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The Road to Prosperity: Saving Capitalism from Capitalists

by Raghuram G. Rajan and Luigi Zingales

The corrupt version of capitalism—when powerful corporations deliberately try to eliminate healthy competition to preserve their privileged position—generates economic inefficiencies and social injustice, thereby undermining political support for the free-market-based system; however, an ownership structure that is too dispersed is just as ineffective and dangerous. When ownership is correctly distributed, given the right dose of regulations and the alleviation of social costs, a political consensus in favor of markets can be achieved.

As far as most Americans are concerned, capitalism is part of the American landscape. Its emergence was as spontaneous as the grass growing in their endless prairies, and like the prairies the only risk it faces is too much human intervention. According to them, no intervention is the best policy.

Capitalism: Taking It for Granted?

As the American experience has dominated economic thinking, economists tend to be overconfident about exporting capitalism to other countries. Some think that exporting American law and institutions is sufficient to make capitalism blossom instantaneously. It worked for the United States, why shouldn't it work for other countries? For this reason, economics has typically been oblivious to the political preconditions for the development of capitalism. The fall of the Berlin Wall and the massive experiments with transition economies, however, provided a rude awakening. The experience of the last decade shows that in order to work, capitalism needs more than a good set of laws and institutions. Above all, it needs political consensus among the people. Without political consensus free markets cannot survive.

Once economists recognize this simple truth, then the current American optimism about spreading capitalism seems excessive. Indeed, it is substituted by a moderate pessimism about the intrinsic fragility of capitalism, not its economic fragility (as Marx theorized), but its political fragility. In a nutshell, the idea is as follows. While everyone benefits from competitive markets, no one in particular makes huge profits from keeping the system competitive and the playing field level. Thus nobody has a strong vested interest in promoting and defending free markets. Free markets are a public good, and like all public goods, have no natural constituency.

On the contrary, competitive free markets have many enemies. Not only do their ranks include distressed workers who have lost their jobs because of competitive pressures, but also large industrialists themselves. Truly free markets create competition, which undermines the position of established firms, forcing them to prove their competence again and again. Hence a truly capitalist system not only finds that generating political support is difficult, it also often encounters explicit opposition among the most influential groups. It should thus come as no surprise that true free market capitalism takes root with great difficulty, which is why it is so difficult to export.

After the 1994 Mexican crisis, for instance, the World Bank decided to help the government improve the financial infrastructure. One of the fundamental institutions that was missing was a credit registry, where assets posted as collateral for a loan could be officially recorded so that any potential lenders could be aware of what a borrower had already pledged. In setting up this registry, the World Bank experienced strong resistance from the banks. The banks already had enough clout and local experience that they could get this information regardless of any credit registry. Not only would they not benefit from it, but they would see their competitive position eroded as less established lenders could access that information and compete for business on an equal footing. Thus access to credit was curtailed to support the interests of the few.

This is not an isolated case, and similar examples abound, even in the industrial countries. Worldwide large and established firms and financial institutions have the greatest influence on policy, including the setting up of market infrastructure. Often they are simply not interested in expanding access to everyone, because that would increase competition. No wonder that the interests of free markets are not well served and that the poor around the world see

THE WORLD BANK

What's Inside

markets as being against them, not realizing that what they are experiencing is a corrupted version of what capitalism should and could be.

Not only does this corrupt version of capitalism generate economic inefficiencies and social injustice, it also undermines the political consensus for a truly free market system. In the early 1990s, Robert Shiller documented that Russians had attitudes toward private property and markets that were very similar to those of Americans, but a recent survey finds that 72 percent of Russians would like to see privatized property returned to the state. Ten years of corrupt capitalism have undermined the consensus in favor of free markets even more than seven decades of communist propaganda did.

Why then did capitalism emerge spontaneously in the United States—and before that in England—but is so difficult to establish in other countries? What lessons can we extract from history on what works—and what does not work—in promoting capitalism? Our book, *Saving Capitalism from the Capitalists*, tries to answer these crucial questions.

Right Dose of Government

For capitalism to emerge and function a country needs neither too little nor too much government. To understand why, consider the following example. If you wanted to fly somewhere and the airline industry lacked any overall supervisory authority and no regulations were in place enforcing safety standards, you would be extremely reluctant to fly fledgling airlines. You would prefer the established ones that had a good track record and reputation. Thus a complete lack of safety regulations in the airline industry would favor established firms, making entry impossible and killing competition. By contrast, if the regulations were such that airlines had to have a proven five-year track record of profitable flying before they were allowed to fly passengers, new entry would again be killed off, for how could new entrants have a proven record? Competition flourishes in the delicate middle ground.

A country can only achieve this balance when there is broad consensus in favor of markets, and such consensus arises only with the right distribution of ownership. Too much ownership concentration is inimical to market development, because large owners can protect their interests without a fair and objective judicial system, and so they have no interest in developing one. Indeed, they often have an interest in preventing its development so they can continue their privileged violations unimpeded. But too dispersed an ownership structure is not conducive to capitalism either, because it makes coordinating a strong pro-market movement more difficult.

England achieved this delicate balance in the 16th century following the expropriation of large landowners and the widespread sale of land that took place under Henry VII and Henry VIII. This created a powerful gentry, who were neither too powerful individually to dispense with the law nor too weak collectively to demand its enforcement and to withstand the monarch's depredations. Not only did the United States import this economic structure from England, it actively promoted it. Americans like William Penn and Thomas Jefferson were deeply influenced by the British philosopher James Harrington, who in his 1656 book, *Oceana*, argued in favor of a more equal distribution of land ownership, which he saw as the key to England's success.

Paradoxically, a country can achieve this balance of power more easily when it lacks natural resources. Natural resources such as oil and diamonds create an automatic concentration of economic, and hence of political, power that is difficult to undo, especially during the early phases of development when no offsetting sources of power exist. In the absence of natural resources the government has no choice. If it wants to be able to raise some revenues, it has to promote commerce and trade, and to do so it has to restrain itself and establish a reliable system of law. But when it controls a lot of easily extracted natural resources, the government can fund itself without the people's consent and can therefore afford to be despotic. It is no coincidence that in modern times more democratic forms of government were first established in Venice and the Netherlands, where the prime economic resource was people's industriousness, and it is no coincidence that even today, countries rich in natural resources have some of the most despotic regimes.

Privatizing natural resources is not a panacea either. Given the economic, and therefore the political, power these resources provide, the necessary separation between the government and the resource owners becomes infeasible. Either the owners acquire so much political power that they run the country in practice, or the government eventually succumbs to the temptation of re-appropriating the resources. Either way, a reliable system of law and property rights cannot be established.

By contrast, a country can more readily achieve the balance between too much and too little government when it is open to foreign competition. While local lobbies can hamper local competitors, they have no power against foreign ones, other than by closing the country's borders. When the widespread openness of world trade or the pressure from bordering nations makes this latter option infeasible, markets flourish.

Implications for Transition Countries

While we did not write our book only with transition economies in mind, it does have several implications for them.

• It explains why Azerbaijan, Kazakhstan, and Russia, which are rich in natural resources, have found the path to a market democracy more difficult to follow than the Eastern European countries, which are not as awash in natural resources.

• It points to why voucher privatizations were a mistake. In the attempt to build an extremely fragmented ownership structure, more fragmented than that in any Western country, they undermined the possibility that political demand for legal protection would emerge. The ironic result was an excessive concentration of ownership, when the few who were well connected and well informed were able to scoop up the shares that citizens unable to get any value for their claims dumped on the market. In Russia the problem was only made worse by the loans-for-shares agreement, whereby the most valuable natural resource companies were given away to the politically well connected.

• It suggests that the hopes of a rapid move to a free-market democracy in Russia may be overly optimistic. These hopes are based on the idea that the process of consolidation of ownership in the Russian oil and gas industry has created some powerful players who virtually own their firms, and therefore have an enormous stake in promoting the good of the country. This idea is not new. In the 1950s Charles Wilson, president of General Motors (GM) and later secretary of defense under President Eisenhower, stated: "What's good for GM is good for the country." This was not true for the United States back then, and it is not going to be true for Russia today. On the contrary, the extreme concentration of ownership in Russian natural resources spells trouble for the future.

What we are witnessing now is a battle between the oligarchs and the state over who will control the huge profits generated by natural resource extraction. On the one hand, President Putin is trying to raise revenues (and potentially quell political dissent) by threatening the oligarchs with the specter of government expropriation, legitimized by the illegality of the privatization process. On the other hand, the oligarchs are trying, literally, to buy consensus among the legislators to ensure that their will becomes law. Either outcome, however, will be bad for free markets and democracy. If the oligarchs win, their property will become more secure, but competition and free entry will not be promoted. More important, they will undermine the credibility of the new fragile democracy. If voters, who deeply resent the privatization process, see their will overturned by a servile parliament, what future will democracy have in Russia? But if the government succeeds in expropriating the oligarchs, what future will private property, and therefore a market economy, have in the country?

Betting Against the Odds

What can be done? In our book we pin our hopes on market openness and a set of structural reforms to promote wider and more efficient distribution of ownership. We also argue that alleviating the social costs that markets generate is important so as to reduce antimarket sentiment. This is unfortunately widespread in countries like Russia, where the introduction of a market system has brought unemployment, and often poverty, to large segments of the population. We are well aware, however, that our policy recommendations contain a potential contradiction. If the oligarchs are so influential in politics, what hope do we have that any policy aimed at reducing their long-term power will be implemented?

The missing piece, the source of hope, is to create widespread political awareness that will sustain reform. While we are realistic about the power of money, we are not so disillusioned as to believe that ideas have no power. Indeed, our aim in writing *Saving Capitalism from the Capitalists* was to help create awareness that capitalism is not broken, but that in much of the world it just needs to be saved from the capitalists.

Raghuram Rajan and Luigi Zingales are professors at the University of Chicago. (Mr. Rajan succeeded Kenneth Rogoff as chief economist of the IMF in October 2003, their book, Saving Capitalism from the Capitalists: Unleashing the Power of Financial Markets to Create Wealth and Spread Opportunity, was published in February 2003 by Crown. ❇

NEW FINDINGS

Investment Climate in China: A Tale of Five Cities

by David Dollar, Mary Hallward-Driemeier, Anqing Shi, Scott Wallsten, Shuilin Wang, and Lixin Colin Xu

In 2001 and 2002, with the collaboration of the Enterprise Survey Organization of China's Bureau of Statistics, the World Bank surveyed 1,500 Chinese firms in five cities—Beijing, Tianjin, Shanghai, Guangzhou, and Chengdu—to compare the investment climate. The results show large variations across the five cities, but Shanghai and Guangzhou had the best "report card." Improvements in the investment climate can spur additional investment, sales growth, and productivity, thereby accelerating economic growth. Greater global integration and a stronger private sector are especially important, in addition to less stringent entry and exit barriers, greater labor market flexibility, and good financial services.

For China and other developing countries to do well, good macroeconomic and trade policies need to be complemented by a host of other institutional factors and policies that can be classified under the broad heading of the investment climate.

Defining the Investment Climate

The quantity and quality of investment flowing into China or any specific region depend on the returns that investors expect and the uncertainties surrounding those returns. The expectations can be categorized into the following broad, yet inter-related, components:

- **Macroeconomic, fiscal, monetary, trade, and exchange rate policies and political stability.** In relation to trade, China has reduced its tariff rates to about one-third of what they were two decades ago, from 49.5 percent in 1982 to 16.8 percent in 1998. Partly as a result, trade increased from 15 percent of GDP in 1980 to nearly 50 percent of a much larger GDP in 2000. During the same period imports increased from about $36 billion to $192 billion (in constant 1995 dollars), while exports increased from $27 billion to $239 billion.
- **Efficacy of the regulatory framework.** At the firm level the regulations affect entry and exit; labor relations and flexibility of labor use; efficiency and transparency of financing and taxation; and efficiency of protecting the environment, safety, health, and other legitimate public interests. Such regulations need to be designed in incentive-compatible ways, avoid adverse selection and moral hazard, serve the public interest, be implemented expeditiously without harassment and corruption, and facilitate efficient outcomes.
- **Quality and quantity of physical and financial infrastructure, such as power, transport, telecommunications, and banking and finance and the endowment of skills and technology.** Entrepreneurs often cite infrastructure issues, such as power reliability, transport time and costs, and access to and efficiency of finance, along with the lack of skilled workers and the difficulty of access to advanced technologies, as key determinants of competitiveness and profitability.

China's success since the 1980s suggests that its investment climate incorporates many positive features, especially those related to political and macroeconomic policy stability. However, some recent changes in the structure of China's economy require further structural reforms. China's accession to the WTO, for instance, requires it to shift from discretion-based governance to rules-based governance, which in turn requires a reduction of the government's role in how firms operate. For example, a vast majority of credit is provided to state-owned enterprises, which often cannot service their debts. At the same time small and medium enterprises have to rely mainly on retained earnings, personal wealth, or parent company financing to finance their investments.

Another challenge is to create jobs for rural residents who have migrated to the cities and for workers laid off from state-owned enterprises. This also calls for regulatory reforms to reduce entry barriers for new small and medium enterprises, which have become the most important force behind job creation, and for financial institutions to make their credit facilities available to small and medium enterprises. China also lags behind its more developed East Asian neighbors in terms of education level and infrastructure. Within China, the investment climate is not uniform, and national indicators can mask important variations across regions.

In collaboration with the Enterprise Survey Organization of China's National Bureau of Statistics, the World Bank surveyed 1,500 Chinese firms in 2001 and 2002 in five cities (regions): Beijing, Tianjin, Shanghai, Guangzhou, and Chengdu (see Table 1). The survey asked in-depth questions related to firm performance, production, labor, governance, financing, and technology. To collect objective quantitative data, instead of asking, for example, whether red tape is an obstacle, managers were asked how much time they spend with officials to meet regulation requirements. Similarly, rather than asking them if labor laws are restrictive, the survey gathered information about the share of temporary workers and the extent to which firms have excess workers.

Investment Climate Indicators

Those indicators that were the most significant determinants of firm performance can be classified into the following categories:

- **International integration.** A friendly investment climate encourages foreign entry and openness to foreign-made goods. Three measures are used to capture the extent of international integration:
  - The first two measures are the share of foreign-ownership and the share of firms that partnered with foreign

companies, including joint ventures and joint research and development, training, and marketing. In Shanghai almost 40 percent of firms have foreign partners, and foreign ownership accounts for almost a third of the value of surveyed firms. In Guangzhou roughly 28 percent of firms have foreign partners, although overall foreign ownership stands at 35 percent. Chengdu, the only inland city in the sample, is, not surprisingly, the laggard, with only 10 percent of firms having foreign partners and an even lower share of foreign ownership. Beijing and Tianjin fall between these extremes.

– Market share of the firm's main product accounted for by imports. The higher the import share, the greater the exposure or openness to international competition. Guangzhou and Shanghai have greater exposure to international competition, with the market shares accounted for by imports being 11.7 and 8.8 percent, respectively. Chengdu and Tianjin have lower openness scores, with their shares being 5.9 percent and 7.4 percent, respectively.

- **Private sector participation.** Cities with strong private participation are likely to be more dynamic, the government intervention in firm operations would be less severe, and this should bolster the investment climate. Guangzhou is the front-runner, followed by Tianjin and Chengdu. Shanghai is the laggard. The survey differentiates between three types of private owners: managerial ownership, private individual ownership, and foreign ownership. Chengdu is characterized by the largest managerial ownership and nonmanagerial private ownership, but the lowest share of foreign ownership. Shanghai is characterized by a relatively high level of foreign ownership (ranked just behind Guangzhou), but a lackluster level of domestic private ownership.
- **Domestic entry and exit barriers.** Both policymakers and economic researchers have noted the strong domestic barriers to entry and exit in China. Guangzhou and Shanghai have lower entry and exit barriers and Chengdu has the highest barriers, with Beijing and Tianjin falling in between. The following indexes are used to measure such barriers:

– The extent to which provincial borders deter trade. To compare trade across borders with trade within borders—taking factors such as transport costs and geographical barriers into account—the index involves calculating what the tariff rate would have to be to produce the same pattern of trade if all the markets were perfectly integrated. The imputed tariff level is the border effect. The higher the border effect, the greater the trade barrier erected by a province. In 1997, the most recent year for which data are available, this measure was highest for Chengdu, followed by Beijing, Tianjin, and Shanghai. The least protectionist province was Guangzhou, at less than half Chengdu's level.

– Market share of the surveyed firm's main product. Guangzhou firms have the lowest market share at 7.9 percent, followed by Chengdu at 11.1 percent. Firms from Beijing (16.7 percent) and Shanghai (16.5 percent) claimed the highest market share.

– Costs of hiring subcontracting firms (relative to overall costs). The more flexible the market, the less need for firms to keep all their activities in-house. The availability of subcontractors indicates a greater ease of entry for firms and a greater specialization of production, and would be expected to be an attractive feature of a location. Shanghai leads on this measure, followed by Beijing. Chengdu has a much lower share of subcontracting services.

– Excess capacity. Large shares of excess capacity indicate that the barriers to exit can be substantial. Chengdu and Beijing top this measure of exit barriers, with their ratios being 22.1 and 20.5 percent, respectively. Guangzhou and Shanghai are better, at 16.9 and 17.2 percent, respectively.

- **Labor flexibility.** The survey data provide two measures of exit barriers for labor. More flexible labor markets would be characterized by higher nonpermanent labor ratios and lower overstaffing ratios. Guangzhou leads the other cities in terms of reducing exit barriers in the labor market. On average, firms in Guangzhou have laid off only 6 percent of their workers, but almost 21 percent of their workers are nonpermanent. Shanghai ranks second. Its share of nonpermanent workers is 14 percent, slightly lower than that of Tianjin (14.7 percent), but its overstaffing ratio is only 7.5 percent, more than 10 percentage points lower than in the other three cities. Chengdu is the laggard, with 12 percent of workers being nonpermanent, but a overstaffing ratio of 20 percent. Beijing and Tianjin are once again in the middle of the pack
- **Skills and technology.** Three indexes measure skills and technology:

– Share of workers with formal training.

– Worker quality, which increases with the shares and schooling levels of technical, managerial, and sales personnel.

– Research and development (R&D) intensity, which reflects the R&D expenditure per worker, the ratio of R&D staff to all staff, and the reliance on outside R&D services.

Shanghai, Beijing, and Chengdu appear to be significantly stronger in terms of skills and technology endowment. In

Table 1. Population and GDP Per Capita for Five Chinese Cities, 2000

City	*Population, end of year (millions)*	*GDP per capita (current price) (in yuan)*	*(US$)*
Beijing	11.07	22,381	2,704
Chengdu	10.13	12,957	1,565
Guangzhou	0.70	33,908	4,096
Shanghai	13.21	34,436	4,160
Tianjin	0.91	17,975	2,172

Source: Urban Statistical Yearbook of China 2001.

contrast, even though Guangzhou has the highest ratio of trained staff, it ranks lowest in staff quality and R&D intensity. This may reflect the high ratio of migrants among Guangzhou's workers and the low-tech nature of firms in Guangzhou. Tianjin exhibits the lowest ratio of trained staff, the lowest intensity of R&D, and the second lowest quality of staff.

• **Financial services.** The financial services availability index indicates the availability of external financing, such as t foreign loans, bank financing, parent company financing, and the availability and amount of trade credit. The index decreases with the extent that the firm has to rely on its own retained earning or family financing. Shanghai is clearly the leader, Guangzhou is second, Beijing and Chengdu fall in the middle, and Tianjin lags behind.

• **Government effectiveness.** An economy is expected to function better if the state ensures a level playing field, if bureaucrats are more interested in enforcing efficient rules than in maximizing bureaucratic budgets, and if the government provides sufficient resources to set up an environment characterized by an adequate supply of public goods (public safety, infrastructure, and so on). Three indexes measure the effectiveness with which the government provides public goods and plays the role of "helping hand" rather than "grabbing hand":

– Informal payment, the share of sales spent on gifts or bribes to officials of government and regulatory agencies. Cities with relatively lower levels of informal payments to government regulators are Shanghai, Guangzhou, and Beijing.

– The costs to firms in terms of the share of time that senior managers spend meeting with government officials. The lowest costs are in Chengdu, Guangzhou, and Shanghai.

– The share of shipments lost because of theft, breakage, or spoilage. Public safety and ports are largely a government responsibility. Beijing, Guangzhou, and Chengdu suffered the most losses.

Main Findings and Policy Recommendations

Guangzhou and Shanghai are clearly leaders as concerns their investment climate, while Chengdu and Tianjin lag the farthest behind. Beijing falls in between. The investment climate shows large variations across the five cities as follows:

• **Shanghai** is characterized by the best international integration, financial services, entry and exit conditions, and labor market flexibility, but has the lowest level of domestic private sector participation. Its top issues for reform should be to improve its domestic private sector participation, and to enhance flexibility in the use of temporary workers.

• **Guangzhou** does not produce products that are as sophisticated as those produced in Shanghai, but it nonetheless uses its advantages to claim the highest sales growth rate and investment rate. It has the most flexible labor market, fluidity of entry and exit, government efficiency, and private sector participation. Its international integration is also reasonably strong. The top reform issues for the city to consider are upgrading skills and finance.

• **Beijing** has no especially strong advantages or disadvantages. It could benefit from some focus on greater labor market flexibility, entry and exit, and international integration.

• **Tianjin** is good in relation to private sector participation, falls in the middle in terms of entry and exit fluidity and labor market flexibility, is poor in international integration and government efficiency, and worst in skills and technology and financial services. Therefore improvements primarily in skills and technology, but also in international integration and government efficiency, should dominate the reform agenda.

• **Chengdu**, the only inland city the survey covered, lags the farthest in most performance measures and investment climate indicators; however, it does have a good level of private sector participation, with reasonable skills, especially in technology. The top priorities for reform should be to foster greater international integration and to lower entry and exit barriers.

Enhancing the investment climate could result in substantial growth. Improvements in the investment climate could spur investment, sales growth, and productivity. For instance, if Chengdu could attain investment climate indicators identical to those in Guangzhou or Shanghai, the productivity of its firms could increase by about 30 percent, the investment rate of its firms could rise from 14 to 19 percent, and sales growth could increase up to 50 percent.

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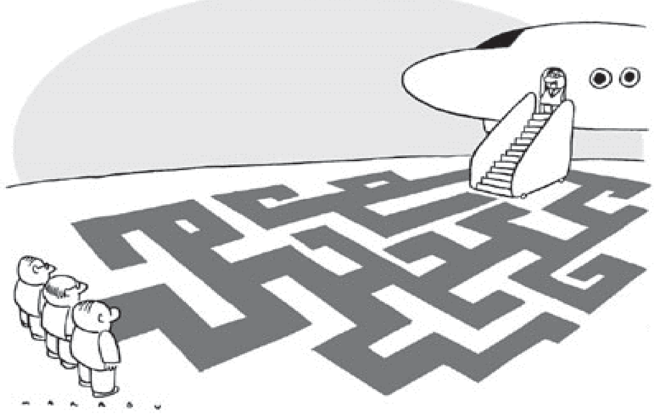
Receiving the VIP



From the Hungarian Magazin Hócipõ

Stability and Growth in EU Accession Countries

by László Halpern

As the EU membership of eight transition economies draws close, new research is drawing attention to the new members' complicated task of meeting the Maastricht requirements. Not only do they have to pursue stability-oriented macroeconomic policy, but they also have to try to catch up with the more developed member states. This implies that figures on the new members' inflation, public debt, current account deficit, and so on should be evaluated using different conditions than those applied to current EU members.

The eight new Central European and Baltic member states of the EU—the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia—are required to pursue stability-oriented policies. If they are unable to meet the criteria of the Growth and Stability Pact (GSP), that is, the Maastricht Treaty, these countries will be subject to the excessive deficit procedure. This procedure authorizes the European Commission, the EU's executive arm, to take draconian measures in relation to any state that threatens the integrity of the monetary union by pursuing inflationary policies until it lowers both its budget deficit and its inflation rate. For example, the French budget presented in late September 2003 foresees a 2004 public deficit of 3.6 percent of GDP, the third year in succession that France will have exceeded the limit set out in the GSP. Enforcement of the excessive deficit procedure could ultimately lead to the imposition of heavy fines if other member states agree. The new members—all of them firmly committed to introducing the euro—must make extra efforts to meet the Maastricht requirements because they are not just pursuing stability-oriented macroeconomic policy, but also trying to catch up with the more developed member states.

These catch-up economies have already achieved a high degree of integration with the EU-15. During the transition period they transformed their production and trade patterns by reorienting themselves toward Western markets and by attracting large amounts of foreign capital. Thus the business cycle in these countries has become strongly synchronized with the EU and with the euro zone. Whether the criteria and the procedures for ensuring macroeconomic stability in the EU will be appropriate for promoting dynamic growth and increasing welfare in the enlarged EU remains an open question, however.

Equal Treatment

Equal treatment of member states is a core principle of European integration. It entails the following three major requirements for euro zone membership:

- **Legality:** no retrospective changes of exchange rate rules
- **Fairness:** the same treatment is to be applied to both new euro zone candidates and old euro zone members
- **Economic rationality:** stability and growth should be maintained as determined in the GSP.

However, this core principle, or rather its mechanical interpretation, is entailing some disadvantages for the new members. The required price stability is a good example. The real exchange rates of currencies in the new member states are expected to appreciate over the long run as a result of their productivity advantage in the tradables and service sectors compared with that of their trading partners (known as the Balassa–Samuelson effect). The trend of real appreciation implies that at a constant exchange rate the new members' equilibrium inflation will be higher than that defined as price stability for the European Monetary Union. Pushing inflation below the rate that is required by Maastricht inflation criterion (see the box) could result in unnecessary output losses.

The equilibrium real interest rate in the new member states is expected to fall. The risk premium on assets denominated in domestic currency is reduced by entry into the European Monetary Union. Lowering interest rates stimulates private sector spending and could increase private debt and external imbalances.

Any shock to the external balance spills over to inflationary expectations. The market is aware that debt crises can be solved either by recession, by depreciation accompanied by inflation, or by both. As the catch-up countries are exposed to a high risk of external balance, they also bear a high inflation risk. Policies that aim at minimizing inflation risk have to minimize external balance risks at the same time.

Capital Flows: Blessing and Curse

Most new member states are small, open economies that are excessively sensitive to changes in exchange rates. They face intensive and fluctuating capital flows as they have already fully liberalized their capital markets, a precondition for EU entry. Globalization has had a clear, positive effect, because foreign investment is necessary for financing the catch-up process, but it makes currencies more vulnerable. The prospect of EU enlargement itself attracts capital flows, but short-term and volatile movements can endanger catching up with speculative attacks and monetary instability.

Thus capital flows could significantly constrain elbow room for an independent monetary policy. Exchange rates may easily deviate from the equilibrium path under the pressure of capital flows, influenced by factors that are beyond the control of domestic economic policy. Countries that offer both relatively high real interest rates and the prospect of steady real appreciation are likely to attract substantial speculative capital inflows.

The resulting overappreciation of the candidate countries' currencies might be even more harmful than an eventual undervaluation. The real appreciation effect of an interest rate hike hurts primarily the tradable sector's competitiveness. Relative prices become distorted, running the risk of a long-lasting disequilibrium. Emerging high external deficits might exceed the limit determined by policy credibility. Hence capital is needed for catching up, but large exchange rate movements induce unhealthy and costly fluctuations that can delay the process for a long time.

The new member states' public indebtedness is well below EU-15 and EU-12 averages. None of them are heavily indebted, with debt to GDP ratios below 60 percent in all the countries, with Hungary having the highest debt level at 56 percent. Member countries with a debt to GDP ratio "well below" 60 percent are allowed to deviate temporarily from the medium-term target of zero-budget or a slight surplus, but they should be committed to fiscal reforms. They are authorized to run small, temporary budget deficits if structural reforms require additional financing.

Finding the Equilibrium Growth Path

The acceding countries need large-scale public investment (primarily in the area of infrastructure and the environment) to support private sector expansion and competitiveness. The demand for public investment might exceed the level that is offered by the new version of the GSP. The equilibrium characteristics of new members maintaining a dynamic growth path in the early phase would allow them to run even relatively high structural budget deficits without endangering fiscal discipline over the long run. Assuming 4 percent potential growth and 3 percent structural inflation, a catch-up economy with a 50 percent debt to GDP ratio can reduce its debt to below 30 percent in the long run by running a 2 percent structural budget deficit, especially if excess expenditures finance growth-supportive investments.

At the same time, however, the private sector's growing need to borrow and the vulnerability of currencies could activate the constraint intended to safeguard current account sustainability. Even though the current account deficit ceiling that foreign investors are willing to finance could be significantly pushed up—one major advantage of EU membership—the volatility of capital flows warns domestic policymakers that exchange rate risks are not negligible. Therefore once growth resumes, they should go ahead with fiscal adjustment (independent of the Maastricht criteria) just to keep the catch-up process within a manageable margin.

Along the equilibrium growth path the new member states can run medium-term structural deficits, at least in the initial phase of catching up. The faster they grow, the greater the probability that they will meet the 3 percent deficit criterion. To avoid excessive external financing and/or inflationary pressure they will have to react to private sector expansion by cutting the public deficit (sometimes achieving budget surplus). Sustainability of the current account remains the number one financial constraint in the run-up period.

The recent reinterpretation of the GSP whereby it gives more flexibility to fiscal policy if public debt is low is a first step in the right direction. However, as a firm theoretical underpinning for what constitutes an optimal level of public debt is not available, particularly given that budgets may have very different tasks in different phases of development, meeting the GSP criteria is likely to cause even more trouble in the enlarged EU than before enlargement. Excessively tight fiscal control in the euro zone might increase adjustment costs, especially in cyclical downturns and in the new member states, because fiscal policy is the tool for responding to country-specific developments and shocks.

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Conditions for Joining the European Monetary Union

To participate in the European Monetary Union EU, member states are required to meet the following economic conditions set out in the convergence criteria:

- **Sound finances**. The public sector budgetary deficit cannot exceed 3 percent of GDP and the public sector gross debt cannot exceed 60 percent of GDP.
- **Price stability.** Inflation during the year prior to examination by the Commission and the European Central Bank should not exceed inflation in the three EU countries with the lowest inflation by more than 1.5 percent.
- **Stable exchange rate**. Member states must demonstrate that their currencies have remained within the normal fluctuation margins provided for by the exchange rate mechanism without devaluing in the two years prior to examination.

Member states must also adapt their legislation so that their central banks can be incorporated in and carry out the tasks assigned to the common system of central banks under the European Community Treaty and the Protocol on the Statute of the European System of Central Banks (ESCB), the main instruments for administering the European Monetary Union. This means that the countries' central banks must be independent in relation to political institutions. When a member state meets these requirements, the EU Council of Ministers determines whether a particular member state can participate in the Monetary Union.

If a member country does not meet the criteria it is granted a derogation, that is, it becomes a nonparticipating member. It will be exempted from the introduction of the common currency, the implementation of a common monetary policy, and the rights and obligations associated with the ESCB.

UNICEF Social Monitor 2003 Reveals Real Mortality Trends in the Caucasus and Central Asia

According to the *Social Monitor 2003*, a publication of the United Nations Children's Fund (UNICEF), infant mortality rates in eight countries of the Caucasus and Central Asia are much higher than official figures have long claimed. The real infant death rate in these countries is 5 times greater than in the rest of Central and Eastern Europe and the CIS and 12 times greater than in Western industrial countries. Most of the infant deaths are preventable. Many are caused by combinations of poverty, poor maternal health and nutrition, infection, and poor medical care.

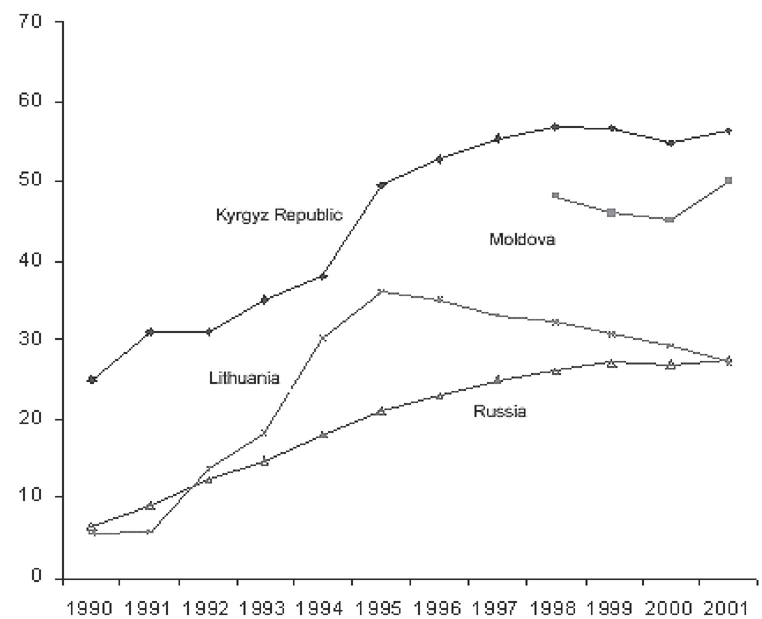
UNICEF's new survey results show high infant mortality rates by global standards in the Caucasus and Central Asia, ranging from 36 per 1,000 live births in Armenia to 89 per 1,000 in Tajikistan. Large portions of the populations in the Caucasus and Central Asia are experiencing persistent poverty, which most directly manifests itself through inadequate nutrition among mothers and infants. The proportion of mothers with anemia, resulting from inadequate iron intake, rose during the 90s, resulting in complications during pregnancy and childbirth (see figure). Poor medical care is also an issue, especially given the low and declining levels of health expenditures in many countries in the region. Problems cited in the report include a lack of preventive health care and failure to carry out basic, nontechnological tests at birth, such as weighing in babies or assessing their activity, pulse, grimace, appearance, and respiration (the APGAR test). Additional factors become important among infants who survive the neonatal stage, including infants' nutrition and hygiene and parents' knowledge about these issues.

The report calls for countries to undertake three measures: adopt and implement the World Health Organization (WHO) definition of live birth, improve the training of medical staff and the management of health care, and provide incentives for parents to promptly register the births of their children.

Infant Deaths: The Official Version

The report focuses on 10 countries: the 8 countries of the Caucasus and Central Asia, plus Romania and Ukraine. It compares the relatively rosy official infant mortality rate in these countries with household survey data where women were asked about their reproductive histories. In all eight countries of the Caucasus and Central Asia, the estimated infant mortality rate from the surveys is far higher than the official rate. In Azerbaijan, for example, the survey estimate

Women with Anaemia Giving Birth, Selected Countries, 1990-2001
(percentage of all women giving birth)



Source: Monitoring Social Conditions and Public Policy in Central and Eastern Europe (MONEE) project database.

The *Social Monitor 2003* and the TransMONEE Database

The *Social Monitor 2003* is the second in the annual *Innocenti Social Monitor* series. It was carried out by the Monitoring Social Conditions and Public Policy in Central and Eastern Europe (MONEE) project of UNICEF, part of the Innocenti Research Centre (IRC), which since 1992 has provided research on people's social and economic well-being in the 27 countries of Central and Eastern Europe and the CIS. The MONEE project also produces the annually updated TransMONEE database, a menu-driven, downloadable database containing a wealth of statistical information covering the period 1989 to the present on social and economic issues relevant to the welfare of children, young people, and women in 27 European and Central Asian transition countries.

The report, other publications, and the TransMONEE database can be ordered or downloaded from the Innocenti Research Centre web site: http://www.unicef-icdc.org/.

Official and Survey-Based Estimates of Infant Mortality, Selected Countries and Regions

Region	*Infant mortality rate*
Sub-Saharan Africa	90.5
South Asia	77.3
Caucasus and Central Asia	59.1
East Asia	41.7
China	32.0
Middle East and North Africa	31.3
Latin America	26.6
Other CEE and CIS countries	11.6
Advanced industrial countries	4.8

Source: Monitoring Social Conditions and Public Policy in Central and Eastern EuropeMONEE project database.

is four times greater: 74 infant deaths for every 1,000 live births, compared with an official rate of 17 per 1,000. In most cases, the official estimates fall well below even the lower bound of the confidence interval of the survey estimates. In Romania and Ukraine, however, the difference between official rates and survey-based estimates is not significant. The table puts the survey-based infant mortality rates from the Caucasus and Central Asia in a global context. They are lower than in Sub-Saharan Africa and South Asia, but much higher than in countries of the Middle East and North Africa and Latin America.

There have long been doubts about the veracity of the infant mortality rates and the completeness of vital statistics registration in the former Soviet Union and, to a lesser extent, in some of the countries of Eastern and Central Europe. The communist systems in the former Soviet Union and Eastern and Central European countries did a remarkable job of greatly reducing infant mortality. However, when the rates began to inch upward in the early 1970s, in many of these countries the official response was simply to cease publishing infant mortality rates and other critical demographic indicators. The publication of infant mortality rates resumed during the *glasnost* period of the late 1980s. More recently, the goals of reducing infant and child mortality embedded in the Millennium Development Goals have made proper measurement of levels and trends a critical issue.

Explaining the Gap

Examining the reasons for the gap between official rates and survey-based estimates, the *Social Monitor 2003* highlights the following three problems:

- **Failing to use the WHO definition of live birth.** A baby's death may go unrecorded because the baby was never officially alive. The WHO definition says an infant is alive if it exhibits any signs of life. The Soviet era-definition—still dominant in several CIS countries-uses breathing as the sole indicator of life. Under the Soviet definition, moreover, infants who are born before 28 weeks of gestation, who weigh less than 1,000 grams, or who are less than 35 centimeters long are not considered live births unless they survive for seven days.
- **Under-reporting of infant deaths.** Misreporting pushes the official figures down further. This is a legacy of the communist era, when hospitals and medical staff could be penalized for failures to reach infant mortality reduction targets. Because hospitals and medical staff faced penalties if they reported increases in infant deaths, they sometimes reported the deaths of babies in their care as miscarriages or stillbirths and thus many CIS countries have a much higher than expected ratio of stillborns to early neonatal deaths (those in the first week). With deteriorating conditions in health services and little focus on health care reform, this has proved a hard legacy to overcome and misreporting continues in some countries.
- **Barriers to birth registration**. A recent UNICEF study estimated that the births of around 10 percent of babies born in the region each year are unregistered, most of them in the Caucasus and Central Asia. Likely causes are difficulty of travel to registration centers, bureaucratic red tape, and lack of incentives. If an infant's birth is not registered, it is unlikely that its death will be registered either.

Other Disheartening Trends

The *Social Monitor 2003* also examines other trends affecting children in the region. It finds economic growth alongside continuing poverty, with almost 11 million children in poverty in Russia alone. It highlights the high level of external debt in some CIS countries, with Georgia, the Kyrgyz Republic, Moldova, and Tajikistan devoting at least one-third of government expenditures to debt servicing. At the end of 2001, the region had 3 million refugees, asylum seekers, and displaced people, with the numbers falling in the countries of the former Yugoslavia, but rising in Russia and Uzbekistan. The report finds that at least 100,000 intercountry adoptions from the region have taken place since 1989, which accounts for one-third of the world total and for most of the increase in intercountry adoption in recent years. An examination of the latest HIV/AIDS trends reveals that only 1 in every 25 people registered as being HIV-positive in the region receives antiretroviral therapy.

The report and other publications and the TransMONEE *database can be ordered or downloaded from the Innocenti Research Center web site: http://www.unicef-icdc.org/. A more detailed Innocenti Working Paper on the issue of infant mortality in the region is forthcoming. For further information contact Tim Heleniak at theleniak@unicef.org or Gerry Redmond at gredmond@unicef.org*

Corporate Governance in Russia: The Yukos Case

by Bruce A. Reznik

Corporate governance—the responsibility of management to shareholders—today enjoys totemic status, but even if this quality were to disappear, its economic importance would remain. Good corporate governance promotes increased stockholder investment and confidence. Thus good corporate governance is good business. This simple truth is resonating loudly in Russia, where many of the "oligarchs," including Yukos majority owner and CEO Mikhail Khodorovsky, are ready to adhere to world corporate governance standards (see box).

A link exists between a country's adherence to the rule of law and its corporations' adherence to corporate governance. Corporate managers unfamiliar with the fundamentals of democracy and transparency cannot be effective occupants of company boardrooms. This applies conversely to those shareholders who, unaware of their rights, are unable to assert themselves against corporate management, both internally and in the courts. Moreover, if a government is corrupt, its corporate management probably is too.

In transition economies, robust advances in corporate governance can only ride on the coat-tails of the change from state to private ownership and control. Even then, however, the nature of such privatizations must be examined.

Investigating Yukos

In Russia, the murky loans for shares privatization scheme of the mid-1990s did not create conditions for responsible corporate management. A dozen or so oligarchs came to own and control much of the Russian economy, some of whom reportedly orchestrated the privatizations from which they benefited. Even though Prime Minister Mikhail Kasyanov insists that the privatizations of the1990s are "irreversible," Deputy Property Minister Alexande Braverman has refused to rule out the possibility that the government could overturn some of the privatizations. "We should distinguish between privatization results as a whole and certain privatization deals," he said recently in a TV interview quoted by the *Moscow Time*s.

Because the privatization laws that were in place in the 1990s left much to be desired, companies that were bought in allegedly rigged auctions are now open to attack Mihail Khodorkovsky bought Yukos, Russia's second biggest oil company and the world's fourth biggest, paying just $170 million for a majority share stake. With 11.4 billion barrels in oil reserves, Yukos is close in size to British Petroleum (about 12 billion barrels), which is worth some $180 billion. Khodorkovsky's purchase of the company drew criticism, as the auction was held by Menatep bank, which he himself owned. Khodorkovsky is now Russia's richest individual with a fortune of $8 billion.

In early October Yukos Oil merged with Sibneft Oil. As a result of the $3 billion deal, the new giant, Yukos-Sibneft, became the world's leading oil company in terms of proven oil reserves. Its assets of $35 billion make it the world's fourth largest publicly- traded oil producer. Maybe it will grow even bigger. At present both Exxon Mobil and ChevronTexaco are considering buying into Yukos-Sibneft.

The Kremlin has not overlooked Yukos's rapid expansion and its involvement in financing opposition politicians before the December parliamentary elections: in July, Platon Lebedev, one of Yukos's top shareholders and the head of the Menatep Group, was arrested on charges of theft of state property in relation to a privatization deal dating back to 1994. The prosecutor-general's office is also investigating other criminal cases connected with the company.

The "Code"

To understand the corporate governance constraints on Yukos one must look to the Russian Corporate Governance Code, which comprises a set of best practice standards of corporate behavior essential to "the development of a vibrant, well-managed and profitable corporate sector." They include the following:

- The shareholders should be provided with a real opportunity to exercise their rights in relation to the company.
- The shareholders should be provided with access to effective protection in the event of a violation of their rights, and those owning the same number of shares should be treated equally.
- The board of directors should provide the strategic management of the company's business. The board should exercise effective control over the company's executive bodies and should be fully accountable to shareholders.
- The company's executive bodies should be provided with the opportunity to manage the day-to-day activities of the company reasonably, in good faith, and solely in the interests of the company, and must report regularly to the board of directors and the shareholders.

The code is not, however, a legally enforceable document. Thus if companies do not adhere to it, the code is only as good as applicable Russian laws. Those laws, in turn, are only as good as the governments, will and ability to enforce them.

Is Russia's Russian Corporate Governance Coming of Age?

Yukos and some other Russian corporations now recognize that they must at least appear to be committed to good corporate governance in order to access foreign capital. Sullied by his 1990s reputation, Khodorkovsky has done just that and is now one of those preaching good corporate governance. "Transparency and good corporate governance are the rules of the game now. The more developed our market, the stricter those rules need to be," he said in an interview last fall.

Yukos now portrays itself as adhering to world corporate governance standards and as having an independent and international board of directors. The company has developed its own code of corporate governance. To its credit, to eliminate dilution risks for its shareholders, the company decided that new share issues can go ahead only with the approval of shareholders who represent at least 75 percent plus one share. The new board of directors, elected at the annual shareholders meeting in June 2003, dismissed all but three members of the previous management team. Two-thirds of the board are representatives of the international finance and oil industries, leading Russian academics, or officials of federal or local government agencies, bringing a wide range of professional experience to Yukos. The chair of its corporate governance committee is an attorney from Washington, D.C.

The U.S. Chamber of Commerce's Center for International Private Enterprise had already concluded from its 2001 survey that executives of major Russian companies had begun to recognize the importance of corporate governance principles and that there was "growing acceptance among Russian businesses of the role of independent directors."

New York Listing Is No Guarantee

Yukos has also succeeded in entering the U.S. capital market to raise money. In March, the U.S. Securities and Exchange Commission approved Yukos's request to issue American depositary receipts tradable on American exchanges. But investors beware: a New York Stock Exchange (NYSE) listing of a foreign company does not imply a *Good Housekeeping* seal of approval. American investors are mistaken if they believe that Yukos's listing on the Big Board means compliance with the NYSE's proposed corporate governance rules, which will apply only to U.S. companies. For foreign applicants the NYSE simply requires a letter from a law firm in the company's home country confirming that the company complies with its country's corporate governance norms, whatever those may be. In relation to corporate governance requirements, foreign listers are regulated by the Sarbanes-Oaxley Act passed in 2002, but that act was approved in the wake of the Enron and MCI accounting scandals, and therefore concentrates on rules of auditing and financial reporting rather than on the range of managerial duties in relation to shareholders. Thus foreign companies could receive the legitimacy of a NYSE listing without full compliance with its rules: not a bad deal for all but minority investors.

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The Yukos Affair—A Debate

The Putin administration's recent measures against some oligarchs, particularly the criminal investigations launched against some leading business people of oil giant Yukos, generated lively discussion in the Russian press. We selected two opposing views represented by two distinguished authors: Ajay Goyal is publisher, editor, and columnist for the *Russia Journal*, a Moscow-based English language daily, and Anders Aslund is director of the Carnegie Endowment for International Peace. Their respective articles were published in the *Russia Journal* and the *Moscow Times*.

Ajay Goyal: "Worries that the Yukos affair will somehow lead to the death of the new Russia are totally misplaced hysteria."

Russians hate their oligarchs. The dozen or so people connected with the regime of former President Boris Yeltsin who divided all the natural resources, industry, and wealth of Russia among themselves have not done anything to earn the love and respect of their fellow citizens. Many remain criminally disposed, laundering money abroad at every available opportunity, while others have already abandoned Russia and adopted new homelands. And, while they may be despised locally, they are doted upon abroad.

Ordinary Russians hate them for a variety of reasons, but the primary one is that they did not want the wealth of their country to end up in the hands of a coterie just as sinister as the upper echelons of the Communist Party. The Russian revolution against the communist apparatus failed, and the inheritors of the latter sneer at the Russian population each day by flaunting their ill-gotten wealth. A very few do seem to have acted professionally to build value in their companies. Yukos Chief Executive Officer Mikhail Khodorkovsky—currently on the outs with the Kremlin—is the first that comes to mind. Yukos is a genuinely well-run enterprise.

The oligarchs have hampered genuine direct investment in Russian industry. Yet, slowly, thanks to the reformist and business-friendly laws drafted by President Vladimir Putin's government, many foreign corporations have managed to build industrial bases in Russia. Their businesses foster the economic lives of a majority of the population and not just the addition of extra zeros to the personal assets of a dozen. Self-starting Russian entrepreneurs have only the monopolies controlled by these oligarchs standing in their way, with taxes and government burdens on the decline.

The corporations and holding companies of the oligarchs—who gobble up industries, land, and resources without ever paying anything for them—are monopolistic, anticompetitive giants that stand in the way of the creation of new businesses, direct foreign investment, liberalization of the economy, and the availability of competitive and quality products in the market. Worries that the Yukos affair will somehow lead to the death of the "new Russia" are totally misplaced hysteria. The Russian economy has its troubles, and oligarchs are one of them. There is nothing good they can do for the country in the long run.

Mikhail Borisovich Khodorkovsky, Chairman and CEO, Yukos Oil Company

The Russian oligarchs are used to attaining ownership of whatever effectively free-of-charge privatized industry comes their way by means of politicking, bribery, embezzlement, and back-room deal making. Then they usually control the company as long as it is possible to manage its cash flow, do transfer pricing, and move capital into offshore accounts. The minimum amount of money necessary to keep the industry afloat is brought back in, but that's about it—there is no attempt at real value-building.

If the Kremlin has decided to clip the political ambitions of some members of the oligarchy, it can only benefit the market, the economy, foreign investors, and consumers. The "chaebolization" of the Russian economy has hindered the development of new industry. [Editor: *chaebols* are huge networks of South Korean companies that operate as one.] Oligarchs have been able to keep protectionist policies in place, forcing poor-quality goods on Russian consumers. But in the last three years Putin's administration has taken decisive steps toward the creation of a civilized legal space. With a good economic and legal framework already in place, the Russian economy is ripe for investment, and great opportunities lie in new industrial enterprises—not in cavorting with thieves.

Anders Aslund: "This destabilizing conflict will cause capital outflow and reduce investment, economic growth, and Russia's credit rating."

Since July 2, a campaign has been pursued against Yukos, Russia's biggest private enterprise and one of its best managed. This serious drama involves many issues, but the most important is probably that the ruling party, United Russia, is in tatters, with no program and little popularity five months before the parliamentary elections. Meanwhile the communists have gained new popularity because of left-wing concerns about oligarchs and corruption. Sensibly, Interior Minister Boris Gryzlov is pursuing a campaign against corrupt police officers, but United Russia also needs to beat up on the oligarchs.

At the same time, this campaign must not go too far, because then three major planks in Putin's platform would be lost. Both the political stability he has achieved and the nation's economic welfare would be jeopardized. Furthermore, hostile reaction among foreign investors could endanger the planned Putin-Bush summit in the United States at the end of September. Therefore the campaign must not run beyond the "silly season" of July and August. If it continued for longer it would harm economic growth, political stability, and Russia's international standing, undermining Putin's authority.

The oligarchs' main concern is that their property rights are not secure, which lays them open to extortion from political parties and the authorities. Reportedly, the Kremlin has extorted a total of $200 million for United Russia's campaign this year, $20 million from each of the big oligarchs. Even if other oligarchs are or were jealous of Khodorkovsky, they all suffer from this attack and are prepared to act with Yukos through the Russian Union of Industrialists and Entrepreneurs.

Being responsible for the economy, Prime Minister Mikhail Kasyanov and his government have every reason to oppose this destabilizing conflict. It will cause capital outflow and reduce investment, economic growth, and Russia's credit rating. The bottom line is that to tamper with the outcome of mass privatization—one of Russia's main accomplishments that has laid the foundation for five years of strong economic growth—would be extremely dangerous. The campaign has seriously shaken any belief in the sanctity of property rights in Russia. A sensible suggestion is the three-year statute of limitations on privatization disputes for which Arkady Volsky, chair of the Russian Union of Industrialists and Entrepreneurs, is now campaigning. It should include not only enterprises, but also land and real estate. Yet foreign investors will be deterred for quite some time.

The oligarchs' huge political contributions remain a sore spot. As this financing cannot be prohibited, it should be legalized, but made public and transparent. The oligarchs would be less keen to fund politicians then, while also becoming less vulnerable to extortion. Politically, United Russia is likely to benefit from this campaign against oligarchs and corruption, but so are the Union of Right Forces and Yabloko, which are mobilizing in defense of the rule of law and democracy. Clearly civil society is being energized.

There is no escaping it: Putin is the master of this drama, and he will be judged by how soon he brings this tragedy to an end, how severely he punishes the culprits, and whether he disciplines the secret police.

Russia's Unpopular Billionaires on Forbes's List

A poll in July 2003 by the Russian Public Opinion and Research Group (ROMIR) Monitoring Service showed that 80 percent of Russians believe that the oligarchs—a small number of tycoons who control more than 60 percent of the economy and who exercised an inordinate degree of influence during Boris Yeltsin's administration—had made their large fortunes dishonestly during the corrupt privatizations of the 1990s. At that time dozens of state-owned companies, including Yukos, were sold by means of insider deals at ridiculously low prices. As Yukos spokesman Hugo Erikssen himself has admitted: "It is no surprise that 70 percent of Russians say that to take out the oligarchs is a good thing. Most people think that privatization was unfair. Many people lost their money while only a few became rich." But while the Kremlin is busy pursuing political gains for the coming election season, it may be mortgaging Russia's future, Mikhail Khodorkovsky warned in an interview with *Business Week* last month. "If we continue hounding rich people and kicking them out of the country, we will not move far from our primordial cave," he said.

Russia's per capita GDP may be behind Costa Rica's, but its headcount of billionaires is the fourth highest in the world, according to *Forbes Magazine's* annual rating of the super rich (see table). The list of the country's billionaires burgeoned to 17 during the past year—10 more than in 2002—thanks to high oil prices, a growing stock market that was up 35 to 40 percent last year, and greater corporate transparency. Worldwide the number of billionaires year-on-year fell from 497 to 476 and their combined wealth dropped from $1,540 billion to $1,400 billion. Microsoft co-founder Bill Gates, steadily number one on the Forbes list since 1998, ended up $12.1 billion poorer than the year before, his worth dropping to $40.7 billion. All but five of Russia's billionaires are heavily involved in the oil sector.

The strongest showing was by Yukos, whose top executive, Khodorkovsky, retained his title as Russia's richest man and shot up from his number101 spot on the Forbes list last year to number 26. Khodorkovsky's estimated worth more than doubled from $3.7 billion to $8 billion. Of the 10 new tycoons on this year's list, 5 earned their riches at Yukos or at affiliated banking and insurance conglomerate Menatep. Khodorkovsky, who says he owns 6 to 7 percent of Yukos, attributed the jump in his fortune to Yukos's growing capitalization. He is now focusing on purchasing gas stations in Germany and integrating the Western and Russian oil markets more closely.

The second richest Russian after Khodorkovsky was Roman Abramovich, governor of the Chukotka Autonomous Region. His fortune swelled from $3 billion to $5.7 billion, boosting him from number 127 to number 49 on the Forbes list. His Millhouse Capital holding controlled the oil company Sibneft until its recent sale to Yukos in Russia's first ever supermerger. Abramovich is also selling his controlling interest of metals giant Russian Aluminum, but he will still be left with major holdings in the automotive and agriculture sectors. He recently purchased the English football club Chelsea for about $100 million.

Russia's number three for the second year in a row was Alfa Group Chairman Mikhail Fridman, whose company's prize holding, the Tyumen Oil Company, signed a landmark $6.75 billion deal with British Petrol. Fridman's worth nearly doubled over the past year, from $2.2 billion to $4.3 billion, hoisting him from number 191 to number 68 on the Forbes list.

The top newcomer to the list was major Tyumen Oil shareholder Viktor Vekselberg, who entered as Russia's fourth richest man with $2.5 billion. Russia's youngest billionaire was Oleg Deripaska, age 34, whose Base Element holding co-owns Russian Aluminum together with Millhouse. Deripaska's worth edged up from $1.1 billion to $1.5 billion, propelling him from number 413 to number 278. He overtook LUKoil's Vagit Alekperov and Surgutneftegaz head Vladimir Bogdanov, the only two Russian billionaires who saw their fortunes shrink

Russia's Billionaires, 2002 and 2003

Rank				*Worth ($billions)*		
2002	*2003*	*Name*	*Age*	*2002*	*2003*	*Company*
101	26	Mikhail Khodorkovsky	39	3.7	8.0	Menatep/Yukos
127	49	Roman Abramovich	36	3.0	5.7	Millhouse Capital (Sibneft/RusAl)
191	68	Mikhail Fridman	38	2.2	4.3	Alfa Group/Tyumen Oil
n.a.	147	Viktor Vekselberg	45	n.a.	2.5	Alfa Group/Tyumen Oil
234	222	Vladimir Potanin	42	1.8	1.8	Interros/Norilsk Nickel
n.a.	256	Mikhail Prokhorov	37	n.a.	1.6	Interros/Norilsk Nickel
n.a.	278	Vladimir Yevtushenkov	54	n.a.	1.5	AFK Sistema
n.a.	278	Oleg Deripaska	34	1.1	1.5	Base Element (RusAl)
327	329	Vagit Alekperov	52	1.4	1.3	LUKoil
n.a.	348	Alexei Mordashov	37	n.a.	1.2	Severstal
n.a..	386	Leonid Nevzlin	43	n.a.	1.1	Menatep/Yukos
n.a.	386	Eugene Shvidler	38	n.a.	1.1	Sibneft
277	427	Vladimir Bogdanov	51	1.6	1.0	Surgutneftegaz
n.a.	427	Mikhail Brudno	43	n.a.	1.0	Menatep/Yukos
n.a..	427	Vladimir Dubov	45	n.a.	1.0	Menatep/Yukos
n.a.	427	Platon Lebedev	46	n.a.	1.0	Menatep/Yukos
n.a.	427	Vasily Shakhnovsky	45	n.a.	1.0	Menatep/Yukos

n.a. Not applicable.
Source: *Forbes Magazine*.

over the past year. As Boris Berezovsky did not disclose his holdings in Russia and abroad, his name is missing from the list, although he recently estimated his fortune at $3 billion. He was declared the country's richest man in 1997.

The 17 billionaires on this year's list put Russia behind only the United States, Germany, and Japan.

Based on articles by Anna Badkhen in the San Francisco Chronicle and Natalia Yefimova in the Moscow Times.

Corporate Management Scrutinized Worldwide: Closer Oversight, Stricter Regulations

by Adolf Enthoven

The collapse of Enron Corporation (see *Transition,* "The Enron Crisis: Some Lessons for Transition Economies," January-February 2002, pp. 1-4) and other scandals involving Worldcom, Tyco, Global Crossing, and other companies have drastically shaken the accounting profession, financial intermediaries and analysts, stock exchanges, and the legal community. The ethical and managerial conduct of many major corporations and the organizations that were supposed to protect public interests have induced concerned citizens to demand stricter provisions for corporate governance. The new Corporate Responsibility Act in the United States is a first result of this trend.

The new Corporate Responsibility Act of 2002, also known as the Sarbanes-Oxley Act, has undoubtedly brought with it the most radical changes since the 1933/34 securities and exchange acts that followed the 1929 stock market crash. The new legislation has the following major provisions, to be implemented by the Securities and Exchange Commission (SEC):

- **Executive compensation and related corporate governance reform**. Requires chief executive officers (CEOs) and chief financial managers (CFOs) to give up incentive-based compensation and trading profits if the company's accounting statement is not accepted and a restatement is required. During investigation the company also has to freeze extraordinary payments to directors, officers, and controlling persons. Public companies are prohibited from extending most types of credit to any director or executive officer. The SEC has been empowered to prohibit individuals from serving as directors or officers of public companies.
- **CEO/CFO certification**. Requires CEOs and CFOs of public (listed) companies to certify that their companies' annual and quarterly reports with the attached financial statements are appropriate and fair. This implies increased liabilities, and in the case of improprieties, even lawsuits and jail terms.
- **Audit committees**. Directs all public companies to set up audit committees with extended responsibilities comprised solely of independent directors, including one financial expert who oversees the activities of a company's accounting firm.
- **Corporate codes of ethics**. Mandates that public companies must disclose whether they have adopted a corporate code of ethics for senior financial officers.
- **Accelerated reporting of insider transactions.** Requires that insider transactions within U.S. public companies must be reported within two business days.
- **Benefit plan blackouts**. Prohibits a public company's directors and executive officers from trading the company's stock during any blackout period if the company's other employees are also prohibited from trading those stocks they hold in company benefit plans. [Editor's note: These blackout days relate mostly to the period preceding earnings statements in order to prevent speculation.]
- **Attorneys' professional responsibility**. Requires attorneys representing public companies to adhere to professional conduct standards, including reporting evidence of material violations of securities law or breaches of fiduciary duty to the CEO or general counsel and, if the CEO or general counsel does not respond appropriately, to the audit committee of the board of directors.
- **Whistleblower protection**. Provides job protection to employees of public companies who provide information to investigators, Congress, or their supervisors regarding violations of securities or antifraud laws.
- **Disclosure of off-balance sheet transactions.** Will set rules requiring the disclosure of all material off-balance sheet transactions and the conduct of a study within one year of so-called special purpose entities to close existing loopholes. (Enron used off-the-books special partnerships and set up fake companies to disguise debt and inflate profits, supposedly acting within the rules.)
- **Increased frequency of SEC review**. Requires the SEC to review all public companies' filings at least every three years.
- **Real-time disclosure**. Requires "rapid and current" public disclosure of material changes to public companies' financial condition or operations as may be required by future SEC rules.
- **Auditor independence and rotation.** Prohibits auditors of public companies from providing specified nonaudit services to the companies they audit, requires the rotation of audit partners, and requires the comptroller general to conduct a study of mandatory rotation of audit firms.
- **Auditor oversight board.** Creates a self-regulatory organization to establish auditing standards and regulate accounting firms that audit public companies. This organization has been established under the auspices of the SEC and is known as the Public Company Accounting Oversight Board.

• **Principles-based accounting.** Directs the SEC to study the adoption of a principles-based accounting system versus a rules-based system. The intent is to prevent companies from issuing distorted results that nonetheless comply with accounting rules.

• **Conflicts of interest.** Requires the adoption of rules to prevent conflicts of interest on the part of securities analysts.

• **Document retention.** Provides criminal penalties for destroying audit records and for destroying or falsifying any documents in order to impede a federal investigation.

• **Enhanced criminal penalties for securities fraud.** Defines new criminal offenses involving conspiracy and attempts to violate federal antifraud rules, increases criminal penalties for willful violation of federal securities laws, and directs the U.S. Sentencing Commission to review sentencing guidelines for certain white-collar and other crimes.

Foreign companies operating in the United States are also affected, as are international accounting firms operating outside the United States for American clients. U.S. legislation has, however, antagonized certain foreign regulators, especially those in the EU, by broadening U.S. securities regulation of foreign entities as follows:

• By applying several provisions to so-called foreign private issuers (foreign private issuers are public companies and the word “private” distinguishes them from governments), the legislation changed the SEC’s general policy of allowing these entities to continue to follow home country practices on a variety of accounting, corporate governance, and securities law issues.

• By mandating that foreign accounting firms would have to subject themselves to new U.S. registration requirements, adding to their existing home country (and for EU firms, EU-wide) regulations with which such firms must already comply.

Whether the new rules will be compatible with Generally Accepted Accounting Principles in the United States or with International Accounting Standards is questionable. Under these principles and standards, the “earnings game” that was underlying the various scandals (corporations trying to maximize their profits by using loopholes in the rules) have not abated. It may require new accounting, disclosure, and reporting standards in a move away from the pure accountability concept toward the notion of greater economic relevance. The debate about whether a more principles-based approach versus a rules-based approach is needed for accounting standards is already raging, with the latter undoubtedly giving greater protection to accountants and auditors, while the former is more relevant in economic terms. The focus will gradually be more on the economic substance instead of the historical financial accuracy of balance sheet items and income/expense transactions.

We are witnessing a global trend toward stricter provisions for corporate governance, although the requirements still vary greatly. In the EU the legislative approach to be followed is in close harmony with the Corporate Responsibility Act’s requirements. The expected implementation of the use of International Accounting Standards in Russia and the EU in 2004 will undoubtedly also require greater corporate transparency and concomitant corporate governance. In Russia, companies will be required to disclose corporate governance practices for the first time this year in accordance with the Corporate Governance Code approved last year.

For transition economies in general, the challenge is to step in with legislation and other procedures to prevent similar manipulations without killing the entrepreneurial spirit. Close international oversight on corporate governance codes and regulations would channel the legislation and rules in the right direction.

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Crime Victim

“His self-esteem was completely destroyed. He, who is embezzling millions, became the victim of a pickpocket.”

From the Hungarian Magazine Hócipõ

BEST PRACTICE

China's Knowledge Revolution

by Douglas Zhihua Zeng

As China opens up further to international competition after its accession to the WTO it faces increased pressures to keep up with new knowledge and restructure its economy to take advantage of innovative and better ways of producing goods and services.

Confronting Challenges Through Knowledge

The knowledge revolution provides countries with opportunities to strengthen their economic and social development by suggesting more efficient ways to produce goods and services and deliver them more effectively and at lower cost to more people. This is also the case for China which faces the following daunting challenges:

- **Providing employment.** Conservative estimates indicate that China will need to create 90 million to 100 million jobs during this decade to provide employment for the projected 40 million to 50 million people no longer required in the agriculture sector, state-owned enterprises, and town and village enterprises, as well as the new entrants to the labor force. However, other estimates suggest that the number of jobs that has to be created is actually much larger, from 200 million to 300 million. Effective unemployment is already about 10 percent, and regardless of which figures are correct, job creation is at the top of policymakers' list of priorities.
- **Maintaining growth and international competitiveness.** China's rapid growth has been possible because of the shifting of workers and resources from low-productivity agriculture to industry and because of high rates of both domestic and foreign investment. However, given the huge burden posed by state-owned enterprises and nonperforming loans, maintaining economic growth will be difficult.
- **Reducing income and regional inequalities.** China's rapid growth has been concentrated in the coastal regions, while the central and western provinces are falling behind. As

Lifelong Learning by the Elderly in China and the United States

In the United States lifelong learning, which includes career enhancement, distance learning, and job retraining, has become a profitable industry. Historically, China has made a commitment to lifelong learning, especially to its elderly population, not seen in many other countries, and has provided by far the greatest number of educational opportunities for its older learners, encompassing a million elderly at 15,000 campuses at government-funded universities. However, the Chinese government is now moving from a nationally-based to a community-based system, and from a wholly publicly financed system to a system encouraging mixed public and private financing.

The prevailing thinking in the United States on lifelong learning for older adults has been guided by a social welfare orientation that focuses on providing seniors with the knowledge and skills to cope successfully with the problematic aspects of growing older. Programs for older learners have addressed the crisis of adjusting to retirement and the need for outside assistance to overcome the trauma of role change. The intent of many U.S. programs has been to help seniors find self-worth and participate in public affairs and volunteerism. The federal role in older learner programs has remained relatively limited, with modest and declining support for older adult education at the state level. Rather than participating in government-funded courses, learners in the United States take advantage of programs provided by private organizations, such as travel organizations, hospitals, retirement groups, and college alumni organizations.

At China's government-sponsored universities, mature students have access to programs on practical, aesthetic, and intellectual subjects, including how to care for the sick, follow a proper diet, practice good hygiene, exercise, and use herbal medicines. They also receive training in painting and calligraphy, flower growing, and other traditional Chinese art forms. Older students keep intellectually fit by studying world history, psychology, philosophy, and principles of economic science.

Both in China and the United States there is a trend toward using new technology, such as distance learning and the Internet, to make learning accessible to a greater number of elderly people. Mass media, especially television, as well as radio and newspapers, are being used as tools for delivering educational opportunities. In China, the government ensures access to educational materials, including hundreds of newspapers and periodicals. Its mass media resources are used as campaigns for healthy living, self-help, enrichment programs, and exercise classes. Several television channels are explicitly devoted to providing cultural and enrichment programs for older learners.

In the future, lifelong learning opportunities will become increasingly important in both China and the United States. Given today's trend toward globalization, people must continue to learn and become more knowledgeable about social, cultural, and economic issues to ensure an educated citizenry worldwide.

Source: Florida Atlantic University web site on Continuing Education and Lifelong Learning, available on http://www.adulteducation.fau.edu/ade5185/eburr/comparison_of_lifelong_learning_.htm.

a result, inequality is growing. Some people have access to capital, education, and other assets, but others still rely primarily on their own labor in subsistence agriculture or in low-productivity enterprises.

- **Sustaining the environment.** Degraded water quality has damaged agriculture, ecosystems, and fisheries, with air pollution becoming a serious threat to the economy and the population. Each year more than 2 million people die from air and water pollution, the result of rapid industrialization and urbanization. China therefore needs to move away from resource-intensive development and move into services and knowledge-based development.

To confront these challenges and take full advantage of the opportunity to leapfrog provided by the knowledge revolution and knowledge economy, China has decided to undertake the transformation toward a knowledge- and service-based economy. In 1998 the government officially adopted the concept of a knowledge economy.

Industrial Parks Boost China's Economy

by Qi Xiao-Mei

China's nonstate sector is developing rapidly, especially since the government lifted several restrictions and gave entrepreneurs more leeway for conducting business. The nonstate sector produces two-thirds of annual GDP from one-third of the total gross capital. The flourishing new industrial parks are an important engine of the country's rapid economic development.

Zhejiang province, located on China's southeast coast south of the Yangtze River delta, with a population of 45 million, is China's most rapidly growing region. Last year the province's enterprises generated revenues totaling Y 110 billion, up from Y 80 billion a year earlier (using an exchange rate of Y 8.3 to the dollar). Both in terms of GDP growth and trade surplus, Zheijang has been among the top provinces for several consecutive years. It is also the province that has the most nonstate firms, with annual sales topping Y 100 million. Nearly one-fifth of Forbes 100 wealthiest people in China are from Zhejiang.

This prosperity is driven by the nonstate industry, which is concentrated in the province's more than 300 industrial parks, whose average annual production value exceeds Y 100 million. The parks' average annual growth rate is about 4 percent, faster than the average growth in the province. Industrial parks account for almost two-thirds of the province's total production and have become the main driving force in the region. Several new industrial parks are under construction in Zhejiang and elsewhere, especially along the southeast coast and the Zhujiang delta.

China's first industrial zones, created in the early 1950s, were designed to host huge state-owned enterprises processing such basic materials as iron, steel, aluminum, and petroleum. Even today, these are mostly resource-based industrial areas. Even though many of these state-owned enterprises have been struggling with large losses for years, they still receive significant support from the government.

Thus the traditional industrial parks have preserved their dominant position, but the new privately built and managed industrial parks are becoming increasingly important. Smaller more dynamic enterprises—which are autonomous, flexible, and profit-oriented—are replacing the huge, dominant, state-owned enterprises. These new enterprises are not just saving on energy and transport costs, but are also developing horizontal and vertical ties with each other, exchanging information and knowledge in addition to commodities. Thus these industrial parks are becoming knowledge zones, providing a favorable environment for developing innovative abilities and maintaining a competitive edge over global rivals. In another departure from tradition, the parks are managed by nongovernmental business associations made up of representatives of the parks' enterprises.

Many of the firms are small workshops responsible for an intermediate phase of manufacturing, allowing those at the finishing end of the production cycle to choose between numerous design varieties. Thousands of these small, highly specialized workshops are clustered around industrial park trading companies, which are usually major players on the international arena that can professionally market hundreds of products. This organizational pattern combines the flexibility of small enterprises with the stability and support provided by large networks. Smaller companies can focus on highly specialized production and share the costs of infrastructure investment and of various business services, such as consulting, quality control, and training. They can also save on transaction costs by keep smaller inventories and spending less on transportation.

Even though industrial parks can achieve economies of scale in production through specialization and collaboration, they cannot compete with large state-owned enterprises in the fields of research and development and finance. They are too small to build up a marketing network and brand recognition. The state-owned research and development centers are therefore extremely important: they can provide technical support and professional training, can lower the technology barrier to market entry, and can create a sustained competitive edge for the areas in which they are located. As for finance services, local governments are under pressure to support loan guarantee agencies, help enterprise credit centers, develop local finance institutions, establish local stock markets if conditions permit, and provide direct financing for medium and small enterprises.

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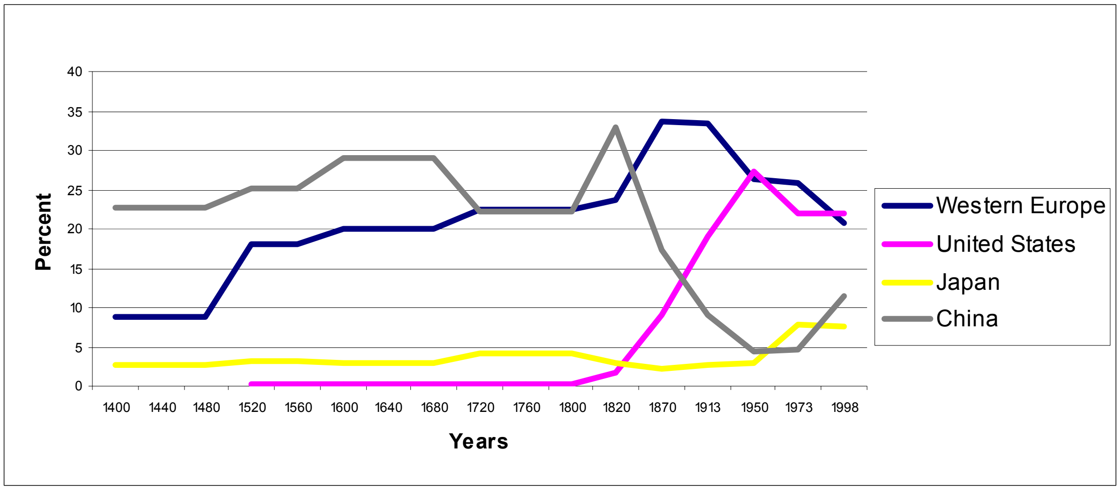
Percentage Share of Global GDP Western Europe and Selected Countries, (1400-1998)



Source: Angus Maddison, *The World Economy : A Millennial Perspective*, (Paris: OECD, 2001).

World Bank Recommendations

In September 2000, responding to the government's request to provide input for its 10th Five-Year Development Plan from a knowledge economy perspective, the World Bank produced a report titled *China's Development Strategy: The Knowledge and Innovation Perspective*. The Bank later significantly expanded and enriched the report, which is now called *China and the Knowledge Economy: Seizing the 21st Century*, which is available in both English and Chinese. It highlights the following policy recommendations:

- **Redefining the role of the state** by having the state back off its role as controller and producer and turning to becoming the architect of a new market economy and knowledge-based system.
- **Revamping education** by placing more emphasis on higher education and lifelong learning.
- **Developing the information infrastructure** by deploying foreign resources and expanding Internet access and domestic content.
- **Diffusing technology** throughout the economy by strengthening technology diffusion programs.
- **Strengthening research and development** (R&D) by increasing funding and paying more attention to strategic areas such as agriculture and the environment.
- **Exploiting global knowledge** by acquiring foreign knowledge through direct foreign investment and technology licensing

To further implement the strategies proposed in the report, the government asked the Bank to provide help with building a lifelong learning system based on distance (online) learning (see box 1). The Bank responded by establishing the China Lifelong Learning Project in 2002, which is currently being implemented. The project addresses a wide range of issues, such as the government's new role, the expansion of distance education, the demand for and supply of labor, the required training and retraining, and the accreditation of learning programs. Meanwhile, the World Bank Institute's Knowledge for Development Program organized a series of knowledge economy training courses for Chinese policymakers and other stakeholders in association with the Global Development Learning Network.

Initial Impact

Preliminary assessments indicate that China has made major strides since it embraced the knowledge economy concept as follows:

- China's leadership at various levels has recognized the importance of a knowledge strategy and has incorporated components of such a strategy into the country's 10th Five-Year Development Plan.
- China's overall economic growth has recovered from the momentum lost since the industrial revolution, has come back on track following market reforms, and since the 1990s has entered a period of stable growth (see the figure). In 2002 the government implemented employment and social security system policies. From 1998 to 2001, of 25.5 million laid-off workers, 4.2 million (almost 20 percent) were re-employed. By the end of 2001, 140 million people were participating in the pension insurance plan.
- China has almost doubled its tertiary enrollment ratio from 7 percent in 1997 to 13 percent in 2001. It has also began to unleash the strength of private education, and in 2002 the government passed the Private Education Promotion Law.
- China has increased its R&D expenditures from 0.7 percent of GDP in 1998 to 1 percent in 2001. In the last five years it has also significantly strengthened the role of the private sector in R&D: enterprises' R&D expenditures as a percentage of their total expenditures increased from 37 percent in 1996 to 60 percent in 2000, mostly because of the transformation of government research institutes into independent units.
- During the last five years China's average annual growth rate has been 32 percent. The value added from the information industry was 4 percent of GDP in 2001, up from 2 percent in 1996. The information technology industry is expected to double in gross product by 2005 and to increase its share of GDP to 7 percent. In addition, the telephone penetration rate is expected to increase from 24 percent in 2001 to 40 percent in 2005. According to the latest estimates, the number of Internet users already exceeds 50 million.

Conclusions

Given its size and its unique position of being both a developing country and the second largest economy in the world (in purchasing power parity terms), China has no model to follow. However, it can leapfrog to a knowledge economy, and its success could chart a new path for other developing countries. The adoption of a knowledge strategy must be carried out in a systematic way, with priorities set and actions sequenced for each aspect of policy. In addition, the implementation of a knowledge strategy requires full commitment from the highest levels of government and strong coordination across functional sectors and between the central and local governments.

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Russian Infrastructure Needs Overhaul: Moscow Workshops Urge Reform

Recent policy workshops in Moscow organized by CEFIR focused on two of Russia's key infrastructure sectors: the railroads and telecommunications. As the government weighs and chooses policy options for reforming and regulating these sectors, discussion at the workshops highlighted the importance of learning from the complexity of international experience and of avoiding one-size-fits-all solutions.

Railroad Restructuring

by Sergei Guriev

The next stage of Russia's railroad restructuring program,to be implemented between 2006 and 2010, basically follows the EU's restructuring approach. That was the general view at a recent roundtable, "Railroad Restructuring in Russia: Regulation Versus Competition," held in Moscow and hosted by CEFIR.

The conference brought together high-level officials from the Russian government, including the Ministry of Railroads, the Ministry of Economic Development and Trade, the Federal Energy Commission, representatives of the private sector, including both shippers and operators, and Russian and foreign academics to talk about the challenges of restructuring Russia's vast railroad system.

The roundtable began with the presentation of findings from the project "Railroad Restructuring in Transition Economies" supported by the Think Tank Partnership Program and sponsored by USAID. The partners in the project—CEFIR in Russia, the Stockholm Institute for Transition Economics (SITE), and the Institute for Social and Economic Reforms (INEKO) from Slovakia—discussed international experience in railroad restructuring.

Anna Tomova, professor at the Zilina University of Transportation (Slovakia), and Lubos Vagac (INEKO) described the design, expectations, and realities of railroad reform in Slovakia and other countries of Central and Eastern Europe. They emphasized the challenges and complexities of railroad restructuring in transition countries, as well as political resistance to change.

EU Experience

Guido Friebel of the School of Higher Education in Social Sciences—Institute of Industrial Economics, Toulouse, France, and SITE and Marc Ivaldi and Catherine Vibes of the University of Toulouse, have looked at EU railroad reforms over the last 20 years. They matched the World Bank's railroad dataset with information about three main reforms in EU countries:

- Separating infrastructure from operations (vertical separation)
- Creating an independent regulatory institution
- Allowing competitors to enter the market (third party access).

Different countries have adopted these reforms to different extents and at different times. Sweden and the United Kingdom implemented reforms early and comprehensively, while other countries, for instance, Belgium and Italy, have lagged behind. In some countries, such as Germany, the access of third parties is not only possible by law, but has already occurred on a considerable scale, while elsewhere, like Belgium and Portugal, competitors cannot enter.

The variation over time and across countries permits estimating the impact of reforms on railroad factor productivity. Such estimation revealed the following:

- Reforms have indeed improved the efficiency of European railways; however, more reforms do not necessarily improve efficiency. What really matters is the initial set of reforms in a country. Starting with one set of reforms, learning about its effects, and then implementing the next set may often be the best approach.
- Many experts believe that complete separation of infrastructure from operations is necessary to improve railroad efficiency. According to Friebel and his colleagues' analysis, however, this view cannot be supported empirically. Other things being equal, complete separation of railroad infrastructure from operations does not enhance railroad efficiency more than other more conservative reform models, including, for instance, separating accounts and changing the

organizational structure of railroads to make operations and infrastructure management more independent from each other.

These results have also motivated theoretical research by Friebel and his colleague Aldo Gonzales on the costs and benefits of complete vertical separation. Their model identifies a trade-off that is important for Russia. While complete vertical separation may increase competition and raise efficiency, its success depends substantially on a country's ability to subsidize the expected losses of railroad infrastructure through nondistortionary taxation. If a country's tax system is weak and large deadweight losses are therefore associated with taxation, full separation of infrastructure from operations may reduce rather than increase consumer gains.

The CEFIR Proposal

In a report written with Russell Pittman of the Antitrust Division of the U.S. Department of Justice and Elizaveta Shevyakhova of CEFIR, we proposed an alternative scheme, arguing first that whether the vertical separation approach has succeeded in raising efficiency even in EU and CEE countries is not clear, and second that the initial conditions and goals of railroad restructuring in Russia are quite different from those of the EU.

Railroads play an extremely significant role in the Russian economy, more so than in the EU, where alternative means of transport, primarily road transport, are more readily available. In Russia the share of railroad traffic in freight transportation exceeds 80 percent (excluding pipelines) and is highly profitable. Railroads are especially important for long-haul traffic. They are the only economic mode of transportation for most shippers of bulk freight—such as coal, ore, timber, and construction materials—and these constitute the major share of railroad freight. The share of loss-making passenger traffic in overall revenues is only 11 percent. Even though in many respects (such as freight volumes and intensity of traffic) the Russian railroads perform similarly, or even better, than rail services in other countries, Russian railroads are still burdened by inefficient regulation, lack of competition, depreciated infrastructure and rolling stock, lack of investment, and huge social spending. Thus reform is unavoidable.

The government's program for structural reform of the railroads is similar to the EU's plan in that it is based on separating the infrastructure (rail system) from operations and keeping the infrastructure in state hands (see the box). However, the structure of Russian and European railroads is quite different, and therefore so are the problems. In Europe the railroads still make huge losses, and the main goal of reform is to reduce subsidies and increase market share at the expense of road traffic. Competition in the railroad sector is aimed primarily at reducing budget subsidies, creating equal conditions for companies from different EU countries, and developing an all-European railroad transportation market.

While in Europe fierce competition between roads and railroads eliminated the monopoly of the railroads, Russia has hardly any intermodal competition. The government's program envisages competition only in operating the system and in related industries, while preserving the tracks and locomotives in a single, 100 percent state-owned company. As a result, the reform will not eliminate the railroad monopoly. Regulating this monopoly to avoid overcharging for infrastructure services will be a complex task, both technically and politically. The state-owned company could seriously impair private investment in railroads.

The current plan for railroad reform is unlikely to increase efficiency, induce investment, and create competition. The costs of mistakes in railroad reforms in Russia could be high, given that railroads are much more important in Russia than in the EU. Our report suggests an alternative model of railroad restructuring based on competition between vertically integrated, competing railroad companies. This model has been successful in Argentina, Brazil, Canada, Mexico, and the United States, countries that are similar to Russia in terms of their size, density of railroad network, and structure of traffic.

Long-term concessions for vertically integrated railroads may help achieve three goals simultaneously: promote competition, increase investment, and keep state ownership of infrastructure. Competition between concessions will be possible given enough parallel tracks, that is, tracks of approximately equal length going in the same direction. [Editor's note: Concessions are an arrangement whereby a private party, the concessionaire, leases assets from a public authority for an extended period and is responsible for financing specified new fixed investments during the period and for providing specified services associated with the assets. In return the concessionaire receives specified revenues from the operation of the assets, which revert to the public sector at the expiration of the contract.]

The Official Russian Railroads Reform Plan

Creating Competition: 2003-05

• Independent freight operators run up to 50 percent of carriages.

• The Russian Railroad Corporation still owns the track, trains, locomotives infrastructure, and so on, but spins off noncore activities, such as suburban trains, long distance trains; maintenance units; and social, telecommunications, and construction activities.

Privatization: 2006-10

• Most carriages and some locomotives are already privately owned.

• Vertically integrated companies might be established that own both trains and tracks (most likely using the corporate railroads).

• The feasibility of full vertical separation is evaluated.

• Privatization enables competition in long distance passenger traffic.

• Franchises are granted for suburban train operators.

The geographic structure of railroads in the eastern part of Russia, that is, the lack of parallel tracks, precludes the introduction of such a scheme; however, the western part of the railroad network is dense enough to permit competition. Dividing the railroads in the European part of Russia into two vertically integrated companies will provide a choice between major shippers and will also introduce competition for most freight traffic. Certainly the network could be divided in other ways: the size and density of European Russia's railroad system could permit up to six vertically integrated companies. Choosing the optimal design of concessions requires further analysis using detailed interregional traffic flow and activity cost data that are not yet publicly available.

To make the plan work, concession contracts and operational rules need to incorporate several provisions. In particular, concessionaires must be obligated to post tariffs, allow shippers to use their own cars, and create a joint dispatching service. Scrutinizing the ownership structure of concessions is important to reduce the risk of collusion between concessionaires.

Critics and Supporters

At the workshop, Anna Belova, deputy minister of railways, presented the official position on progress in implementing the structural reform program. Belova focused on the current stage of the reform, emphasizing success in drafting and passing the legislation necessary for subsequent stages, increasing transparency, and implementing the separation of activities within the current system. Belova paid special attention to the emerging private freight operators. Even though these still represent a small part of the sector, their market share and investment in rolling stock are growing.

Belova criticized the CEFIR proposal on several grounds, namely:

• Having two companies is not enough to assure competition given Russia's weak antitrust regulation system.

• Dividing the grid as proposed may not provide the basis for parallel competition given that many parts of the infrastructure are depreciated and substantial investment may be required to reroute existing traffic flows to the competing company.

• Auctioning off concessions may be too costly for private owners and may take away cash and working capital needed for further investment.

• Creating and maintaining two infrastructure companies may be wasteful from the point of view of social efficiency.

• Determining the true costs of different activities, and therefore putting together a workable solution for competition between vertically integrated companies, is too hard during the current stage, before railroads' internal governance has been restructured.

Other workshop participants were more supportive of CEFIR's proposal. Senior officials from the Ministry of Economic Development and Trade and the Federal Energy Commission (the agency responsible for regulating natural monopoly tariffs) suggested that while further work was required, the proposal to create competition may be the only viable solution. The existing plan preserves a monopoly in infrastructure, including tracks and locomotives, hence competition may emerge only in freight wagon operations, which account for only 15 percent of total costs. In addition, whether the government's plan will provide incentives for infrastructure investments is not clear, a problem encountered in the U.K. rail reform. The participants agreed that the current plan requires effective regulation to assure nondiscriminatory access; restrain abuses of monopoly power; and provide incentives for investment by the infrastructure monopoly, which is hard to achieve even in EU countries.

Sergei Guriev is a senior economist at CEFIR, Moscow. Russell Pittman is director of the Antitrust Division, U.S. Department of Justice, and Ålizaveta Shevyakhova is a researcher at CEFIR. The views expressed in the CEFIR report are those of the authors alone and not of the US Department of Justice or the U.S. government. The report cited is part of the Railroad Restructuring in Transition Economies project supported by the Think Tank Partnership Program and sponsored by the U.S. Agency for International Development. CEFIR, SITE, and INECO (Slovakia) are partners in the project. For more information about the workshop and the project go to http://www.ttpp.info, http://www.cefir.org and www.cefir.ru. ❈

Equal Opportunity School

From the Hungarian Magazin Hócipõ

Telecommunications Reform

by Ksenia Yudaeva

The Russian government wants to develop the telecommunications sector, mainly through centrally funded and regulated projects, while foreign and Russian experts believe that Russia could converge with the industrial countries more rapidly through market methods, that is, liberalization, competition, and cost-related pricing. China's positive experience in this area should be instructive to Russia as emphasized during a roundtable organized by CEFIR.

During the last three years the number of telephones in Russia has been increasing by about 3.2 million per year. The telephone penetration rate has reached 26 percent, which is comparable to the level in the CEE countries, for example, 23 percent in Montenegro and Serbia, 26 percent in Slovakia, 27 percent in Lithuania, and 29 percent in Poland, although it is still well below the 70 to 90 percent level in the industrial countries. Dmitry Milovantsev, Russia's deputy minister of communication and information, presented these figures during the conference on Designing Russia's Telecommunications Regulatory Reforms: Theory and International Experience.

Mixed Results

According to Milovantsev, the overall volume of sales in the sector in 2002 exceeded $8.5 billion, and independent providers of new services, such as mobile telecommunications and Internet services, accounted for more than half this amount. Indeed, the mobile telephone penetration rate in Russia is now similar, or even higher, than the penetration rate of traditional fixed-line services. The mobile telecommunications market is becoming increasingly concentrated in the hands of three federal providers—MTS, Vympelcom, and Megaphon—which now control about 80 percent of the market. Regional expansion of these companies has resulted in a massive fall in mobile telecommunications prices and a sharp increase in the number of subscribers.

Internet provision is still small—only 8 percent of the population has Internet access—but it is growing: in 2002 alone the growth rate was 39 percent. The government is establishing public centers for Internet access. The new Law on Communications includes Internet provision in the list of universal services, and communities with a minimum population of 500 are entitled to receive public Internet connection centers.

In 2002 the fixed-line industry was reorganized, and seven new interregional companies were formed. In relation to the number of telephone lines, these companies are comparable to companies in other countries, but their market capitalization is small by international standards and foreign investors are staying away. To change this trend the companies need to improve their efficiency, reduce their costs, and lower the amount of cross-subsidization of local calls from long distance call revenues. The latter has been taking place to some extent during the last three years: the prices of local communication services increased 1.7 times, while long distance prices decreased by 15 to 30 percent in real terms. However, the government would like to retain some level of cross-subsidization, and this is why it insists on retaining the monopoly of Rostelecom for long distance services. This is part of the Russian bargaining position at the WTO accession negotiations currently taking place.

The new Law on Communications guarantees nondiscriminatory interconnection access to all operators and rules that interconnection rates are state regulated. The law also stipulates that universal services be provided at an affordable price on Russian territory, and this is to be subsidized from a reserve fund that will pool special nontax contributions by all telecommunication operators. Under the universal services provision every Russian citizen should have access to a pay phone within an hour's distance. According to Milovantsev, the government believes that the government-implemented universal services plan will allow Russia to reach a level of telecommunications infrastructure in three to four years that would not be possible for 20 years using market solutions.

Regulation or Market?

Peyton Wynns of the U.S. Federal Communications Commission expressed some skepticism about regulators' ability to outperform the market. In his paper "The Limits of Economic Regulation: The U.S. Experience," Wynns argues that entry, exit, and pricing regulation is usually complicated and tends to benefit incumbent firms while slowing down the introduction of new technologies and new business strategies. A notorious example of the effect of regulated monopoly market structure on the introduction of new technologies is that even though the fax and answering machines were invented in the early 1900s, they were not introduced until the production of terminal equipment was separated from telecommunications service providers.

U.S. experience shows that cross-subsidization, on which the Russian government is so keen to rely, usually does not help bring service to small towns or increase penetration rates. When cross-subsidization was abolished in the United States after the breakup of AT&T, the penetration rate rose from 91.4 to 93.3 percent. In Russia, where families are often geographically dispersed, the demand structure may be similar. Moreover, new technologies such as mobile telecommunication may be more suitable for bringing telephone service to small and remote locations than pay phones, so technologically the government's universal services plan may not be the most efficient. U.S. experience also suggests that direct subsidies for providing services to small communities are a more efficient and less costly solution than cross-subsidization.

George Rozanski of the U.S. Department of Justice agreed that U.S. regulatory agencies had difficulties finding effective ways of regulating domestic telephony. Regulation remains costly and burdensome and results in highly inefficient outcomes. Regulation proved to be a little more successful in international telecommunications. The current market structure of the Internet seems to reach an efficient outcome without intervention by regulators. Structural merger policy, which prevents the creation of monopolies, is an effective substitute for regulation in this sector.

The European experience in regulation and competition policies in the telecommunications sector leads to broadly similar conclusions to those drawn from American experience, according to Gerard Pogorel (Ecole Nationale Supérieure des Telecommunications, Paris), David Salant (Nera Group, Economic Consulting) and Luis Cabral (New York University), who discussed the issue of state regulation of standards, a problem that is especially relevant to the area of wireless telecommunications. U.S. and EU approaches to regulation of this area are sharply different. The United States relies on market solutions, while the EU stipulates a mandatory standard. The tentative conclusion from the papers presented is that a market-based solution can lead to an economically more efficient outcome in the long run, while mandatory standards may result in faster sector development in the short run.

The Chinese Case

Several WTO specialists criticized the government's plan to maintain the Rostelecom monopoly for long distance and international services until 2010. Peter Cowhey of the University of California in San Diego pointed out that data transmission, not voice services, is becoming the largest and most important kind of telecommunications service. Delays in the liberalization of service provision may slow the development of the commercial data transmission infrastructure, causing problems for the development of the Russian economy as a whole.

Jonathan Aronson of the University of Southern California stressed the importance of liberalizing telecommunications by looking at the effects of China's WTO accession on its telecommunications sector. In the 1970s China's telecommunications sector was underdeveloped. The penetration rate was around 0.43 percent and international connections were available in only a few cities. In 1994 two companies were established to compete with the dominant operator, China Telecom. In 1999 China Telecom was split into four separate corporations: China Telecom, China Mobile, China Paging, and China Satellite. In 2001 China Telecom was further split into regional companies. At the same time the Ministry of Information Industry gave special attention to fostering the development of China Unicom, China Telecom's main competitor. Because of WTO accession, in December 2001 telecommunications companies were opened to foreign investment. Foreign investors are required to form joint companies with local providers. Upper limits on foreign shares differ for different locations and types of services, but nowhere do they exceed 50 percent.

The restructuring program had an enormous effect. Between 1995 and 2002 the fixed-line penetration rate more than tripled and is expected to grow by more than a factor of five by 2005. The cellular penetration rate closely follows the fixed-line penetration rate. Prices for long distance and international services have fallen sharply and are now comparable with prices in the industrial countries. The Chinese example suggests that more aggressive liberalization and introduction of competition in the sector can produce better results than keeping a state monopoly on long distance services and cross-subsidizing government-regulated universal services provision

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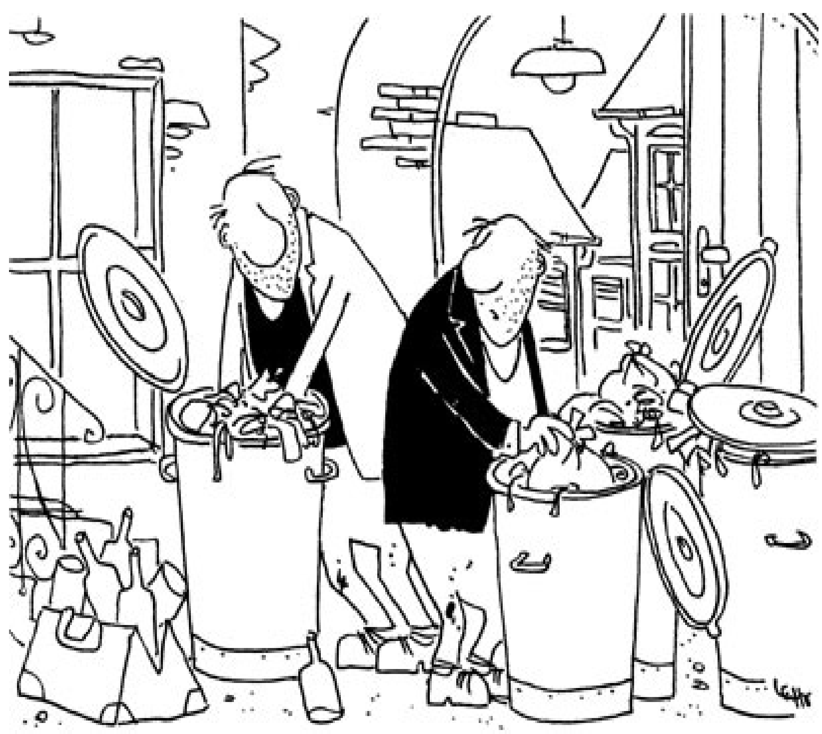
Garbage Gap



"No wonder they call us losers. In the posh Budapest districts you can scavenge laptops in the garbage."

From the Hungarian Magazin Hócipõ

CEPR/WDI Conference on Transition Economics

The Centre for Economic Policy Research (CEPR) and the William Davidson Institute (WDI) recently convened the Annual International Conference on Transition Economics in Budapest. The conference provided a forum for leading economists and other social scientists working on transition and on broader issues of development and institutional change to present new research, develop collaborative relationships, and complete ongoing research.

While some of the challenges facing transition economies are also typical of those confronting emerging markets, some issues are specific to countries that have only recently replaced state ownership with private property and state allocation with markets. The CEPR/WDI conference, hosted by the Institute of Economics of the Hungarian Academy of Sciences and the Central European University, examined the roles of major economic actors—households, firms, and financial intermediaries—as well as the role of the state in both a political economy context and in a development framework. Although most papers made use of economic analytical tools, some multidisciplinary research was also presented. For example, Janos Kornai discussed the project on Honesty and Trust in the Light of Postsocialist Transition, which looks at interaction among enterprises and the roles of the state, nonpartisan bodies, and international institutions.

Philippe Aghion (University College London, Harvard University, WDI, and CEPR) and Alan B. Krueger (Princeton University) gave the meeting's two keynote talks. Aghion introduced a research agenda entitled Institutional Change and Economic Growth, and asked whether all developing or converging countries should follow the same basic elements of the Washington Consensus, for example, maintaining a sound fiscal and monetary stance, investing in education, and ensuring that intellectual property rights are respected. He argued that given their distance from the technological frontier of the market leaders, less developed countries can only imitate the leaders, while more developed countries will be able to innovate. Different policies should be advised accordingly, for example, more developed nations should encourage investment in higher education (as opposed to secondary schooling), flexible labor markets, and openness to trade.

At the closing session, Krueger talked about an exciting multidisciplinary project to measure well-being by creating national well-being accounts, a system comparable in scale only to the national accounts that measure GDP. Krueger mentioned various experiments on how people value all sort of activities, only to find that the link between income and satisfaction is generally weak. While acknowledging that the effort is a complex one, Krueger argued that early results are allowing the research group to weight feelings or experiences (of happiness or distress) by how much time people allocate to them, yielding the first approximation of well-being.

The conference also featured a roundtable discussion on corporate governance. This area has received greater attention since sound corporate governance practices have been proven to enhance access to external financing and lower the cost of capital, according to Stijn Claessens (University of Amsterdam, World Bank, WDI, and CEPR). Other presenters at the roundtable were Erik Berglöf (SITE, Stockholm School of Economics, WDI, and CEPR), Géza László (Antenna Hungaria), and Sergei Guriev (CEFIR, WDI, and CEPR).

This article is based on a conference report prepared by Gábor Békés of the Central European University and Miklós Koren of the Harvard University and Institute of Economics of Hungarian Academy of Science. For more information about the conference see http://www.cepr.org. ❇

Roma in an Expanding Europe: Challenges for the Future

by Dena Ringold

Roma—or "Gypsies," a unique minority that migrated in waves from northern India to Europe between the 9th and 14th centuries and dispersed across nearly all the countries of Europe and Central Asia—have historically been among the poorest people in Europe. However, in the former socialist countries, their living conditions have deteriorated even further since regime change. Most Roma had jobs during the socialist era, but with the radical economic changes in these countries they were the first to become unemployed, and together with their families regressed into deep poverty.

Because of their higher birth rates, the relative size of the Roma population is increasing throughout the CEE countries. Therefore policies to address poverty among the Roma need to be an integral component of countries' economic and social development strategies, especially of those that are joining the EU. Against this socioeconomic backdrop, the World Bank and the Open Society Institute, together with the European Commission, organized a conference in Budapest between June 29 and July 1, 2003, titled "Roma in an Expanding Europe: Challenges for the Future," hosted by the prime minister of Hungary.

Before the conference, the World Bank launched a study: "Roma in an Expanding Europe: Breaking the Poverty Cycle" that summarizes some basic facts as follows:

- **Roma are the largest and most rapidly growing minority in Europe** (**see map on page 27**) **and the main poverty risk group in CEE.** The total Roma population of Europe is estimated at 7 to 9 million. They will represent roughly 2 percent of the 450 million people in the enlarged EU once 10 new member states join the EU in 2004. Approximately 6 million Roma live in the CEE countries and nearly 5 million in the EU candidate countries. The Roma population is significantly younger than the majority populations in the countries in which they live. Currently between 25 and 30 percent of Roma are under 15 years of age, in contrast with 10 percent for the majority population.

• **Roma poverty is multifaceted, stemming from low education levels, inadequate housing, and poor health status, leading to a vicious cycle of poverty and exclusion**. Roma live in deep poverty even in the more prosperous CEE countries, with Roma poverty rates sometimes being more than 10 times those of non-Roma. In 2000, nearly 80 percent of Roma in Bulgaria and Romania were living on less than $4.30 per day (calculated on purchasing power parity of the currency), compared with 37 percent of the total population of Bulgaria and 30 percent of the Romanian population (see the figure). Even in Hungary, 40 percent of Roma were below this line, in comparison with 7 percent of the total population.

• **Roma were often the first to be laid off from jobs in the early 1990s, and have been among those most persistently blocked from re-entering the labor force.** In 1993 in Hungary, Roma accounted for 26 percent of the labor force, compared with 63 percent for the general population. In 1999, 70 percent of Roma in the Czech Republic were unemployed.

• **Many Roma children do not attend school and many study in segregated schools.** They are over-represented in special schools intended for physically and mentally handicapped children. One-fifth of Roma children in Hungary attend such schools. The situation is similar, or even worse, in other countries. Less than 1 percent of Roma in CEE countries continue on to any kind of postsecondary education.

• **Roma face a lower life expectancy than the populations of the countries in which they live.** The estimated life expectancy of Roma is 10 years less than that of the majority population in CEE countries.

• **Social and cultural factors affect access to and interactions with social service providers.** Because of language barriers, Roma may have difficulty communicating with teachers, understanding doctors, and maneuvering through local welfare offices. Poor communication and stubborn stereotypes among both Roma and non-Roma breed mistrust and reinforce preconceptions on both sides.

The challenge of engendering economic and social development among Roma represents one of the most critical outstanding issues on the agenda of CEE countries as they prepare for EU membership, and one they share with existing EU member states, including France, Italy, Spain, and the United Kingdom. They have much to contribute to an enlarging Europe, and cannot be left behind.

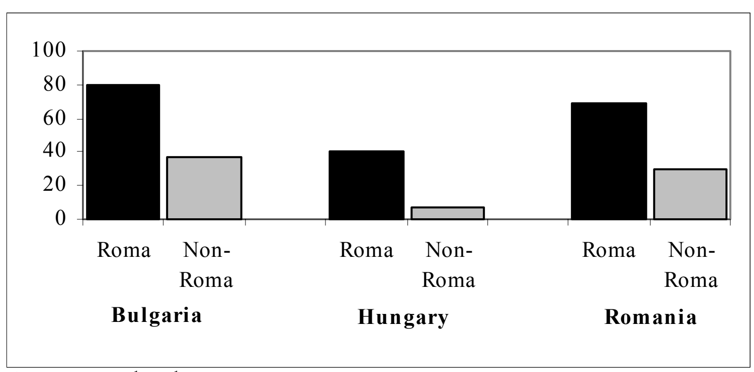
During the conference, governments of Bulgaria, Croatia, the Czech Republic, Hungary, FYR Macedonia, Romania, Serbia and Monetenegro, and Slovakia agreed to launch the Decade of Roma Inclusion starting in 2005. During this decade, countries will provide their Roma populations with increased economic opportunities and better education and health status and promote their empowerment and participation by strengthening communities and families. The recent past is littered with projects and programs that, however well intentioned, failed because they were designed and implemented without the intended beneficiaries' involvement. Such failures range from housing projects that built apartments unsuitable for Roma to social assistance programs that provided Roma with goods they did not want.

In order to move ahead and measure results, good data need to be collected and analyzed with strong Roma involvement. Policymakers and project managers need to know how policies affect Roma, that is, how they influence school attendance, health conditions, access to social welfare benefits and services, and so on. Data must also be available to hold public services accountable for their performance.

Education is the key to breaking the poverty cycle and ensuring that no Roma child lags behind. The correct policies could quickly boost Roma participation in schools, help Roma students to stay in school and graduate, and improve the quality of the education they receive. That in turn requires expanding access to preschool education, involving parents in education and in the classroom, and increasing opportunities for Roma children to attend mainstream schools. The conference agreed to set up the Roma Education Fund, which would support the scaling up of some successful pilot initiatives and would strengthen partnerships between the NGOs that are implementing them and the governments that are supporting them.

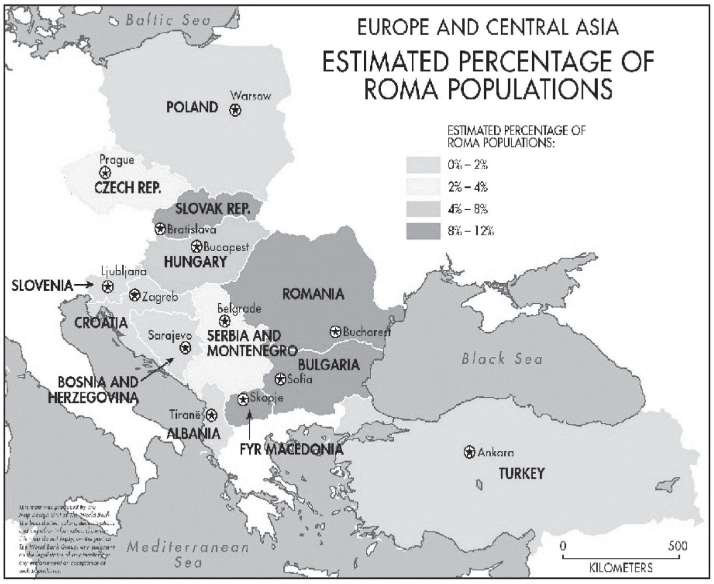
Through better education, Roma will be able to find a wider range of jobs, assuming that discrimination in hiring Roma is eliminated. Roma should also be provided with opportunities to expand their skills, access microcredit, and start their own businesses. Promising examples from Bulgaria, Hungary, and Slovakia were presented at the conference. For example, the Pakiv European Roma Fund (*pakiv* means trust in the Romani language) has begun to support small-scale employment projects in Bulgaria, Hungary, Romania, and Slovakia. It has trained young Roma

Poverty Rates Among Roma and Non-Roma, Selected Countries, 2000
(Percentage of the population living on less than $4.30 per day)



Source: Yale dataset.

Estimated Percentage of Roma Population in Selected Central and Eastern European Countries



Source: The World Bank

leaders to initiate local development projects in their communities, start vocational training programs, and establish community centers and has set up funds for financing small-scale agricultural projects.

To prepare for the launch of the Decade of Roma Inclusion and the Roma Education Fund and to monitor their implementation, the prime ministers and heads of delegations at the conference agreed to set up a joint working group under their direct supervision and invited the World Bank and other organizers to become partners in this endeavor. The Bank would primarily play a support role by helping the countries to develop the details of the initiatives. The Open Society Institute has committed to playing a similar role, and the EU is also invited to support these initiatives. Hungary offered to take the lead during this first year, with the presidency to be rotated among the participating CEE countries. All agreed to meet again in 12 to15 months to get ready for the formal launch of the decade and the fund in 2005.

The author is Senior Economist, Human Development Sector Unit, the World Bank. The related document is available from http://wbln0018.worldbank.org/ECA/ECSHD.nsf/ExtECADocByUnid/3B1AFD4257085BE0C256CEC0035F8DC?Opendocument) ❉

Life in Slovakia's Roma Settlements

Recent interviews in Slovakia's segregated Roma settlements reveal a miserable, often hopeless existence for the majority of their population. Unemployment and the lack of even basic education are major hurdles to integrating Roma into society at large.

More Roma in Slovakia (about 120,000 people or a quarter of the country's Roma population) live in settlements on the outskirts of villages and towns than in other countries of the region. Many of these settlements are rooted in exclusionary policies adopted during World War II and the early socialist period, which curbed the rights of Slovak Roma in many ways, including housing. Regulations allowed Roma to enter towns and villages only on certain days and at specific times and ordered them to move their homes a minimum distance of two kilometers from all public roads. This policy formed the basis for the establishment of many Roma settlements that still exist in Slovakia.

According to the 2001 census, Roma represent 9.7 percent of the population, making them the second largest minority in the country after Hungarians. The share of Roma in the population is likely to rise in coming years because of their higher birth rates. Demographic projections published in the *Economist* indicate that Roma could become a majority by 2060.

The most salient difference between the present time and the communist period for older Roma was that they all had jobs. Roma associate the previous regime with an abundance of job opportunities and benefits, including subsidized consumer goods, utilities, and animals for breeding. Roma also recall having more housing options and better relationships with non-Roma.

Under socialism, many Roma held formal public sector jobs, most commonly in agricultural cooperatives, factories, public construction, and mines. Many of these enterprises have closed or have been substantially restructured over the last decade. Roma were more immediately affected by enterprise downsizing at the outset of transition than other groups. According to official data, in 1996 the Roma share of Slovakia's total unemployed reached 17 to 18 percent, and as much as 40 to 42 percent in the eastern districts with large Roma populations. These ratios have not changed much. Most unemployed Roma have been out of work for more than a year. Unemployment among young people, and especially women, is high. Most young Roma interviewed from the settlements had never been formally employed. Young women generally do not enter the labor force because of early pregnancies. Many get married and begin having children soon after completing primary school. Nearly all the girls over 18 were already married with children or pregnant.

Many Roma cited ethnic discrimination as a significant barrier to employment and as a rationale for not seeking work outside their communities and villages. A number of Roma related anecdotes about friends or relatives who had applied for a job, and even though they were accepted over the phone, were subsequently rejected as soon as the employer realized that they were Roma. Roma also explained that they were denied employment because of low education levels. A young Roma in Rimavská Sobota expressed a common sentiment: "No one will employ a Gypsy anyway, why try?" Many Roma work in the informal sector. Common activities include salvaging and selling scrap metal, petty trade, and part-time work in agriculture and construction. A number of Roma admitted to resorting to theft as a coping strategy, including stealing potatoes, firewood, and construction materials.

Reintegrating unemployed Roma workers into the labor force may be made more difficult by the distorted incentives arising from the design of the social safety net. Social assistance in Slovakia lacks mechanisms for benefits to taper off gradually as workers become employed, thereby building pro-work incentives. Consequently, the system penalizes those who find employment and sets up a dependency trap.

Roma lack opportunities to borrow money, and therefore have limited capacity to establish small businesses. In many cases Roma lack collateral to borrow because of unclear property ownership. Access to loans from commercial institutions is virtually zero. Some Roma do borrow small sums from neighbors, friends, and relatives, as well as through local Roma usurers. In some communities the Roma leader, or *vajda*, lends money, but interest rates were reportedly extortionate—40 percent or higher—compared with an interest rate for consumer credit of around 14 percent.

Most Roma adults interviewed in the settlements had some primary education, but almost none of them had completed secondary school. The majority of Roma who had continued on to secondary school were enrolled in apprentice schools or secondary vocational schools.

Teachers and school directors in the study districts reported that the attendance of Roma children has been declining since 1989. Particularly in the poorest settlements, many children were observed playing in the streets during the school day. In Rimavská Sobota, teachers reported absent students to the police and their families', welfare benefits were cut to motivate attendance. As a result, many parents understood education more as an obligation to the state than to their children.

Few Roma children from segregated settlements between three and six years of age attend preschool. "Kindergarten is not free of charge." Because Roma children begin primary school unprepared, they face additional difficulties in adapting to the school environment. These circumstances exacerbate preconceptions of non-Roma students and teachers that Roma are not capable of learning, and leads to further exclusion.

Roma from isolated and segregated settlements may be introduced to the Slovak language only once they enter primary school. They do not understand their teachers. The teachers do not speak the Roma language, so they communicate by using gestures. In many cases Roma are placed in separate classes or special schools because of their lack of preparation. In many settlements teachers were poorly prepared to work with Roma children. Nevertheless, many teachers interviewed expressed an interest in training and teaching materials in Roma culture and history, as few of them had any knowledge of Roma issues.

Special schools are a legacy from the socialist era, and were designed to provide special education for children with mental and physical disabilities. A disproportionate share of Roma are enrolled in such special schools. Here the curriculum is less rigorous and teachers' expectations are lower than in mainstream schools, but opportunities for graduates of special schools are limited. Even when Roma children are educated within the mainstream Slovak school system, they may be placed in separate Roma classes. Some Slovak teachers argue that Roma should attend special schools and classes because they need special care and assistance that cannot be provided in a regular classroom. Others take an opposite view. Some Roma parents interviewed believed that their children receive more attention at special schools and are not singled out. Most Roma parents expressed a preference for mixed classes, so that their children would be exposed to the Slovak language.

Addressing exclusion and the negative impacts of segregation also involves overcoming divisions between Roma and non-Roma communities. Education is an important vehicle for overcoming cultural barriers by including the history and culture of Roma and other minorities in the curriculum. Training teachers, local government officials, and other personnel working in social services can be important mechanisms for addressing discrimination within public services. Public information campaigns can raise awareness about discrimination.

This article is adapted from chapter 3 of the volume Roma in an Expanding Europe: Breaking the Poverty Cycle, which itself is based on a joint study by the World Bank; Foundation Social Policy Analysis Center, the Institute for Economic andd Social Reorms, and the Open Society Institute, entitled Poverty and Welfare of Roma in the Slovak Republic, 2002. The work was led by Iveta Radicova, Helen Shahriari, and Dena Ringold.

Environmental Protection

"We have been fighting for years to close this dangerous plant. All we have achieved is that it will be covered by ivy."

From the Hungarian Magazin Hócipõ

DISCUSSION

Comprehensive Development Framework Probed: OED Findings and Recommendations

World Bank President James Wolfensohn introduced the Comprehensive Development Framework (CDF) in the belief that the way aid is delivered, not just its content, has an important influence on its effectiveness, and that poverty reduction is the fundamental goal of international aid. A recent multistakeholder evaluation of the CDF managed by the Bank's "watchdog," the Operations Evaluation Department (OED), tracked its progress and crafted recommendations based mainly on case studies that included Romania and Vietnam.

In the mid-1990s, the aid community began a candid self-assessment prompted by growing concerns about how aid was used and managed. After some 15 years of structural adjustment, too few results were positive and sustainable, particularly in Sub-Saharan Africa. Criticism was mounting, especially among NGOs, that aid-supported adjustment programs were at best ignoring the poor, and at worst further impoverishing them. Other critics noted the strain on developing countries as they tried to meet the separate requirements of the many aid organizations working within their borders. The clear conclusion was that the full potential of international aid was not being realized and that remedial action was needed.

As donors and recipients began exploring paths to improvement, World Bank President James Wolfensohn proposed the CDF in January 1999 as a new way for the Bank to do business. The framework was based on the assumption that all development actors (governments, multilaterals, bilaterals, civil society, and the private sector) play a part in poverty reduction and in equitable, sustainable development. None of the four individual elements of the CDF was new. The CDF innovation was to weave them together in a common, balanced framework for poverty reduction and to vigorously promote that framework as an organizing principle to inform World Bank work and to coordinate with other aid agencies and developing country governments.

The Four CDF Pillars

The following are the four basic pillars of the CDF:

- **Long-term, holistic development**. Development strategies should be comprehensive and holistic. They should no longer focus only on short-term macroeconomic issues, but should also embrace social and structural issues.
- **Results orientation**. Development performance should not be measured by inputs and outputs, but by results on the ground. What really matters is the impact on people and their needs.
- **Country ownership**. Development goals and strategies should be "owned" by the country, based on broad citizen participation in shaping them.
- **Country-led partnership**. Recipient countries should lead aid management and coordination through stakeholder partnerships and aid should not be dominated by donor preferences.

Principles and Implementation

After analyzing the implementation of these four principles in international aid operations, OED came to the following conclusions (see the box also):

- **A long-term development framework has operational meaning only when it is translated into affordable priorities through a disciplined budget process.** Consequently, recipient countries should strengthen the links between medium-term frameworks, such as the poverty reduction strategy papers (PRSPs) and budgets. [Editor's note: PRSPs describe a country's macroeconomic, structural, and social policies and programs to promote growth and reduce poverty, as well as associated external financing needs.] Donors should support such linkages and provide reliable financing with transparent, multiyear indicators based on clear country performance criteria.
- **A results orientation is important for improved effectiveness and for public accountability.** The weak capacity of central and regional public agencies, combined with competing budget priorities, inadequate incentives, and fragile accountability structures, makes implementing a government-wide results orientation difficult. Indeed, the OED found that implementation of this principle was the most challenging of the four. Recipient countries should train public servants to open up information channels and educate the public, strengthen systems for internal and external accountability, and present development strategies through the media and in languages and forms that the general public will understand. As for the donors, development programs should have measurable objectives linked to concrete outcomes for which all stakeholders hold themselves accountable.
- **In many countries ownership remains confined to the executive branch of the government.** Consultation with sectoral and regional authorities, elected officials and legislators, and marginalized groups is selective, sporadic, or not timely. Recipient countries should consult with a wider range of interest groups; the private sector; and those who lack an organized voice, including women and the poorest and most marginalized citizens. To enhance country ownership, the World Bank should clarify its role in reviewing PRSPs, as some countries believe that Board review constitutes approval, and therefore inhibits country ownership.
- **The transaction costs of delivering aid remain high** and donors continue to engage in unproductive competition. Recipient countries should place the responsibility for aid coordination at a high level of government and give this function sufficient resources, authority, and political support to

manage the aid process. Many donors will not move to greater country leadership in the presence of corruption or economic mismanagement. Recipient countries should implement and enforce procurement and other accountability rules that will engender donor confidence. Donors should avoid micromanaging the country aid process and provide the capacity building and resources countries need to assume aid management, such as creating independent, country-level aid review panels.

This article and the box are excerpted from the Summer 2003 issue of Précis, an OED publication, available at http://lnweb18.worldbank.org/oed/oeddoclib.nsf/DocPgNmViewForJavaSearch/precis233cdf/$file/Precis233_CDF.pdf . The OED study, titled "Toward Country-Led Development: A Multi-Partner Evaluation of the Comprehensive Development Framework," is available at http://www.worldbank.org/evaluation/cdf/cdf_evaluation.pdf. ❋

Tensions Among the CDF Principles

A long-term, holistic approach to development is essential for embarking on a broad set of economic, social, and political changes. However, various tensions derive from the development process that must be acknowledged and managed if they are not to defeat the good intentions of the CDF and PRSPs.

- **One tension is between country ownership and partnership.** Country ownership implies a situation in which the balance of decisionmaking is in the hands of governments and other domestic stakeholders receiving external funding. By fostering country-led partnerships, the CDF encourages governments to only accept external aid in line with country-owned policies. In addition, it encourages development assistance agencies to align their assistance with country-owned strategies rather than to impose conditions developed at donor headquarters. The tension between ownership and partnership stems largely from the asymmetry of power between the recipient country and donors. Despite the rhetoric to the contrary, the recipients are never completely in the driver's seat. The case studies are replete with examples of long-standing tensions between recipient countries and donors over such issues as health (Vietnam), civil service reform (Ghana), and coca eradication (Bolivia).
- **Another tension is between the long-term focus and the emphasis on results.** Long term in development can mean decades or more, but political pressures in aid-giving countries often demand indicators of results within a year or two. Frequently the more quantitative and shorter term the results indicators, the less they have to do with the impact of aid. Short-term indicators do not necessarily reflect causality, a relationship that can be obscured in the eagerness to show positive outcomes.
- **A third tension involves the possible divergence between the need for a framework for long-term, holistic development and the reality of economic decisionmaking in a democratic, market economy.** Although some suggest that the CDF implies a form of indicative planning that is inappropriate for free market economies and democratic discourse, the six case study countries show that planning using the CDF and PRSP approach is consistent with free markets and broad participation of the population, including in national elections.
- **A fourth tension is between ownership and participation.** For governments to consult widely with their citizens on development strategies and programs can be extremely useful, but this process is time-consuming and costly, and it may not produce clear-cut preferences. Indeed, it could well produce conflict, as different interests demand different approaches. The CDF recognizes that, in the end, elected governments should be responsible for policymaking and must decide on the extent of consultations, weighing the time needed to consult widely and the risk that broad consultations can raise expectations that will inevitably disappoint some groups.

In 2000, the OECD Development Assistance Committee Task Force on Donor Practices surveyed a number of recipient country officials from central governments, line ministries, project implementation units, and relevant civil society organizations in Bangladesh, Bolivia, Cambodia, Egypt, Mozambique, Romania, Senegal, Tanzania, Uganda, and Vietnam. The recipient country officials named several problem areas of donor practices which ranked by the Task Force (see table).

Main Burdens Caused by Donor Practices in Selected Countries

Rank	*Type of burden*	*Frequency of mention*
1	Lack of fit with national priorities and systems	11
2	Donor procedures in partner countries	10
3	Inconsistency among donors	7
4	Excessive demands on time (transaction costs)	6
5	Disbursement delays	6
6	Lack of information	4
7	Inconsistency with national systems	3
8	Demands beyond national capacity	2

Source: P. Amis and L. Green, *Survey on Partners' Priorities and Perspectives on Harmonizing Donor Practices* (Birmingham, U.K.: University of Birmingham, International Development Department, School of Public Policy, 2000).

Crossing Lithuania and Kaliningrad by Bike

by Barry D. Wood

It's compact, friendly, cheap by Western European standards, and flat. What more could a touring cyclist ask? Indeed, crossing Lithuania, this West Virginia-sized, soon to be EU country is a cyclist's delight.

Lithuania is a poor and rural land. While cycling, I can't help but think that it's a miracle that this little country—so recently part of the former Soviet Union—is actually about to achieve EU and NATO membership. Even five years ago this seemed an impossible dream. I suspect the average person on the street in France or Germany has no idea of just how poor rural Lithuanians are and how much support they're going to seek from the EU budget. The average monthly wage is $380, and with prices except for housing now nearly at Western levels, it's hard to imagine how Lithuanians are getting by on less than $5,000 a year. For example, according to Lithuanian statistics, the farmer I watch splitting firewood on his 6-acre farm will be earning about $200 per month. A pensioner I encountered—stooped in old age as he surveyed his stock of turkeys, geese, and hens—gets about $100 a month in social security.

But lovely Lithuania brings some pluses to the EU. It has arguably the best road network in the former Soviet Union. Lithuania has political stability, and relations with its Russian minority are free of tension. The pace of farm mechanization is moving quickly. Tractors are common, although I did see a woman planting a 2-hectare field by hand. Economic growth has exceeded 5 percent in each of the past three years, about four times the EU average. And last year Lithuania registered 6.7 percent growth, the highest in all of Europe.

Klaipeda is a delightful old town with storybook north German houses from the 18th century, and is the gateway to the Courland Spit, one of northern Europe's most compelling natural attractions. The spit is a 60-mile long sand dune, seldom more than a few hundred meters wide, that extends far out into the Baltic Sea. It proceeds southwest from Klaipeda into the Kaliningrad region of Russia. Because the entire region was a closed military zone during Soviet times the spit—particularly on the Russian side—is relatively untouched. I encountered numerous elk and wild boars. The seaside cottages of fisherman and vacationers from a century ago are charming.

Barry Wood at the Kaliningrad-Poland Border

Klaipeda stands in stark contrast to the neglect and absence of facilities on the Russian side of the spit. The first village, Rybachy, is a dilapidated place of rutted dirt lanes, cottages without paint, a derelict Soviet-era community center, and unemployed people on street corners drinking in mid afternoon. Its redeeming attraction is its 1870s church, one of only a handful still intact from what was until 1945 German East Prussia. The once vibrant German resort town of Kranz is now Zelenogradsk. It too is desolate and dispirited. Everything—except for a single modern hotel—is run down. A large workers' resort under construction on a prime seafront location when the Soviet Union collapsed in 1991 stands unfinished and fenced off. Only a handfull of people stroll the sandy beaches where waves roll in from the open sea.

It's apparent after only a day in Kaliningrad district that almost everything that was German was obliterated in the early decades of Soviet rule. Not only were tens of thousand of Germans killed, but all traces of their several-hundred-year-presence were expunged: the German inscriptions on buildings were removed and even the gravestones are gone. Saying that Kaliningrad faces an identity crisis is an understatement. At Potsdam Stalin demanded and got this part of East Prussia, with its fine, ice-free port, as war booty. The region of more than 1 million people remains Stalin's gift to Russia, and Germany has foresworn any claim. However, as of May 2004 Kaliningrad will be surrounded by the EU and travelers on buses and trains bound for Russia proper will have to have special permits to cross EU member state Lithuania.

I spend a morning in the city of Kaliningrad. Most visitors here wonder why the main street is still Lenin Prospect, which intersects Soviet Prospect. Lenin's statues remain as they were. The district's second city is Sovietsk. Two pensioners who scrape by on well under $100 a month explain why Kaliningrad clings to its Soviet past: "This is the only history Kaliningraders have. What are we supposed to do, go back to the German names as if this were not part of Russia?"

Riding south from Kaliningrad toward Poland I am struck by the sense that economically this region is slipping as the neighboring postcommunist states advance. In Lithuania, despite their poverty, rural people now own their farms. They often work their fields late into the evening and on weekends. Yet here in Kaliningrad, with the same fertile countryside, family farms are few. After 80 years of communism and czarist serfdom before that, people have little sense of and interest in private property. Institutions such as the church, which serve the Lithuanians and Poles so well, are fragile and new here. Yet Russia and Kaliningrad have opened to the world. People are warm and generous to travelers even though they have little to share. Border formalities are professional and courteous. Fear is gone from this part of Russia.

My guess is that if the new Europe is going to produce any economic success stories that could rival the East Asian Tigers of the 1990s, it's going to happen up here in the Baltics. Estonia, Latvia, and Lithuania are all small, open, and relatively flexible economies that are not burdened with large governments. While corruption is a problem, it's not as widespread as in many East European countries. Public spending is not as big a percentage of GDP as in most parts of either Eastern or Western Europe. The three Baltic states have already shifted their trade westward and are benefiting greatly from foreign direct investment, particularly from Finland, Germany, and Sweden. Far from being dispirited or cynical, their populations are enthusiastic about joining the West and supportive of governments whose policymakers tend to be young and highly educated. Against all odds and starting from a low base, the Baltics are determined to catch up.

Barry Wood, an economics correspondent, is riding a bicycle across Eastern Europe from north to south assessing how people's lives have changed since communism collapsed.

WORLD BANK/IMF AGENDA

Top Bank Borrowers: India, Brazil, Mexico, China, Argentina, Colombia

During the last fiscal year, which ended on June 30, 2003, the World Bank (IBRD) approved loans worth $11.2 billion for 99 projects worldwide, slightly less than the $11.4 billion approved the previous fiscal year. As the Bank's annual report for 2003 announced, the $5.7 billion in loans to Latin America represented more than half this total, while lending to Europe and Central Asia amounted to $2 billion. In fiscal year 2003 Argentina, Brazil, China, Colombia, India, and Mexico accounted for 49 percent of total lending by the IBRD. The International Development Agency (IDA), the concessionary loan arm of the Bank, committed $7.3 billion, including $1.2 billion in grants, to support 141 projects, compared with $8.1 billion in fiscal year 2002.

Top Ten IBRD and IDA Borrowers, Fiscal Years 2002 and 2003

Borrower	*Fiscal year 2002*		*Fiscal year 2003*	
	IBRD + IDA commitments ($ millions)	*Share of total (percent)*	*IBRD + IDA commitments ($ millions)*	*Share of total (percent)*
India	2,190	11	1,523	8
Brazil	1,566	8	1,237	7
Mexico	660	3	1,172	6
China	563	3	1,145	6
Argentina	735	4	1,100	6
Colombia	482	2	905	5
Indonesia			584	3
Russia			581	3
Uruguay			556	3
Bangladesh			554	3
Turkey	3,550	18		
Pakistan	800	4		
Vietnam	593	3		
Congo, Dem. Rep.	500	3		
Total for top 10 borrowers	11,639	60	9,356	51
Total lending	19,519	100	18,513	100

Source: Annual Report

The World Bank focused on education, the fight against AIDS, water and sanitation, and health care. World Bank loans and grants for education reached a record $2.3 billion. Approvals for health and social services projects totaled $3.4 billion, while loans for water, sanitation, and flood prevention projects amounted to $1.4 billion.

IMF Warns Countries About Emerging Market Debt

Emerging market economies are on the verge of acute public debt problems unless they rein in their spending and increase taxes, the IMF warned. The Washington-based lender said that public debt in these countries has risen sharply as governments have issued domestic debt at market interest rates in record quantities, lured by low market interest rates. During a conference call to discuss initial chapters of the Fund's *World Economic Outlook*, which was released on October 2, Kenneth Rogoff, outgoing chief economist for the IMF, said, "This study should be viewed, at the very least, as a yellow warning light." Latin America and Asia saw the biggest increase in debt. The Fund noted the stiff cost of recent debt defaults and restructurings in such emerging markets as Argentina, Ecuador, Pakistan, Russia, Ukraine, and Uruguay. According to the IMF, this is a worry given that the revenue base of the average emerging market government is much smaller than that in the industrial countries and that most debt crises of the past ten years have involved domestic debt. At current levels emerging market nations' public debt is unsustainable, and fiscal policies will be insufficient to ensure that the debts are repaid. The Fund said that large cuts in public debt ratios were possible, often in conjunction with a debt restructuring program. A combination of strong growth and fiscal consolidation has also brought down public debt without recourse to debt restructuring. Bulgaria and Hungary had had success with this strategy.

IFC Posts a Huge Earnings Jump

The operating income of the International Finance Corporation (IFC), the arm of the World Bank that lends money to private companies and is investing in such risky areas as the Chinese banking sector, rose to $528 million during fiscal year 2003, more than triple the level of the previous fiscal year. IFC's net income was $487 million, up

Trade Issues Preoccupy Transition Economies—Interview with Pradeep Mitra

The World Bank's *Development News* recently interviewed Pradeep Mitra, the Bank's chief economist for the Europe and Central Asia Region (ECA) , to talk about major trade issues for European and Central Asian countries. A shortened version of the interview follows.

Major Trade Issues

The region is a diverse one, so trade issues play themselves out somewhat differently across subregions, but an important unifying theme is the integration of the formerly socialist countries into the world trading system by means of the WTO. The region can be grouped in three subregions:

- **Eight ECA countries** will become members of the EU in May 2004, and the countries' unsettled trade issues with the EU and with each other will become intra-EU issues.
- **Bulgaria and Romania** have signed "Europe" agreements with the EU and are hoping to enter the organization in 2007. Others countries, such as Albania, Bosnia, Croatia, Macedonia, Serbia and Montenegro, have signed stabilization and association agreements with the EU that provide the roadmap for joining the Union at a future date. The EU is their major trading partner and they enjoy fairly good access to EU markets right now. However, these countries should set up a single free trade area among themselves to replace the current patchwork of bilateral trade arrangements and cooperate not only in trade, but also in areas such as transport and energy. This would further open up their economies and enable them to reap greater benefits from the preferential arrangements with each other and with the EU.
- **CIS countries** trade mostly with each other, but have been reorienting their exports, and the EU has emerged as their most important trading partner outside the CIS. They are already benefiting from preferential access within CIS markets, but they would also be well advised to create free trade areas and cooperate in areas such as transportation, water, and electricity. They also benefit from most favored nation status in non-CIS markets, this status having been extended on a voluntary basis by industrial countries until the CIS countries join the WTO. While the countries also benefit from the Generalized System of Preferences, this does not cover textiles, clothing, and such "sensitive" agricultural products as wine. They are also on the lowest rung of the EU preference ladder, so that countries in southeastern Europe, for example, enjoy greater preferences. Furthermore, the industrial countries have characterized the CIS countries as nonmarket economies; imposed quantitative restraints on their exports; and brought antidumping actions against iron, steel, and nonferrous metal exports from Russia and Ukraine. The hope is that as part of the move toward a more open trading system, the industrial countries will reduce tariff barriers to CIS countries' goods and once they become WTO members will no longer consider them to be nonmarket economies.

WTO Accession

All the "first wave" EU accession countries in ECA—the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia—as well as Bulgaria and Romania, are already WTO members. Albania, Croatia, and Macedonia are also members. In the CIS, only Armenia, Georgia, the Kyrgyz Republic, and Moldova are in the WTO, while a number of large countries, such as Kazakhstan, Russia, and Ukraine, while engaged in accession negotiations, have yet to become members. Countries that do not yet belong to the WTO should make every effort to accede to it. Joining the WTO provides governments with an instrument to push through measures such as tariff reductions and phasing out quantitative controls that might otherwise be difficult to do. It also allows countries to undertake further liberalization of policies affecting merchandise trade and services on a multilateral, reciprocal basis.

The World Bank's Role

The Bank has worked extensively with the EU accession countries on what may broadly be described as an agenda of integration over the last several years to bring them to where they are now. The bulk of this has been analytical work on trade-related issues, such as improving the investment climate, services, and so on. The Bank is currently providing analytical advice to countries on the road to WTO accession, including to Kazakhstan, Russia, and Ukraine. The Bank's Trade and Transport Facilitation Program promotes integration in Southeastern Europe and is trying to get a similar project off the ground in the CIS countries. The Bank is also completing customs and tax administration projects in a number of ECA countries.

from $215 million in fiscal year 2002, according to the Corporation's annual report. The big increase in profitability mainly reflects IFC's exposure to Argentina's financial crisis in fiscal year 2002, which caused portfolio losses and affected IFC's bottom line. In addition, this year's financial results got a boost from falling interest rates worldwide, which helped some companies reduce their debt burdens.

New IFC loans and investments soared 89 percent in Europe and Central Asia, where the Corporation invested in projects such as a new energy company in Tajikistan. IFC committed about $35 million to finance a project to sell about $1.3 billion in bad Chinese bank loans. The China Huarong Asset Management Company, one of four firms the Chinese government has set up to handle bad debt, sold the loans to a consortium led by investment bank Morgan Stanley. To date IFC has invested about $130 million in four Chinese banks. In the coming year, in addition to the banking sector IFC will focus on China's power generation and distribution, education, and health care sectors. As one way to raise financing for its commitments in China, the World Bank said it planned to issue a yuan-denominated bond.

François Bourguignon Becomes the World Bank's New Chief Economist

The World Bank has appointed Francois Bourguignon as its new chief economist and senior vice president, replacing Nicholas Stern, who is leaving to work for the U.K. Treasury. In a statement, World Bank President James Wolfensohn noted that "Bourguignon is internationally recognized as an intellectual leader in the economics of public policy, inequality, and economic growth and development. He also has considerable practical experience of the Bank and its interaction with developing countries and other partners." A paper Bourguignon presented at the Bank's annual development economics conference three years ago argued that there was no intrinsic trade-off between equity and efficiency in developing countries and that reducing inequality could, in some circumstances, boost growth.

Bourguignon has advised many developing countries, the OECD, the United Nations, and the European Commission. He was professor of economics at the School of Higher Education in Social Sciences in Paris, where he founded and directed the DELTA research unit in theoretical and applied economics. He has also held academic positions with the University of Chile in Santiago and the University of Toronto. Bourguignon, a French national, was named director of the Development Research Group, part of the Development Economics Vice Presidency, in April. He previously served as managing editor of the *World Bank Economic Review*. The London based *Financial Times* commended his appointment.

World Bank Warns of AIDS Epidemic in Eastern Europe and Central Asia

The World Bank has said that governments in Eastern Europe and Central Asia must make a greater political commitment to avert a potentially catastrophic HIV/AIDS epidemic. A newly released report, *Averting AIDS Crises in Eastern Europe and Central Asia*, is intended to make politicians and other decisionmakers aware of just how extensively the epidemic could affect economies and social stability if not confronted adequately. The region already has a million HIV-positive inhabitants, and even optimists put this figure above 8 million by the end of the decade. This currently translates to 500 deaths each month in Russia alone, increasing to 20,000 a month by 2020. However, Russia's current AIDS budget is 1 percent of that spent in the United Kingdom, even though the problem in Russia is 20 times as severe.

The report estimates that total funding available to tackle the epidemic in the region is $300 million. It recommends that this be increased to $1.5 billion by 2007. While other international agencies can help on the ground, the World Bank sees its role as promoting the exchange of information, helping to improve data collection, and providing estimates and planning for the social and economic impacts of the growing epidemic. Among the more severely effected areas are the Baltic states, the Russian Federation, Belarus, and Moldova.

Suggested Priorities for Russia to Fight AIDS

In a commentary in the *Financial Times*, John Tedstrom, president of Transatlantic Partners Against Aids, writes that Russia's priority should be as follows:

- To dramatically expand its own resource allocation for combating HIV/AIDS. Russia's federal AIDS budget for 2003 is only $3.9 million and its draft federal budget for 2004 does not increase HIV-targeted resources.
- To meet the surging demand for treatment that will soon arise, Russia must begin to train doctors and give them the skill to treat AIDS patients.
- To provide vastly increased supplies of antiretroviral medication to the thousands of new AIDS patients that will soon emerge. Compulsory licensing, production of generic drugs, and procurement of drugs at significantly reduced prices are all options for expanding treatment in a manner that is fair, efficient, and sustainable.
- To acknowledge that, for the foreseeable future, injecting drug use will remain an important channel of new infection. Needle exchange and substitution therapy programs reduce HIV transmission among drug users. These programs should be legalized and supported alongside other education initiatives aimed at reducing drug use.

New Business Model Needed in Eastern Europe and Central Asia

Shigeo Katsu, the World Bank's new vice president for Europe and Central Asia, is quoted in Germany's *Frankfurter Allgemeine Zeitung* newspaper as saying that "in order to remain attractive, the World Bank needs a new business model, which allows us to react spontaneously." The additional value that the World Bank could bring in areas of the environment, HIV/AIDS, minorities, and regional development has to be better marketed. Even if most EU accession countries are no longer loan takers, the Bank still have a lot to offer them, he said, because market and economic institutions are weak in many places. Both for the Balkans and Central Asia, Katsu envisions mixed financing that combines World Bank money and concessionary IDA funds.

World Bank President James Wolfensohn Calls for New Balance Between Rich and Poor

In his opening speech to the World Bank/IMF annual meetings in Dubai in September, James Wolfensohn said that the collapse of trade talks in Cancun, Mexico, reflected the forces causing imbalance between the world's rich and poor. Two-third of the world's poor people depend on agriculture for their livelihoods. As the developing nations see it, rich nations put forward proposals that did not respond to the developing countries' central demands in this crucial area, said Wolfensohn. "We need a new global equilibrium, a new balance in the relationship between rich and poor nations," he added. Rich countries are spending $56 billion a year on assistance to the poor, compared with the $300 billion they spend on agricultural subsidies and $600 billion on defense. But Wolfensohn also slammed the poor countries for spending a total of $200 billion on defense, more than what they spend on education.

Poor Nations Want IMF and World Bank Reforms

Developing countries want a louder voice in the workings of the IMF and the World Bank reports BBC Online. They want to see changes in staffing, top management, and the voting system. South African Finance Minister Trevor Manuel said the two institutions suffered from a "deficit of democracy." Zambia's Finance Minister Ng'andu Peter Magande complained that a continent the size of Africa has only two seats on the executive boards of the two institutions, which each have a total of 24 board members. The voting systems in the two institutions do not do any favors for the poorest countries either, he asserted. World Bank President James Wolfensohn said he would review the proposals on reform and offer an intermediate report in February 2004.

Unequal Access to Education in China

On a recent mission to China, Katarina Tomasevski, UN rapporteur for the right to education, observed a growing gap between the elite, who have access to state-of-the-art schools, and the poorest peasants, for whom education presents a cost they cannot afford. Thus millions of school-age children, especially girls, are prevented from attending school in a country where school is mandatory and universal for nine years. Today China spends less than 2 percent of its GDP on education, when UNESCO recommends at least 6 percent. Moreover, only 53 percent of total spending on education comes from public funds, with the central government being responsible for only 8 percent of this amount, leaving the remainder to be footed by local authorities who, when they lack funds, ask parents for money. The rest of the spending on education comes from private funds. ❈

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Thilak Ranaweera
Alternative Paths to Structural Adjustment in Uzbekistan in a Three-Gap Framework
WPS 3145, September 2003, 29 pp.

Rather than embracing the shock therapy favored by the so-called Washington Consensus that has been tried in several transition countries, Uzbekistan has adopted a gradual, state-controlled strategy. Policymakers are pursing this goal by subsidizing employment, controlling the prices of essential items, privatizing large enterprises gradually, and attempting to attain self-sufficiency in energy and food supplies. This policy dictates a slow pace of foreign exchange liberalization and defers convertibility to some future year. This study focuses on the major imbalances of the economy in evaluating some of the policy choices facing Uzbekistan. It also attempts to quantify the relative importance of external financing and the sustainability of the balance of payments under alternative structural adjustment paths. The three-gap approach emphasizes domestic savings and investment constraints, foreign savings and capital inflows, and fiscal constraints to growth and structural adjustment. As presented here, the three-gap framework is intended as a first step toward a more comprehensive qualitative and quantitative assessment of the adjustment alternatives facing Uzbekistan. The paper argues that an aggressive adjustment policy, that is, the unification of exchange rates and the implementation of current account convertibility, would improve most performance and welfare indicators.

Thilak Ranaweera
Market Disequilibria and Inflation in Uzbekistan, 1994-2000
WPS 3144, September 2003, 25 pp.

Lev M. Freinkman, Raj M. Desai, and Itzhak Goldberg
Fiscal Federalism and Regional Growth: Evidence from the Russian Federation in the 1990s
WPS 3138, September 2003, 29 pp.

In the Russian Federation, fiscally autonomous regions have often resisted market-oriented reforms, the enactment of rules protecting private property, and the dismantling of price controls and barriers to trade. The authors argue that the presence of unearned income streams—particularly in the form of revenues from natural resource production or from budgetary transfers from the central government—has turned regions dependent on these income sources into "rentier" regions. As such, governments in these regions have used local control over revenues and expenditures to shelter certain firms from market forces.

Quy-Toan Do and Lakshmi Iyer
Land Rights and Economic Development: Evidence from Vietnam
WPS 3120, August 2003, 28 pp.

Land reform in Vietnam gives households the power to exchange, transfer, lease, inherit, and mortgage their land use rights. The authors expect this change to increase households' incentives and ability to undertake long-term investments. Their findings indicate that the additional land rights led to significant increases in the share of total area devoted to multiyear crops as well as to some increase in irrigation investment. These effects are stronger in areas that felt the impact of the land reform earlier.

Beata Smarzynska and Mariana Spatareanu
To Share or Not to Share: Does Local Participation Matter for Spillovers from Foreign Direct Investment?
WPS 3118, August 2003, 28 pp.

A survey of Romanian firms from 1998 to 2000 shows positive intrasectoral spillovers from fully-owned foreign affiliates, but not from projects with joint domestic and foreign ownership. This finding suggests that foreign investors tend to put more resources into technology transfer to their wholly-owned projects than to those they own only partially. However, foreign investors entering a host country through greenfield projects are less likely to source locally than those engaged in joint ventures or partial acquisitions, partly because fully-owned foreign subsidiaries tend to use newer or more sophisticated technologies than jointly-owned investment projects, and thus may have higher requirements that only a few, if any, domestic suppliers are able to meet.

Robert Buckley, Kim Cartwright, Raymond Struyk, and Edward Szymanoski
Integrating Housing Wealth into the Social Safety Net: The Elderly in Moscow
WPS 3115, August 2003, 36 pp.

Russia's elderly have often been among those least able to cope with all the changes that have taken place during the transition. Unlike the situation prior to reform when pensions were stable, they now face considerable uncertainty, but they have also been the beneficiaries of a large transfer of wealth, because housing was privatized under giveaway terms. Unfortunately, in the absence of a developed financial system, using this wealth without selling the housing is difficult. Hence there is a good opportunity to provide what might be termed "housing safety net insurance" at low public cost. Such a scheme could allow also many of the elderly to move out of poverty and into middle-income status. The situation is similar in many other countries of the former Soviet Union where elderly populations also own a great deal of unencumbered housing wealth.

Giovanni Majnoni, Rashmi Shankar, and Eva Varhegyi
The Dynamics of Foreign Bank Ownership: Evidence from Hungary
WPS 3114, August 2003, 30 pp.

Elena Ianchovichina, and Terrie Walmsley
The Impact of China's WTO Accession on East Asia
WPS 3109, August 2003, 28 pp.

China's WTO accession will have major implications for China and present both opportunities and challenges for East Asia. China is the biggest beneficiary of accession, followed by the industrial and newly industrializing economies (NIEs) of East Asia. By contrast, developing countries in East Asia are expected to incur small declines in real GDP and welfare as a result of China's accession, mainly because with the elimination of quotas on Chinese textile and apparel exports to industrial countries, China will become a formidable competitor in areas in which these countries have a comparative advantage.

China will increase its demand for petrochemicals, electronics, machinery, and equipment from Japan and the NIEs and for farm, timber, and energy products and for other manufactures from the developing countries of East Asia. New foreign investment is likely to flow into these expanding sectors. The overall impact on foreign investment is likely to be positive in the NIEs, but negative for the less developed East Asian countries as a result of the contraction of these economies' textile and apparel sectors. China's comparative advantage will shift into higher-end products. This is good news for the poor developing economies in East Asia, but means heightened competition in global markets for the NIEs.

Bartlomiej Kaminski and Manuel de la Rocha
Stabilization and Association Process in the Balkans: Integration Options and Their Assessment
WPS 3108, August 2003, 51 pp.

The stabilization and association process launched by the EU in the aftermath of the war in Kosovo in 1999 has created a new policy environment for five South East European countries. In exchange for EU assistance, the prospect of EU accession, and the continuation of preferential access to EU markets, the five countries' governments have to upgrade their institutions and governance to European standards and engage in mutual regional cooperation, including becoming Stability Pact member countries. The paper argues that the process of regional trade liberalization should be extended to multilateral liberalization and that priority be given to structural reforms and regional cooperation aimed at trade facilitation.

Jan Rutkowski
Does Strict Employment Protection Discourage Job Creation? Evidence from Croatia
WPS 3104, July 2003, 68 pp

Employment protection legislation in Croatia is among the strictest in Europe. Firing people is difficult and costly and flexible forms of employment are limited. The paper shows that job and worker turnover is low, hiring is limited, and average job tenure is long. While job destruction is low, job creation is even lower. The result is accumulating unemployment. New labor market entrants are unable to find jobs. The high degree of job protection seems to strengthen insiders' bargaining position and result in relatively high wages. Thus wages are higher in Croatia than in its competitor countries, even after adjusting for productivity. These high labor costs are contributing to limited job creation in existing firms and are also discouraging job creation in new firms. Liberalizing the labor market would foster job creation and employment.

F. Desmond McCarthy, William Bader, and Boris Pleskovic
Creating Partnerships for Capacity Building in Developing Countries: The Experience of the World Bank
WPS 3099, July 2003, 26 pp.

The World Bank has successfully participated in developing a number of institutions specializing in economics education. The paper discuses the experience of countries that introduced Western-style programs using partnerships that combine the different needs of private donors with those of the World Bank on the supply side. Much of the success was due to adapting each effort to the individual country's situation at a relatively low cost.

The Bank has been involved in the development of nine institutions, of which five were institutions of higher education offering economics training at the graduate or postgraduate level and four were research networks or centers funding research projects and building links between individual researchers and research institutions. The training institutions are the Economics Department of the Central European University in Budapest, the Center for Economic Education and Graduate Research—Economic Institute in Prague, the China Center for Economic Research in Beijing, the Economic Education and Research Consortium's MA program at the Mohyla Academy in Kyiv, and the New Economic School in Moscow. The research networks and centers include the Economic Education and Research Consortium in Moscow.

Other World Bank Publications

François Bourguignon and Luiz A. Pereira da Silva, editors
The Impact of Economic Policies on Poverty and Income Distribution: Evaluation Techniques and Tools
World Bank and Oxford University Press, 2003, 440 pp.

This book reviews techniques and tools that can be used to evaluate the poverty and distributional impact of economic policy choices. It describes the most robust techniques and tools now available—from the simplest to the most complex—and identifies best practices. The tools reviewed here help quantify the trade-offs and consequences of economic policies that affect countries through various channels. Each chapter addresses a specific evaluation technique and its applications, and household survey data are used to describe economic welfare distribution. The focus is on the micro level in the first part of the book, and links between macro modeling and the microeconomic distribution of economic welfare are the focus of the last five chapters.

World Development Report 2004: Making Services Work for Poor People
World Bank and Oxford University Press, 2003, 288 pp.

Too often services fail poor people in terms of access, quality, and affordability. Service providers are often trapped in a system where incentives are weak, corruption is rife, and political patronage is a way of life. Even when poor people have access, the quality of services can be distressingly low. In some cases, however, basic services such as water, sanitation, health, education, and electricity do work for poor people. A program in Mexico, for example, gives cash to poor households if they visit a clinic regularly and their children attend school. As a result, illness among children has been reduced and secondary enrollment has increased for both boys and girls. Services can be improved by putting poor people at the center of service provision by

- Enabling the poor to participate, make choices (for example, through a school voucher system), and monitor and discipline service providers
- Amplifying their voice in policymaking through the ballot box and by making information widely available
- Strengthening providers' incentives by rewarding the

effective and penalizing the ineffective delivery of services to poor people.

While problems with public services arise frequently, concluding that governments should give up and leave everything to the private sector would be wrong. No country has achieved significant improvements in child mortality and primary education without government involvement. Private sector participation in health, education, and infrastructure is not without problems, especially in reaching poor people.

China: Country Economic Memorandum—Promoting Growth with Equity
September 2003, 15 pp.

This report assesses possible patterns of inequality in China in the future and outlines policy options that could help accomplish China's objective of growth with equity. Growth and inequality projections suggest that if recent trends in widening rural-urban inequality and the disparate growth of per capita incomes across provinces continue, income inequality would rise sharply, bringing the Gini coefficient up to 47.4 by 2020 (compared with 43.7 in 1999), with essentially equal contributions to national inequality from rural-urban and interprovincial disparities.

The report identifies the following problems:

- Local government protectionism, which arises from local governments' dependence on own enterprises, and local government control of market regulations, enterprise management, and the courts which fragments China's, domestic market for goods and services
- Shortage of low-income housing in urban areas, weak execution of land use rights in rural areas, and direct and indirect discrimination against migrants, all of which inhibit migration
- Government control over resource allocation and inadequate information about enterprise performance that inhibit the efficient allocation of capital.

The cost of market fragmentation and rigidities is high. Although exports are likely to continue to grow rapidly, by 2007 more than 70 percent of China's output will still be intended for the domestic market. Obstacles to the efficient allocation of labor and capital and to competition reduce the speed of technological upgrading and China's competitiveness in the global economy. Market integration and flexibility can ease the pain of restructuring. The report proposes a package of policy actions aiming at creating new job opportunities and raising returns to farm labor and land. It suggests facilitating migration, commercializing the banking sector, and extending the social security system in both urban and rural areas.

Olusoji Adeyi, Enis Baris, Sarbani Chakraborty, Thomas Novotny, and Ross Pavis
Averting AIDS Crises in Eastern Europe and Central Asia: A Regional Support Strategy
September 2003, 222 pp.

The Eastern Europe and Central Asia region is experiencing the world's fastest-growing HIV/AIDS epidemic and a large burden of tuberculosis. Controlling HIV/AIDS and tuberculosis is a corporate priority for the World Bank Group. The regional support strategy translates the Bank's commitment into an agenda for action in the region. It seeks to

- Provide a unifying framework for the Bank's work as part of international support for country-led responses to HIV/AIDS and tuberculosis
- Clarify options for integrating effective interventions against HIV/AIDS and tuberculosis into the broader agenda of poverty reduction and economic development
- Identify the main barriers limiting the effectiveness of HIV/AIDS and tuberculosis control efforts and actions to eliminate these diseases
- Define the short- to medium-term priorities for the World Bank's work in the region, with an emphasis on the Bank's comparative advantages and high-impact partnerships.

Private Participation in Infrastructure: Trends in Developing Countries in 1990-2001
August 2003, 175 pp.

Drawing on data from the World Bank's private participation in infrastructure database, this new book provides an overview of the nearly 2,500 private infrastructure projects that were implemented between 1990 and 2001 in 132 developing countries and mobilized investment of some $754 billion. It covers projects in the transport, energy (electricity and gas), telecommunications, and water and sewerage sectors that received private investment through management and lease contracts, concessions, greenfield projects, and divestitures.

Governments around the world turned to the private sector for innovative and cost-effective solutions to increasing coverage, raising quality standards, and achieving cost recovery and sustainability in infrastructure service provision. Because of the economic crises of the late 1990s, a few (but high-profile) cases of canceled projects, visible corporate governance and accounting problems, and a general global economic slowdown, investment declined, so that 2001 levels paralleled those of the mid-1990s.

Gary S. Fields and Guy Pfeffermann, editors
Pathways Out of Poverty: Private Firms and Economic Mobility in Developing Countries
World Bank and Kluwer Academics, September 2003, 320 pp.

How private firms contribute to economic mobility and poverty reduction and what governments can do to enhance their contribution is the theme of this book. In developing countries, private enterprise is far and away the largest source of employment and investment and a significant source of government revenue. Also private enterprise is an important source of less tangible, but critically important, factors such as openness to ideas, innovation, and opportunity. Drawing on the rich materials of the World Bank's worldwide business environment survey, the book identifies key policy factors. It pays special attention to obstacles facing small and medium enterprises. The concluding chapters focus on practical ways in which governments of developing and transition countries can encourage the capacity of poor people to move up the economic ladder.

A Guide to the World Bank
World Bank, September 2003, 264 pp.

The World Bank Group is one of the world's largest sources of development assistance. In 2002 the institution provided $19.5 billion in loans to its client countries. It works in more than 100 developing economies with a primary focus of helping the poorest people and the poorest countries. This book serves as a general overview of the World Bank's history, organization, mission, and purpose. It describes the World Bank's operations, giving a brief overview of policies, projects, and procedures. An introduction to the wealth of information resources produced by the World Bank will help readers understand and navigate the types of documents, statistics, and reports that are available from the World Bank on its web site and in print publications. The publication is a good introduction for anyone interested in understanding what the World Bank does and how it does it.

Jean Francois Arvis and Ronald E. Berenbeim
Fighting Corruption in East Asia:
Solutions from the Private Sector
August 2003, 260 pp.

This book, based on research conducted by the World Bank and the Conference Board, describes the efforts of Western and Asian companies to develop good standards of business conduct in their East Asian operations. Case studies from a wide range of corporate settings offer concrete examples of best practices in program creation, implementation, and effectiveness. The book also provides examples of the dissemination of those practices that underscore the importance of business partnerships with the public sector and civil society organizations.

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Juha Antila and Pekka Ylöstalo
Changing Future Expectations in
Estonia, Latvia, and Lithuania
Baltic Economies—Bimonthly Review 5/2003

According to the survey known as the working life barometer in the Baltic countries 2002, negative expectations about employment trends in the next twelve months outweighed positive ones. The proportion of those with strongly negative expectations was especially large in Lithuania. Many expected the employment situation to be worse in a year's time, while a few thought it would be much better. Only 15 percent of Estonians expected that employment would improve during the coming year, while 50 percent believed it would deteriorate and just 1 percent expected the situation to be much better in a year's time. People were much more optimistic about development in their own workplace during the coming year than about the general employment situation. Men in all three nations were somewhat more optimistic than women about the outlook at their own workplace. The complete survey results are posted at http://www.mol.fi/julkaisut/baltiabarometer.pdf.

Natalia V. Smirnova
Labor Market Adjustment In Russia
Russian Economy—The Month in Review 9/2003

During transition, less educated single individuals, women, and young people are more likely to be unemployed than others. Furthermore, these groups—except young people—tend to stay unemployed for longer than others. Married women are worse off in terms of job loss and length of unemployment than single women. A positive feature is that returns to education have increased while the gender gap in education premiums has narrowed; however, returns to experience have declined. Transition apparently does not decrease regional asymmetries in employment. A peculiarity of the Russian labor market has been the accumulation of wage arrears, which allow wages rather than employment to adjust downward. In contrast, it was employment that adjusted in CEE countries, which in turn contributed to faster structural change.

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Vladimir Lavraè
ERM 2 Strategy for Accession Countries
WP 19, 2003, 22 pp.

There are reasons to believe that the exchange rate mechanism (ERM) 2 is dangerous, so it would be wise to stay in this mechanism for as short a time as possible (for a prescribed minimum of two years). Staying for too long in this mechanism may cause problems in meeting the Maastricht convergence criteria and may lead to delaying entry into the European Monetary Union for the indefinite future. The ERM 2 is potentially an unstable exchange rate mechanism, because it is a soft peg system, which may become vulnerable to financial crises, particularly in the case of free capital mobility and expected large capital flows before EU and European Monetary Union entry. There should be more transparency, equal rules treatment, and less discretion in the hands of the EU in the process of the monetary integration of accession countries, which could make the formulation of their optimal ERM 2 and euro area entry strategies much easier.

Jo•e P. Damijan and Èrt Kostevc
The Impact of European Integration on Adjustment—Pattern of Regional Wages in Transition Countries: Testing Competitive Economic Geography Models
WP 18, 2003, 29 pp.

Jo•e P. Damijan, Mark Knell, Boris Majcen, and Matija Rojec
Technology Transfer Through FDI in Top 10 Transition Countries: How Important Are Direct Effects, Horizontal and Vertical Spillovers?
WP 17, 2003, 30 pp.

Vladimir Lavraè, Tina •umer
Exchange Rate Arrangements of Accession Countries in Their Run-Up to EMU: Nominal Convergence, Real Convergence, and Optimum Currency Area Criteria
WP 13, 2002, 36 pp.

Andreas Freytag
Central Bank Independence in Central and Eastern Europe on the Eve of EU Enlargement
OP 4, 2003, 30 pp.

WIDER

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Robert J. McIntyre and Bruno Dallago, editors
Small and Medium Enterprises in Transitional Economies
2003, 261 pp.

Even though the new small and medium enterprise sector is emerging as one of the driving forces in transition economies, little is known about the conditions behind its successful development or about policies that could facilitate its expansion. This volume explores the complex relationship between the growth of this sector and the current policies and institutional, historical, and cultural forces that shape its fate.

Vladimir Mikhalev, editor
Inequality and Social Structure During the Transition
2003, 328 pp.

Contributors compare emerging social structures in transition societies and discuss the life of most workers and of socially deprived and marginalized people. They look into causes of high inequality and poverty in Russia and other CIS countries, as well as more the equal income distribution and higher levels of social welfare in Central Europe.

Marjan Svetlicic and Matija Rojec, editors
Facilitating Transition by Internationalization: Outward Direct Investment from Central European Economies in Transition
Ashgate Publishing, 2003, 310 pp.

Foreign direct investment has proved to be the most dynamic defensive and offensive response to globalization. This book provides an in-depth evaluation of the rationale, as well as theoretical and empirical explanations of the outward internationalization of firms from the Czech Republic, Estonia, Hungary, Poland, and Slovenia. The authors evaluate the role of transnational companies from transition economies and the development implications of outward internationalization for their economies.

Edward Elgar Publishing

To order; 136 West Street, Suite 202, Northampton, MA 01060-3711, U.S.A.; URL: http://www.e-elgar.co.uk/.

James Laurenceson and Joseph C. H. Chai
Financial Reform and Economic Development in China
2003, 176 pp.

Covering not only the banking sector, but also nonbank financial institutions, stock market development, and external financial liberalization, the authors examine the impact of financial reform on economic development in China during the reform period.

Jorge Martinez-Vazquez and James Alm, editors
Public Finance in Developing and Transitional Countries—Essays in Honor of Richard Bird
2003, 384 pp.

Martin Myant
The Rise and Fall of Czech Capitalism—Economic Development in the Czech Republic Since 1989
2003, 304 pp.

Other Publications

L. Jerome Gallagher and Raymond J.Struyk
Strengthening Local Administration of Social Assistance in Russia
The Urban Institute, 2001, 33 pp.

Dani Rodrik, editor
In Search of Prosperity: Analytic Narratives on Economic Growth
Princeton University Press, 2003, 520 pp.

Micro and Macro Perspectives on Foreign Direct Investment

February 13-14, 2004, Dublin, Ireland

This conference is organized by the Institute for International Integration Studies at Trinity College, Dublin. The conference will bring together researchers focusing on international trade, finance, and macroeconomics and will highlight new theoretical and empirical research on foreign direct investment. Invited speakers include Assaf Razin (Cornell/Tel Aviv), Matt Slaughter (Dartmouth), Linda Goldberg (New York Fed), and Marc Melitz and Laura Alfaro (Harvard). The program will be finalized in early November.

Information: Philip Lane, James Markusen, and Frances Ruane; URL: iiis@tcd.ie.

The Middle East and Globalization for the Common Good—Integrity, Spirituality, Ethics, and Accountability: Transforming Business, Corporate Social Responsibility, and Globalization for the Common Good

March 26-31, 2004, Dubai, United Arab Emirates

Papers, panels, and roundtable submissions are invited from observers, commentators, academics, postgraduate students, and NGOs to address issues related to globalization within the identified theme of the conference. Especially welcome would be papers from economists, business people, philosophers, theologians, historians, political scientists and those working in the field of international relations, peace researchers, conflict resolution specialists, lawyers, sociologists, psychologists, and environmentalists, as well as those engaged in interfaith action projects. You are invited to send a one-page abstract, which should include a working title and the author's discipline and field, address, institutional affiliation, and email address to either of the conference organizers by December 15, 2003. Should your proposal be accepted, you will be notified by mid-January 2004 about the conference program, registration, social and cultural activities, costs, and other particulars.

Information: Kamran Mofid and Raymond H. Hamden, Directors, 3 St. Martins Rd., Comprehensive Medical Centre, Coventry, United Kingdom, or P.O. Box 11806, Dubai, U.A.E., CV3 6ET; email: k.mofid@btopen world.com,

Master of Public Policy at the Central European University

The Central European University is launching a new master's degree in public policy (MPP), subject to funding, starting in September 2004. The aim is to train a new generation of policymakers, whether from national governments, local authorities, international institutions, or the private sector. As one of the first English-language master's programs in public policy in Central and Eastern Europe (CEE), the MPP is unique in its combination of academic excellence with policy relevance. It

- Is a graduate program that is developed within and for CEE countries and is tailored to the needs and concerns of transition and post-transition countries
- Capitalizes on and consolidates the rich scholarly tradition developed at the Central European University for the benefit of informed policy development
- Provides participants with the skills they need for a critical understanding of national, regional, and global policy issues
- Offers an invaluable opportunity for students and professionals to advance their careers in policymaking, whether in CEE countries or elsewhere.

The program will offer core and elective subjects based on different disciplinary traditions and insights, including political science, economics, legal studies, and sociology. Core courses will focus on policy analysis, public sector management, governance, and public service. A large number of elective courses will also be offered dealing with such subjects as communication and advocacy, social policy, education policy, economics and financial management, corporate governance, and policymaking in the EU.

The program will be taught by international faculty from the university and by visiting professors and leading practitioners from the region and beyond. The MPP will be based at the university's Center for Policy Studies, an academic unit dedicated to making the links between research and policy better known and understood.

Duration: September 2004-September 2005, followed by a three-month internship with a suitable organization. In the case of relevant work experience, students may be exempted from the internship component of the course.

Requirements: BA or equivalent from a recognized university and proficiency in English. Candidates with an MA and relevant work experience are preferred.

Financial support: A number of scholarships will be awarded on a competitive basis.

Application deadline: January 5, 2004.

Further information: Central European University, Center for Policy Studies, 1051 Budapest, Nádor u. 11, Hungary; tel. 361-327-3118; email: cps@ceu.hu: URL: http://www.ceu.hu/prospective_students.html or http://www.ceu.hu/cps/tea/tea_open.htm.

rhhamden@hotmail.com. For frequently updated information on the conference please visit the conference web site: http:// commongood.info.

China: Global Investment Strategies and Opportunities for Growth

April 26-27, 2004, Westin Copley Place, Boston, United States

This conference is being organized by Asia Programs at the Center for Business and Government, the John F. Kennedy School of Government, Harvard University, and Dow Jones. The following issues will be at the core of this investment summit:

• While the world's leading economies continued to suffer from weak and jobless growth, the Chinese economy expanded at an impressive 8 percent in 2002 and its GDP grew by 9.9 percent year-on-year in the first quarter of 2003. Will the government's response to the outbreak of severe acute respiratory syndrome (SARS) stimulate faster reform and allow China to maintain this high growth rate? The task of maintaining growth is falling to a new generation of leaders who are not well known outside China.
• Major challenges facing the new leadership.
• What will the domestic and international priorities of China's new leadership mean both for international companies investing in China and for Chinese companies wishing to expand abroad?
• Challenges and opportunities in developing a modern urban infrastructure in China.
• What are the investment opportunities for Chinese and foreign businesses as Beijing prepares to host the 2008 Olympic Games?

Participants will have the opportunity to hear from China's new leaders about the future they envision and to discuss the implications for the international business community and for China's growing ranks of entrepreneurs.

Organizers expect the participation of U.S., Chinese, and international government officials; senior executives from international financial institutions; chief executive officers, chief financial officers, and managing directors from China's private and state-owned business communities; senior executives from U.S. and international corporations; corporate investors; investment brokers and analysts; and legal and financial professionals with an interest in China.

Information: Vivien Day, email: vivien.day@dowjones.com; speaking opportunities, Joanne Chapman, email:joanne. chapman@dowjones.com.

30th Annual Conference—European International Business Academy: Enlarged European Union: Challenges to International Business and Management

December 5-7, 2004, Grand Hotel Union, Ljubljana, Slovenia

This conference is organized by the Centre of International Relations, Faculty of Social Sciences, University of Ljubljana. The organizers invite both theoretical and empirical papers that may contribute to an understanding of the consequences and challenges of the EU enlargement. Suggested topics include the following:

• Competitiveness of the enlarged EU and challenges of adjustments after the enlargement—company and government perspective
• International business and related economic theories
• Globalization versus regional economic integration
• Knowledge management, technology transfer, research and development, and spillover effects in multinational companies
• Internationalization strategies of multinational companies
• Management and organization of multinational companies
• International business and culture—ethics and related marketing issues
• International finance and accounting
• Legal and policy issues
• Emerging markets and transition economies
• Small countries and companies in the EU and the global economy.

Papers on other aspects of international business are also welcome. All papers or contributions must be submitted no later than 15 July 2004.

Information: Kardeljeva plošèad 5, SI-1000 Ljubljana, Slovenia; tel.3861-5805-190, fax: 3861-5805-109, email: marjana.jevsenak@uni-lj.si, URL: http://www.fdv.uni-lj.si/ anglescina/default.htm. ❇

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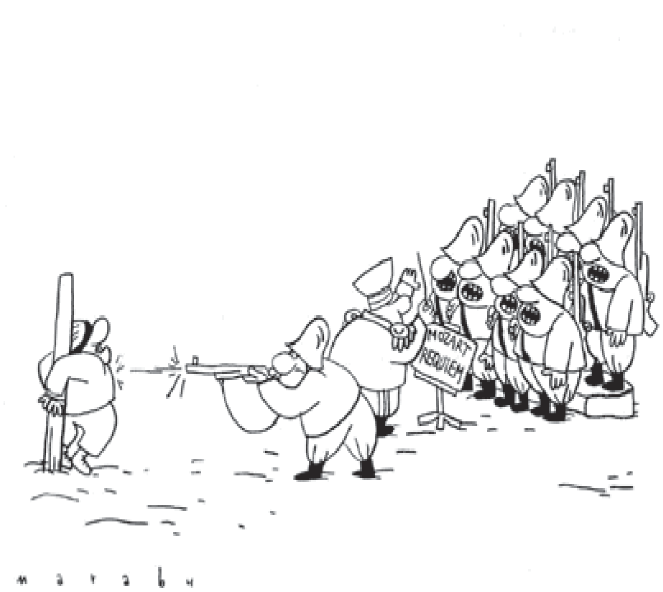

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Editor's Note

Dear Readers:

On a personal note, this is to let you know that I'm retiring from the World Bank and relocating to Hungary. However, I will continue to edit *Transition* thanks to a new arrangement between the World Bank's management and *Transition's* partner, the Stockholm-based SITE. Even though an ocean will separate the members of the *Transition* team, given modern telecommunications, newsletter production will continue without a hitch. We will do our best to remain your favorite information provider on all issues pertaining to transition, with the added benefit of actually being "in the field."

Yours,

Richard Hirschler

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