija and in privatizing the gas company Lietuvos Dujos. Earlier the Bank took similar action in neighboring Latvia, withholding \$40 million in lending because of the country's faltering privatization process.

... and Closes Its Office in Estonia

The World Bank will close its office in Estonia because of the country's sound economic performance. But cooperation between the two will continue. Projects now in the works for agriculture, health care, and rehabilitation of the Tallinn-Tartu road will be jointly brought to an end, Reuters reports.

\$250 Million IDA Credit for Vietnam

The World Bank approved a \$250 million Poverty Reduction Support Credit (PRSC) to aid poverty reduction in Vietnam through economic and structural reform. (The PRSC is a new World Bank lending product designed to help low-income countries with strong policy and institutional reform programs carry out their poverty reduction strategies.) World Bank Country Director Andrew Steer suggested holding a government-business forum in Hanoi. He also suggested that now that Vietnam has made progress in

economic reform legislation it should concentrate on implementation. It can also start on public administration and judicial reform as well as anticorruption measures.

IMF Transparency: Work Program on the Web

For the first time the IMF published a detailed breakdown of the policy issues that the IMF's 24-member board will confront before the annual meetings in Washington this fall and the gathering of members in spring 2002. The IMF is shifting its emphasis from a heavy reliance on macroeconomic indicators to more in-depth surveillance of national balance sheets and banking systems. The IMF is expected to coordinate more efficiently with governments and with private sector lenders and investors. In the search for ways to attach fewer conditions to its loans—and thus give countries more freedom in setting economic policy—the IMF is soliciting comments from academics, NGOs, and other sources around the world. The board will be asked to more clearly define the roles of the IMF and the World Bank as they provide advice to member nations on economic reform and development. Other issues on the board's agenda: continuing review of international tax havens and money laundering, streamlining IMF loan conditions, IMF involvement in poverty reduction efforts, and review of the so-called quota-based system of voting rights.

EBRD Announces Record Profits ...

The EBRD announced a record, nearly tenfold growth in profits in the first quarter of 2001 (35.9 million euros, compared with 3.8 million euros in the first quarter of 2000), a result of increased income from interest charges and a reduction in reserve requirements due to less risky credits. In the first quarter the EBRD approved credits worth 401.8 million eu-

ros for Eastern European and CIS countries, three times the amount approved in the same period in 2000. EBRD investments are also growing rapidly. In late April the EBRD was considering projects worth 270 million euros; by June 1 this figure had reached half a billion euros.

... and Shifts Investment to the East

The EBRD is shifting investment toward Russia, Ukraine, Southeastern Europe, and Central Asia. Bank President Jean Lemierre said that the EBRD will increase total investments by 25 percent to 3.4 billion euros (\$3 billion) annually in coming years without a capital increase. It will manage with its 20 billion euros of capital, and finance its needs from maturing investments. The bank had 12.2 billion euros invested at the end of 2000. Investment in Central Europe—where up to eight countries are hoping to join the European Union—will remain steady at about 1 billion euros a year. The EBRD plans to raise investments in Russia to 1 billion euros a year from 570 million in 2000. It has moved toward that higher figure with projects involving automaker AvtoVAZ and oil company LUKoil and an investment aimed at restructuring electricity giant RAO UES.

IFC Closes Its Budapest Office and Opens One in Istanbul

On July 1 the IFC is closing its Budapest office and transferring oversight of the remaining Hungarian operations to Warsaw. (Hardly any new IFC projects have been launched in Hungary since 1999.) In Istanbul, however, it has opened a new office that will serve as a regional hub for IFC investments in Southern Europe and Central Asia. Khosrow Zamani, the IFC's director for Southern Europe and Central Asia, took up residence in Istanbul on June 1. Zamani will be joined by additional IFC staff from Washington who will work on project finance and provide

legal, technical, and environmental advice for investments. The IFC's exposure in Southern Europe and Central Asia stands at \$1.5 billion. The new office will cover 15 countries: Albania, Azerbaijan, Bosnia and Herzegovina, Bulgaria, Croatia, Kazakhstan, the Kyrgyz Republic, the former Yugoslav Republic of Macedonia, Moldova, Romania, Tajikistan, Turkey, Turkmenistan, Uzbekistan, and the Federal Republic of Yugoslavia.

World Bank Promotes Open and Private Financial Sectors

Countries can boost economic development, combat poverty more efficiently, and reduce volatility in their markets by opening their financial systems to foreign banks, the World Bank suggests in its newly released report, *Finance for Growth: Policy Choices in a Volatile World*. Reducing state ownership of financial institutions can help avert financial crises such as the one that plagued Russia. State involvement in the banking sector can suck precious capital away from health and education spending, particularly when the government faces a need to recapitalize state-owned institutions.

"In countries where the government owns many banks, credit is more likely to be restricted to a few large firms, interest rates are higher, and the nonbank financial sector—such as stock markets—is weaker," pointed out Gerard Caprio, director of the World Bank's Financial Policy and Strategy Group. "These countries have less financial sector development and less growth, and therefore higher poverty levels." But privatization should be carried out carefully, with sufficient capitalization and an appropriate regulatory environment to create the right incentives for private companies. The study cautions against deposit insurance schemes in poor countries, saying that in the absence of sufficiently strong regulation, they can create incentives for banks to lend carelessly.

IMF Standby Credit to Romania—Yes, But When?

Romania is certain to sign a stand-by credit accord with the IMF by the end of the year, Central Bank Governor Mugur Isarescu said on June 14. An IMF delegation has been in Bucharest to negotiate an accord to replace one that was reached in 1999 but suspended after Romania failed to keep its commitments. "Our main problem in the talks with the IMF is credibility," the central bank chief admitted. He said that Bucharest must convince the IMF that the government can reduce inflation while also meeting economic growth targets. The government hopes to bring inflation down to 25 percent on a 12-month basis from last year's level of 40.7 percent and get the economy to grow 4.1 percent, up from 1.6 percent in 2000. The Fund also insists that Bucharest settle the arrears of state enterprises, control public sector wages, and speed the privatization of some of the country's largest state-owned companies.

Azerbaijan: Revival of the Silk Route

With a \$40 million credit approved on June 12, the World Bank is joining an international effort to revive the old Silk Route connecting China and Central Asia with Europe. "The Azerbaijan Highway Project aims to help promote economic growth and private sector development by improving access and lowering transport costs for goods and passenger traffic," said Akbar Noman, the Bank's Azerbaijan country manager.

World Bank Helps Russians to Leave the Arctic ...

The World Bank on June 7 approved an \$80 million project to finance voluntary out-migration assistance schemes for people who live in desperate conditions in three crumbling, overpopulated towns

in the Russian North and want to move back to the heartland. The project will also help demolish dilapidated housing stock and infrastructure and introduce modern management practices for housing and utility services.

... and Improve Vocational Education

A new, \$50 million World Bank loan (the Education Reform Project, approved May 24) will help finance a set of education reforms in three regions (The Chuvash Republic, Samara, and Yaroslavl), with the goal of supporting successful experiences that can be replicated across the country at a later stage. Most school-age children in Russia are enrolled in school, and nearly all adults are literate. But rapid decentralization and demand for new skills could put past achievements at risk. The project will introduce a transparent and equitable financing system that will help schools use existing budgets more effectively on a "money follows the student" principle. In addition, a quality monitoring and assessment system will be developed that will lead to a national system for measuring student performance, thus assuring more equitable access to higher education and training places.

... but Russia Blocks Its Health Loan

The Russian government has blocked a \$150 million World Bank loan for the treatment of tuberculosis (TB) and AIDS, triggering fears of a collapse in health funding in the country at a time of growing concern over a TB epidemic and an increase in HIV infections. The loan, which was requested by the Russian government, has been unexpectedly stalled by the Ministry of Health in a clash over treatment methods and World Bank demands for an international competitive tender for TB drugs. The tender would also require Russian suppliers to meet certain quality standards and, the ministry claimed, would have put the domestic

pharmaceutical industry at a disadvantage. The spread of TB and AIDS could cost the Russian economy 1.5–2.0 percent of GDP by 2005. Russia reports 82 new TB cases a year for every 100,000 people. (Russia joined the World Bank in 1992. Since then, commitments to the country have totaled about \$11 billion for 48 projects.)

Russia Likely to Need More IMF Support

Russia is likely to need a new loan from the IMF and debt rescheduling by the Paris Club of creditors to deal with an enormous debt servicing obligation in 2003, the Russian executive director at the IMF, Aleksei Mozhin, said. Moscow faces debt repayments of \$13–14 billion this year, a similar amount next year, and \$18–19 billion in the following year, he said.

Ukraine Joins Global Development Learning Network

With the support of the World Bank and the Canadian International Development Agency, Ukraine became the first transition economy to set up a distance learning center. The Kiev-based center is housed by the Ukrainian Academy of Public Administration, which trains public servants.

The learning center is part of the Global Development Learning Network (GDLN), linking 18 countries. Using state-of-the-art technology—interactive video, electronic classrooms, satellite communications, and the Internet—the GDLN aims to build and share development expertise and knowledge through courses, seminars, and discussions. Owned, operated, and housed by local training and education institutions, the distance learning centers are expected to be profitable or at least self-supporting. By the end of 2002 more than 50 such centers will be in operation.

Latest World Bank Loans to China: \$100 Million for Environment, \$200 Million for Highway Construction

The World Bank approved an \$100 million loan on June 19 to assist in environmental recovery and water quality improvement in the Liao River Basin in Liaoning Province. Another loan, for \$200 million, was approved on June 5 for the Second Jiangxi Highway Project, which will improve the most important transport corridor in Jiangxi Province, between the provincial capital, Nanchang, and the coastal cities of Shenzhen and Guangzhou in Guangdong Province.

Structural Adjustment Loan for Croatia

On June 6 the Croat government and the World Bank agreed on a structural adjustment loan worth \$202 million, intended primarily for promoting small and medium-size businesses. The loan is for 15 years with a 5-year grace period. The interest rate is six-month LIBOR (London inter-bank offered rate) plus a small margin to cover World Bank costs. Depending on when final approval occurs, the first \$100 million installment could be drawn on as early as September or October.

IMF Monitors Slovakia's Economy

The IMF in early June agreed on a staff monitoring program with Slovakia, a move that clears the way for loans from the World Bank. The Slovak government aims to achieve annual real economic growth rates of 3.0–4.5 percent in 2001 and 2002. IMF staff will monitor economic developments in the country and make their assessments public. Following a banking crisis last year, when the government bailed out state banks saddled with bad debts, Slovak authorities negotiated an enterprise and financial sector adjustment loan of about \$300 million with the World Bank, to help restructure banking and manufacturing. That loan was dependent on authorities sealing the monitoring deal with the IMF.

Conference Diary

Russia and Globalization

October 1–2, 2001, House of Estates, Helsinki, Finland

Organizer: Finnish-Russian working group on social sciences; financed by the Academy of Finland.

Topics: Russia and the European integration, Russia today, globalization seen from the enterprise level, economic policy in a globalizing world, Russia and international organizations, and regional perspectives on globalization.

Information: Kristiina Helansuo, Academy of Finland, kristiina.helansuo@aka.fi, or Päivi Karhunen, paivi.karhunen@hkkk.fi, fax: +358-9-408-417.

Third Conference on International Management: Transition or Integration Economies?

November 29–30, 2001, Angers, France

Organizer: ESSCA Graduate Business School (Ecole Supérieure des Sciences Commerciales d'Angers), in collaboration with Budapest University of Economic Sciences and Public Administration.

This will be a unique opportunity to meet with international experts in the field, such as Wladimir Andreff (University of Paris), John Child (University of Birmingham), and Janos Kornai (Harvard University).

Information: http://www.essca.asso.fr/Colloque_transition_2001/anglais/Default.htm.

Institutional and Organizational Dynamics in the Post-Socialist Transformation

January 25–26, 2002, Amiens, France

Organizer: CRIISEA, Université de Picardie; and OEP, Université de Marne-la-Vallée, with the support of the European

Association of Comparative Economic Studies, the East-West Network and East-West Journal of Economics and Business, and Centre Interuniversitaire d'Etudes Hongroises, Université de la Sorbonne nouvelle. (Language: English.)

Topics: Postsocialist transformation—organizational, institutional, and systemic approaches; the state and the new social compromise; monetary and financial institutionalization; corporate governance; networks, entrepreneurship, and industrial cooperation; the institutional dynamics of regional integration; foreign investment—organizational and institutional impact.

Information: Université de Paris I, Maison des Sciences Economiques, 106-112 boulevard de l'hôpital, 75013 Paris, France, tel.: 331-44-07-81-90, fax: 331-44-07-81-91.

28th Annual Meetings of the Eastern Economic Association

March 15–17, 2002, Park Plaza Hotel, Boston, Massachusetts, United States

Information: Dr. Mary H. Lesser, tel.: 914-633-2088, fax: 914-633-2549, email: mlesser@iona.edu, Web site: <http://www.iona.edu/eea>.

Bibliography of Selected Articles

Postsocialist Economies

Szapáry, G. **Transition Countries' Choice of Exchange Rate Regime in the Run-Up to EMU Membership.** *Finance and Development, A Quarterly Publication of the International Monetary Fund* (international) 38(2): 26–29, June 2001.

Central and Eastern Europe

Harper, J. **Short-Term Effects of Privatization on Operating Performance in the Czech Republic.** *Journal of Financial Research* (United States) 24(1): 119–32, spring 2001.

Keane, M., and E. S. Prasad. **Poland: Inequality, Transfers, and Growth in Transition.** *Finance and Development, A Quarterly Publication of the International Monetary Fund* (international) 38(1): 50–53, March 2001.

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Liargovas, P., and D. Chionis. **Economic Integration between the European Union and the Transition Economies of Central European Initiative Countries.** *Post-Communist Economies* (United Kingdom) 13(1): 57–70, 2001.

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Repss, A. **Taxation of E-Commerce in Latvia.** *Tax Planning International E-Commerce* (United Kingdom) 3(4): 8–10, April 2001.

CIS

Alexandrovich, A. S. **Bankruptcy Law, an Economic Medicine: How Russia's New Bankruptcy Legislation Facilitated Recovery from the Nationwide Financial Crisis of August 17, 1998.** *Cornell International Law Journal* (United States) 34(1): 119–63, 2001.

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

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World Bank Working Papers

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

Earlier studies of privatization in the Czech Republic focused largely on how the broad distribution of shares through vouchers may have motivated the new owners to strip assets from privatized firms. This paper finds evidence for asset stripping, but also for "looting"—borrowing heavily with no intent to repay and using the loans for private purposes. Large privatized companies had privileged access to credit from state-controlled banks, which had little incentive to enforce debt contracts. The policy implications are significant: financial incentives and regulation are as important as ownership structure in the design of privatization.

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

Men and women may be affected differently by the transition process, and especially by the privatization and restructuring of state-owned enterprises. In Vietnam during the massive downsizing in the early 1990s, many more women than men were laid off. But in the downsizing that is evolving in the early part of this decade women are less likely than men to be retrenched in large numbers. Labor redundancies are concentrated in male-dominated sectors, such as mining, transport, and construction; redundancies are smaller in female-dominated sectors, such as footwear, textiles, and garments. Moreover, temporary and short-term contracts are more prevalent in female-dominated sectors, suggesting demand for women's work.

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Chong-En Bai and Shang-Jin Wei, **The Quality of Bureaucracy and Capital Account Policies**, WPS 2575, March 2001, 34 pp.

The quality of bureaucracy may be an important structural determinant of the macroeconomic policies of an open economy—especially the imposition or removal of capital controls. In the authors' model capital controls are an instrument of financial repression. They entail efficiency loss for the economy but also generate implicit revenue for the government. The results of the model show that

bureaucratic corruption translates into the government's reduced ability to collect tax revenues. Even if capital controls and financial repression are otherwise inefficient, the government still has to rely on them to raise revenues to provide public goods.

The more corrupt a country, the more likely it is to impose capital controls. The authors' results suggest that as countries develop and improve their public institutions, reducing bureaucratic corruption over time, they will gradually liberalize their capital accounts. Removing capital controls prematurely when forced by outside institutions to do so, however, could reduce rather than improve their economic efficiency.

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Bartłomiej Kaminski, **How Accession to the European Union Has Affected External Trade and Foreign Direct Investment in Central European Economies**, WPS 2578, April 2001, 43 pp.

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

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

When average incomes rise, the average incomes of the poorest fifth of society rise proportionately. A sample of 92 countries extending over the past four decades shows that this holds across regions, periods, income levels, and growth rates. Several determinants of growth—such as good rule of law, openness to international trade, and developed financial markets—have little systematic effect on the share of income that accrues to the bottom quintile. Thus these factors benefit the poorest fifth of society as much as everyone else.

There is some weak evidence that stabilization from high inflation and reductions in the overall size of government not only increase growth but also increase the income share of the poorest fifth in society. The same is true for other factors commonly believed to disproportionately benefit the poorest in society.

The absence of robust findings reveals that relatively little is known about the broad forces that account for the income differences of the poorest fifth of society across countries.

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David Ellerman, **Hirschmanian Themes of Social Learning and Change**, WPS 2591, April 2001, 20 pp.

Quite a few development strategies assume (or desperately hope) that a country already has the capacity to plan and implement institutional reform or that such reform can be pushed through with the external pressures of aid and conditionalities. In a decentralized reform strategy developmental change is induced not

by government decree but by releasing and channeling local energies in smaller projects that will in due course spread through links, learning, imitation, and benchmarking. This is the “Hirschmanian approach.”

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Evgeny Polyakov, **Changing Trade Patterns after Conflict Resolution in the South Caucasus**, WPS 2593, April 2001, 42 pp.

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Bartlomiej Kaminski and Francis Ng, **Trade and Production Fragmentation: Central European Economies in European Union Networks of Production and Marketing**, WPS 2611, June 2001, 61 pp.

The unprecedented globalization of the production process has brought the integration of trade and the disintegration of production, with deep implications for the international division of labor. Global competition has brought a growing emphasis on product standards, rapid innovation, adaptability, and speedy response. Technology has enabled the fragmentation of production. Firms that become part of global production and distribution networks do not have to be foreign-owned, as many multinationals contract out the delivery of services or products. Foreign involvement facilitates the transfer of managerial and technological know-how, so firms benefit from becoming part of a network.

Small producers, rather than servicing small local markets, can supply large firms abroad. Countries of Central and Eastern Europe have made large strides toward readjusting their production struc-

tures to international markets, mainly in the European Union. Three of them—Estonia, Hungary, and Slovakia—have done especially well.

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David Dollar and Aart Kraay, **Trade, Growth, and Poverty**, WPS 2615, June 2001, 45 pp.

To determine the effect of globalization on growth, poverty, and inequality, the authors first identify a group of developing countries that are participating more in globalization. China, India, and several other large countries are part of this group, which contains well over half the population of the developing world. Over the past 20 years these “post-1980 globalizers” have seen large increases in trade and significant declines in tariffs. Their growth rates accelerated between the 1970s and 1980s and again between the 1980s and 1990s, even as growth in the rich countries and the rest of the developing world slowed. The post-1980 globalizers are catching up to the rich countries, but other developing countries (“the non-globalizers”) are falling further behind.

Trade has a strong positive effect on growth, but there is little systematic evidence of a relationship between changes in trade volumes and changes in the income share of the poorest—or between changes in trade volumes and changes in household income inequality. The increase in growth rates that accompanies expanded trade translates on average into a proportionate increase in the incomes of the poor. Absolute poverty in the globalizing developing economies has fallen sharply in the past 20 years. The evidence from individual cases and from cross-country analysis supports the view that globalization leads to faster

growth and poverty reduction in poor countries.

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World Bank Technical Papers

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

The electricity price increase in Armenia in 1999 provides a lesson: a two-stage approach should be used. In the first stage revenues should be increased by ensuring payment from households that have reliable service but are not paying their bills. After collection capacity is strengthened, the utility should implement a program of tariff adjustment, based on improved service and meter-based billing.

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

This assessment of the performance of rural financial markets in Romania—based on the 1998 rural household, rural enterprise, and financial intermediary surveys, along with other official statistical data for 1997—indicates that limited access to credit markets has constrained investment by households and enterprises.

Csaba Csaki and Zvi Lerman (eds.), **The Challenge of Rural Development in the EU Accession Countries**, World Bank Technical Paper 504, May 2001, 228 pp.

This book considers the reforms and policy changes required in the rural sectors of the 10 countries that have started the process of accession to the European Union. The papers in the volume were selected from presentations at the Third World Bank–FAO EU Accession Workshop, held in Sofia, Bulgaria, in June 2000.

Other World Bank Publications

Aldo Baietti, **Private Infrastructure in East Asia: Lessons Learned in the Aftermath of the Crisis**, April 2001, 90 pp.

This report analyzes the impact of the financial crisis on investment trends in infrastructure and evaluates the strengths and weaknesses of private participation in infrastructure in six East Asian countries, including Vietnam.

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

Francis Fukuyama, Amartya Sen, Joseph Stiglitz, and other authors evaluate the extent to which democracy is necessary for achieving sustainable development in Asia. They argue that democracy and markets are complementary and that democracy is intrinsic to development. Liberal and participatory democracy encourages development by providing legitimacy to reform efforts. Movement toward liberal and participatory democracy will allow convergence of the political and economic institutions of Asia and the West. There is broad agreement that effective and sustainable development is multifaceted, not based just on changes in per capita income.

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One hundred leading cases are presented in 15 chapters that cover the most important areas of law in the European Union.

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

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

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

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

Melanie Beresford, **Economic Transition in Vietnam: Trade and Aid in the**

Demise of the Centrally Planned Economy, February 2001, 176 pp.

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

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SITE
Stockholm Institute of Transition Economics and East European Economies
STOCKHOLM SCHOOL OF
ECONOMICS

Box 6501, SE-113 83 Stockholm,
Sweden, Sveavägen 65, 9th floor
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Senior Editor: Richard Hirschler
Room MC3-374
Telephone: 202-473-6982
Fax: 202-522-1152
Email: rhirschler@worldbank.org

Production Manager:
Jennifer Prochnow
Telephone: 202-473-7466
Fax: 202-522-1152
Email: jprochnow@worldbank.org



The World Bank
1818 H Street, N.W.
Washington D.C. 20433
Telephone: 202-477-1234
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THE WILLIAM DAVIDSON INSTITUTE
AT THE UNIVERSITY OF MICHIGAN BUSINESS SCHOOL

724 East University
Wyly Hall 1st floor
Ann Arbor, MI 48109-1234, U.S.A.
tel. 734-763-5020
fax 734-763-5850
<http://www.wdi.bus.umich.edu>

Editor: Anna Meyendorff
Email: Ameyen@umich.edu
Associate Editor: Deborah Jahn
Email: Djahn@umich.edu

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