

The Newsletter About Reforming Economies

Beyond Transition

July – September 2005 • Volume 16, No. 3

<http://www.worldbank.org/transitionnewsletter>

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From the Managing Editor:



Dear Reader,

Transition is still transforming the post-Soviet political landscape. Popular movements of different colors and shades are unseating governments throughout the region. Understanding these episodes of dramatic institutional change, or at least change in political power, requires a wide lens. Change is often triggered by specific issues, but the preconditions are usually much more complex.

Beyond Transition normally has a cross-country theme, but in this issue we focus on one country, Ukraine, and the striking developments there over the last two years. To shed light on the scope of the reform process we bring together research and opinion pieces on different aspects of Ukrainian reforms.

Ukraine is important in its own right, with 55 million people and a strategic location in between the enlarged European Union and a Russia that is reasserting its role in the world. Ukraine is also an interesting example of an economy that, after years of stagnation and muddling-through, experienced rapid growth, but without institutional development keeping pace. The events of last October brought this imbalance to the fore.

The lead article by Andrew Triffin puts the Ukrainian economy in international perspective. As he points out, Ukraine is potentially a very wealthy country, with an enviable endowment of both natural and human resources. But a persistent and widespread pattern of market-unfriendly rules and practices has prevented the country from using these resources efficiently. In another contribution, Valentin Zelenyuk uses growth accounting to look at the evolution of Ukrainian productivity and efficiency over a longer historical period.

The case of Ukraine post- October 2004 brings out the challenges in sustaining institutional change. The new government started off with a strong and far-reaching mandate, but had to work under the rules of democracy in view of upcoming parliamentary elections in March 2006. Such rules invite economic policy-making driven by election cycles. How can reformers resist the temptation to resort to "extraordinary politics" or administrative intervention? How can they commit themselves to not playing the populist card?

Most emerging market economies also have emerging political institutions and are struggling with these challenges. The going has gotten particularly tough in Ukraine as income inequality has increased dramatically for over a little more than a decade. Justified resentments over unfair privatizations and poorly enforced laws and regulation are also easily channeled into simplistic policy proposals that either assume a first-best world of well-functioning institutions, or are weakly concealed attempts to transfer power from one group to another.

The purpose of this issue is not to evaluate the pros and cons of different regimes in Ukraine, but to see what a sample of recent research has to say about the challenges facing policymakers and the lessons from previous reforms. We include short articles on the effects of privatization and labor market policies. Kerstin Zimmer discusses the business-government relationships in Donetsk, an important part of the current power arrangement in the country.

To give a sense of Ukraine's political realities, this issue also includes the reflections of two observers, Anders Aslund and Irina Akimova, both with extensive, in-depth experience of working in Ukraine. Although they represent two different perspectives, their views of the reform process largely coincide. Judging by their contributions, the achievements of last fall are by no means secure.

An important aspect of institutional change in Central and Eastern Europe has been the desire to join the European Union (EU). But this aspiration in Ukraine, so palpably manifested on Independence Square last fall and in the new government's program, has not been met with much enthusiasm in the EU. Iryna Solonenko discusses EU support for democratization in the country. In the past these programs have had very little to show in terms of results, but she argues that the situation has changed. If Ukraine meets "tests on constitutional reform and the parliamentary elections in 2006... then opportunities for closer cooperation and integration ...will appear." Let us see.

Erik Berglof, Managing Editor

The Role of Institutions and Efficiency in Ukraine

Andrew Tiffin

Ukraine is potentially a very wealthy country, with an enviable endowment of both natural and human resources. But unfortunately, the economy has not been able to use these resources efficiently. Using cross-country data, our study suggests that Ukraine's inefficiency arises mainly from a persistent and widespread pattern of market-unfriendly rules and practices. Looking forward, particularly in light of the new administration's ambitious reform agenda, the study finds that durable growth in Ukraine will depend primarily on the authorities' ability to secure the basic foundations of a modern market economy.

Following the dramatic political events of 2004, the incoming Yushchenko administration moved quickly to articulate their new policy goals. They presented a broad agenda that extended beyond simple macroeconomic stabilization, focusing instead on accelerating Ukraine's institutional transition toward a modern market economy. Much of this agenda is anchored within a medium-term strategy of greater integration with the European Union (EU) and global markets, and has been expressed operationally in documents such as the Ukraine-EU Action Plan and the recent Development Policy Loan with the World Bank.

Our study investigates the economic importance of institutions in Ukraine, and attempts to quantify the potential benefits of structural reform. It addresses two questions. To what extent have market-unfriendly institutions hampered economic performance in the past? And what would be the likely payoff if the new authorities succeed in their medium-term objective of strengthening market-enhancing institutions?

From the large and growing literature that seeks to explain international differences in income, a key finding is that income disparities result mainly from differences in productivity, rather than factor accumulation. In turn, these differences in productivity can be broken down into differences in: i) technology, representing a country's knowledge as to how factors of production can best be combined, and ii) efficiency, representing how effectively a country's factors are actually used.

It should be stressed that, in this context, "technology" refers to the sum of knowledge that is implicitly available to local producers. This is conceptually distinct from the technologies that are actually observed in the workplace. Indeed, most of this type of knowledge is publicly available, and even proprietary information is typically accessible through licensing arrangements or foreign direct investment. In this sense, the presence of obsolete production techniques does not necessarily imply a technology/knowledge gap. Rather, it may reflect

instead a situation in which producers are discouraged from adopting best-practice techniques; either because of burdensome regulations, or because their economic environment is such that they are unable to employ these techniques profitably. Therefore, the presence on the ground of suboptimal technologies may be a symptom of poor efficiency, rather than a result of unavailable technology.

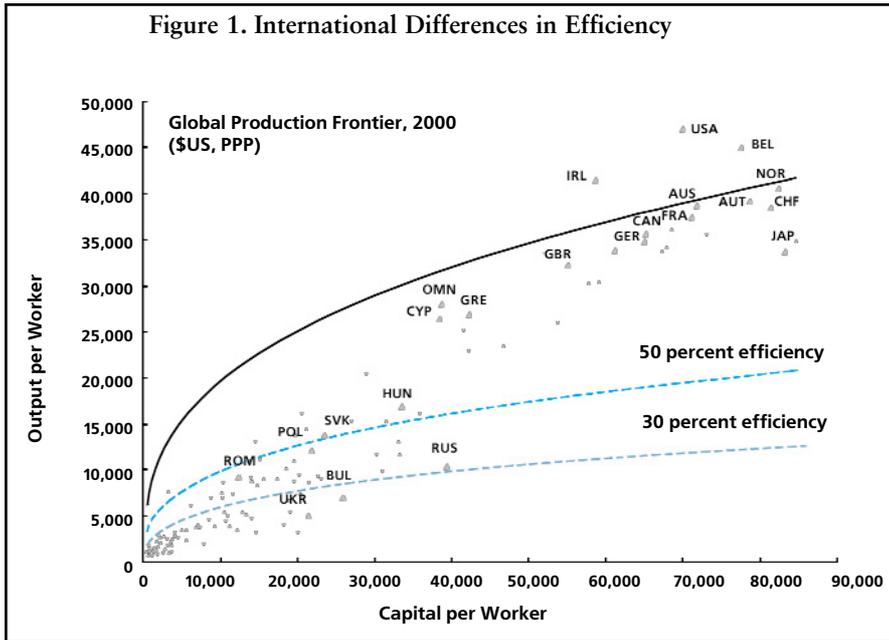
For the purposes of our study, the main challenge is to explore the reasons behind these international differences in efficiency. Theoretically, there is a strong view that low levels of efficiency result from an underlying absence of market-friendly institutions. In this context, "institutions" refer to the set of formal and informal constraints that shape an individual's ability to act productively and cooperatively. Typically, a market-friendly institutional base will include the rule of law, secure property rights, enforceable contracts, an even-handed and transparent government, and so on.

To quantify the level of efficiency in Ukraine, we develop a stochastic-frontier framework that exploits a recent cross-country dataset provided by Baier, Dwyer, and Tamura (2004). In short, this framework allows us to estimate what a country could have produced if it were operating at 100% efficiency, using the best available technology. The actual output of the country is then measured against this hypothetical benchmark as a guide to its overall level of efficiency. To investigate the impact of market-enhancing institutions, we use the indices provided in the World Bank's cross-country governance dataset, as developed and presented in Kaufman and others (2005). The results are illustrated in Figures 1 and 2 below, which clearly show that Ukraine is operating well below 100 percent efficiency, and that this outcome is strongly associated with its weak institutional base.

Soviet Bloc Countries were 20-35% Less Productive

Our study may also help quantify the impact of technology constraints during the cold war. From our results, legal restrictions on the flow of technology from west to east meant that the best-practice technology available to the Soviet bloc countries was about 20-35% less productive than the technology available to the rest of the world.

By 2000, however, the latest western technology was equally available to all countries, including those in Eastern Europe and the former Soviet Union. Over the 1990s, therefore, these countries faced an inflow of new ideas and techniques and so enjoyed a dramatically accelerated pace of technological growth.



For the most part, those countries that were not part of the Soviet Union were able to capitalize on this rapid influx of new technology, posting significant gains in output per worker. For countries such as Romania and Poland, these gains resulted primarily from increases in efficiency rather than factor accumulation (although in the case of Poland, the net vertical movement conceals an investment collapse and subsequent boom during the 1990s). For countries such as Slovakia and Hungary, on the other hand, output gains were the result of improved efficiency combined with significant increases in capital stocks, which in turn reflected dramatic inward flows of foreign direct investment.

In contrast, CIS countries dealt less well with the sudden exposure to western techniques during the 1990s. Instead pro-

duction continued in the same old manner, and showed little improvement. Moreover, Ukraine and other countries from the CIS also experienced a serious contraction in output over the 1990s, despite significant capital investment. In contrast to other countries in Eastern Europe, former members of the Soviet Union largely failed to replace the old central planning apparatus with a viable alternative. So, rather than moving to a more market-oriented system, the new states of the CIS found themselves without an effective institutional setup. Instead, they faced a chaotic system that encouraged a surge in rent-seeking behavior and uncertainty regarding property rights.

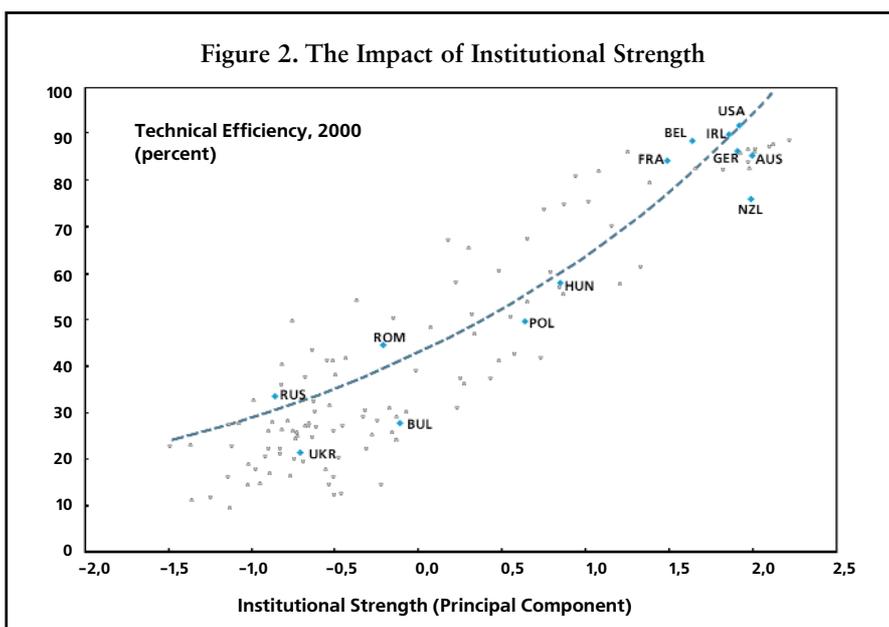
Efficiency is Key

The nadir of Ukraine's output contraction occurred in 2000. Since then the economy has grown strongly, often surpassing local and international forecasts. The causes of the recovery reflect a complex combination of factors, including: a huge boost in competitiveness following the financial crisis of 1998, the availability of significant excess capacity, and a recovery in neighboring Russia. In addition, however, Ukraine's turnaround also reflected the impact of first-generation reforms on efficiency introduced in 1999-2000. These focused initially on the energy sector, and were key in reducing the prevalence of barter payments and arrears. Addressing Ukraine's nonpayment culture in turn helped foster a more efficient allocation of resources and the beginnings of a working financial system.

Looking forward, our study suggests that lasting improvements in living standards will depend mostly on the authorities' ability to further increase Ukraine's efficiency; rather than higher rates of capital accumulation. This in turn will require a sustained commitment to improving market-oriented institutions, and a renewed effort to push forward long-delayed structural reforms.

In this light, the reform agenda outlined by the new administration, which is anchored within the Ukraine-EU Action Plan, is both timely and appropriate. The Action Plan covers a wide range of tasks and measures, and by harmonizing Ukrainian standards with those of the EU, it aims to accelerate Ukraine's progress toward a market-based economy that is firmly integrated within Europe and global markets.

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Democracy Promotion in Ukraine: the Role of the EU

Iryna Solonenko

The European Union (EU) from its creation has promoted democracy in other countries. Expanding EU norms and values beyond its boundaries has been a prominent part of EU foreign policy. However, EU initiatives to spread European values of democracy and the rule of law have had only a weak influence on former Soviet states and in particular on Ukraine. In terms of its quality of democracy score, annually compiled by Freedom House, Ukraine scored 4.5 (on a scale from the highest 1 to the lowest 7) in 2004 and 2005. This was the best score among post-Soviet countries, but was, however, well below the EU new member states, which averaged 2.03. Democracy in Ukraine has been marred by the prosecution of journalists and election rigging, prompting policy analysts to tag Ukraine as a "defective democracy" (Beichelt, Pavlenko 2005). While domestic factors account for most of Ukraine's problems, the EU has enough room to play a more active role in building a democratic Ukraine.

The effectiveness of the EU's policy towards Ukraine is hindered by several important shortcomings. To begin with, economic interests and security considerations have left value promotion and norm dissemination in the shade. The budget reflects this: only 15 million euro out of 212 million over the period 2004-2006 have been earmarked for legal and administrative reform, 10 million euro for civil society, media and democracy, and 25 million euro for education and training — areas related to democracy promotion. The emphasis has been on improving the business environment: commercial law is the key priority among initiatives to strengthen the judicial system, and the key areas for legislation development are competition, intellectual property, and standardization procedures. At the same time 60 million euro is envisaged for the Action Plan on Justice and Home Affairs, which mostly deals with combating illegal migration and border management.

Within this institutional mosaic an important element has been missing: a strategic commitment by the EU to integrate Ukraine. Even if the promise of future membership, which played a crucial role in the transformation of the Central European states, is not forthcoming in the foreseeable future, strong integration incentives would have a stronger impact on mobilizing domestic actors and eventually carrying out reforms.

With the development of the European Neighbourhood Policy (ENP), the EU has acquired new instruments to promote democracy in Ukraine. The ENP has provided new incentives for Ukrainian reforms.

Firstly, the adoption of the EU-Ukraine Action Plan, supplemented by the 10-point plan of Benita Ferrero-Waldner and Javier Solana, has offered Ukraine such incentives as EU support for Ukraine's World Trade Organization accession and has granted Ukraine market economy status. Furthermore, it has started negotiations on facilitating a visa regime for Ukrainians, and increased EU assistance including in the field of democracy and the rule of law, legislative approximation, support for the

strengthening of civil society, and people-to-people contacts. Additional funding from the European Investment Bank is conditional upon Ukraine's successful implementation of the Action Plan. Previously, a lack of conditional instruments deprived the EU of sufficiently strong leverage to push Ukraine towards reforms. Moreover, EU carrots held out to Ukraine were too small to stimulate reform by themselves.

Secondly, the ENP offers new elements to enhance the socialization process, which according to Michael Emerson, along with conditionality, is an important tool in the Europeanization of neighbouring countries. In particular, the EU now extends programs to Ukraine aimed at fostering people-to-people contacts and sharing experiences of transition at all levels, including educational programs. In addition, the EU is planning to offer Ukraine initiatives aimed at strengthening the administrative capacity of civil servants at all levels. The ENP also promises to improve cross-border cooperation by permitting a single application process for organizations from either side of the EU-Ukraine border, and a joint selection process for projects.

Third, the ENP regularly monitors progress. According to the Action Plan Plus, adopted by the EU Council in December 2004, monitoring will be carried out at the end of each year. Previous policy arrangements lacked mechanisms to monitor progress. For example, the European Commission, which produces annual progress reports on each accession country, made no attempt to assess the development of the EU-Ukraine relationship until 2003.

Finally, these policy developments will succeed only when Ukraine aspires to EU membership and when real political will and commitment to EU values emerge. Until recently, the Ukrainian political leadership had no desire to join the EU. Pro-EU rhetoric was simply used by the authorities to legitimize themselves in the eyes of the European democratic community. Despite the significant number of ambitious programs and documents, and far-reaching declarations, domestic policy has demonstrated that Ukraine's authorities do not share basic democratic values with the EU. This became especially evident when the public authorities employed strong anti-EU and anti-Western propaganda during the pre-election period in 2004. The Orange Revolution has arguably changed the situation. Before the recent turmoil within the political elite, the authorities demonstrated a higher level of commitment to domestic reforms than before. If Ukraine passes the tests of constitutional reform and the parliamentary elections of 2006, and successfully implements the Action Plan, then opportunities for closer cooperation and integration between Ukraine and the EU will appear.

Iryna Solonenko is Director of the European Program at the International Renaissance Foundation, Kyiv, Ukraine. She has contributed this article to BT. ■

The Ukrainian Labor Market in Transition

Hartmut Lehmann, Katherine Terrell

The findings from five recent studies of the Ukrainian labor market shed some light on the extent, incidence, and costs of wage inequality, the gender gap, unemployment, and worker displacement brought about by the transition to a market economy.

Knowledge of labor market adjustment during the transition in Ukraine, the second largest successor state of the former Soviet Union, has been very limited. Until recently, due to the absence of appropriate and accessible data, no serious research existed on the behavior of individuals and households in Ukraine's labor market.

With the arrival of the Ukrainian Longitudinal Monitoring Survey (ULMS), carried out in 2003 and 2004, panel data on individuals both in and out of work have become available. ULMS, which was patterned after the Russian Longitudinal Monitoring Survey (RLMS), contains a household questionnaire and a lengthy individual questionnaire, as well as an extensive retrospective section, which allows a complete reconstruction of workers' employment record between 1998 and 2003. The 2003 ULMS was carried out on a representative sample of approximately 4,000 households and 8,500 individuals. In 2004, 81% of the individuals were resurveyed. In the second half of 2006, the data from these first two waves will become accessible to researchers anywhere in the world.

We present here a brief survey of findings from five recent unpublished studies that have used these data to analyze different aspects of the labor market.

“Glass Ceiling” Lower in the Public Sector

As Ukraine considers the process of negotiating entry into the EU, discussions have begun on how to create gender equal policies in line with those of Western Europe. "Wage Ceilings and Floors: The Gender Gap in Ukraine's Transition" (Ganguli, Terrell, 2005) presents the first estimates on the gender gap in the distribution of wages at different points in time: during communism in 1986, at the beginning of the transition in 1991, and after Ukraine started to be considered a market economy in 2003. In all three time periods, the authors find the gender gap in wages is much higher in the top half of earners than in the bottom half. Men earn about 45-50% more than women in the 50th, 75th and 90th percentiles of the wage distribution, consistent with the hypothesis of a “glass ceiling.” On the other hand, the gender gap narrowed from approximately 0.20-0.40 in 1986 and 1991 to 0.10-0.20 in 2003, indicating that the wage floor rose for women in 2003. Closer inspection of two sectors — the private and the public — reveals the striking finding that the glass ceiling is lower in the public than in the private sector while the floor for both sectors is the same.

Which factors are producing these differences? Is it the differences in men's and women's rewards for labor market characteristics or differences in their productive characteristics? Ganguli and Terrell find that if women were rewarded as men are, the wage gaps would fall to almost nil throughout the distribution. The different ceilings in the public and private sectors are largely due to differences in men's and women's productive characteristics, which favor men in the public and women in the private sector. The fall in the gender gap in the lower part of the wage distribution from 1986 to 2003 is explained partially by the improvement in women's productive characteristics and partially by the worsening in men's rewards over time. However, probably the most important reason for the reduction in the gap is that the value of the minimum wage was set relatively high in 2003 and it raised the wage floor for a larger number of women than men.

Thus, if the new government wants to implement gender equal policies, it should start re-evaluating the system of compensation in the public sector and recognizing the incidence of discrimination. If it were to eliminate the gaps in the public sector, or at least reduce them to the current levels in the private sector, Ukraine's gender wage gaps would be on par with the EU.

In the second paper by Ganguli and Terrell ("Institutions, Markets and Men's and Women's Wage Inequality: Evidence from Ukraine," 2005) the authors find that the wage inequality of full-time workers rose between 1986 and 2003 — that is, the Gini coefficient increased from 0.291 to 0.333. This, however, is not as much as in Russia over this period. The increase in inequality has been driven by market forces through changes in wage premiums, especially in inter-industry differentials. The changes in the composition of the labor force, which can be attributed to a larger exodus of low skilled workers from full time work, moderated the increase in inequality.

Wage gender inequality for all workers grew in the top half of wage distribution and actually fell in the bottom half from 1986 to 2003. The rise in the top half however, is not as great as may be expected after a decade of reform. The decline in woman's wage inequality in the lower half of the distribution in 2003 was driven by institutional change. The minimum wage, acting as a wage floor primarily for women, is playing an important role in lowering the growth in inequality. Looking ahead, if the government wants to ameliorate the effects of market forces on wage inequality, it should recognize the importance of maintaining the value of, and compliance with, the minimum wage.

Older People and Females: More Probable to Lose Job, Harder to Find One

In recent years there has been much policy discussion about unemployment in transition countries and the impact of unemployment benefits on the duration of unemployment. Since the

incidence of long-term unemployment in Ukraine is very high from an international perspective, it is particularly interesting to study the behavior of the unemployed and the determinants of the duration of unemployment. A priori, unemployment benefits or income from casual activities or subsidiary farming might be important factors that retard outflows from unemployment.

The paper by Kupets ("What is behind Stagnant Unemployment in Ukraine: The Role of the Informal Sector", 2005) finds those who receive unemployment benefits do not have significantly longer spells of unemployment than those who do not receive benefits. However, income from casual activities or subsidiary farming provides a strong disincentive for the unemployed to enter gainful employment. An individual's age, marital status and gender, the level of education and place of residence are significantly related to the total time spent out of work. Older workers and females have greater difficulties finding employment, while married persons have a substantially easier time getting back to work. Workers with completed higher education as well as residents of large cities have much shorter spells of unemployment and are more likely to return to employment. These results are clearly in line with those found in other transition economies.

In the transition literature, the discussion about restructuring and privatization focuses nearly exclusively on efficiency issues and rarely considers the effects of these processes on workers in the short to medium term. Addressing this oversight, the paper by Lehmann, Pignatti, and Wadsworth (2005) estimates annual displacement rates for 1992-2002 and finds them to be between 2.7% and 4.9%, indicating that Ukrainian firms have been permanently laying off workers at rates comparable to those in mature market economies. These estimates contradict the frequently held notion that involuntary separation from employment is unimportant in CIS labor markets because of low labor costs. Displacement is not entirely random. Female workers have a higher probability of being made redundant than men. Job losers are typically older compared with job quitters, although their educational backgrounds are similar. Workers in industry, construction, wholesale and retail trades, and hotel services were particularly hard hit by redundancies. In addition, persons residing in Kyiv city are disproportionately affected by permanent layoffs.

By the standards of industrialized economies, displaced Ukrainian workers have extremely low return rates. While a minority of workers finds reemployment after a very brief spell of unemployment, the majority of workers linger on out of work for a very long time. While the individual costs in terms of unemployment are large in Ukraine, wage losses due to displacement are rather limited. For those who return to work, there is evidence of a small fall in wages one year prior to displacement, and that this loss is not recovered in the first year in a new job.

Winners from Privatization: Unmarried, High-Skilled Workers

The principal argument for privatization around the world is that profit orientation will increase firm efficiency and competitiveness. Does any increase in efficiency, however, come at the expense of workers? If privatization results in layoffs, wage cuts, or both, this could help explain why workers have so often vehemently opposed privatization.

The paper by Brown, Earle, and Vakhitov (2005) explores the effects of privatization on worker job loss and wages to determine who the winners and losers are. The analysis suggests that privatization reduces worker job losses of all types, halving the dismissal and resignation rates. Wage levels are also reduced by about 5%. Workers in worker-controlled firms suffered large wage losses, while those in outsider-controlled firms may have enjoyed wage gains. A possible explanation for this pattern could be that worker-controlled firms do not enjoy substantial efficiency gains, necessitating labor cost cuts. Workers have chosen to accept lower wages in exchange for continued employment. In contrast, workers in outsider-controlled firms need not make such an unpleasant trade off, as the firms may have expanded their scale, making cuts in labor costs unnecessary.

The biggest winners from privatization appear to be unmarried and high-skilled workers (particularly those with computer skills) and those in large firms. Private owners may invest more in new technologies, leading to increased demand for skilled workers. This is particularly likely in large firms, which tend to be more capital-intensive and where capital and skills complement each other more.

Concluding Remarks

This short review of five recent papers on the Ukrainian labor market that utilize the ULMS improves our understanding of several phenomena in the labor market brought about by the transition to a market economy. These include changes in and some determinants of wage inequality and the gender gap, unemployment, and worker displacement and an understanding of who gains and who loses from privatization. Evidence on the extent, incidence, and costs of the above is needed in Ukraine to develop appropriate policies and institutions, especially as Ukraine considers the process of negotiating entry into the EU.

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The ULMS was initiated by the program "Labor Markets in Emerging and Transition Economies" at IZA in Bonn, Germany, www.iza.org; the field work was carried out by the Kiev International Institute of Sociology (KIIS). ■

Donetsk: A Powerful Business Empire

Kerstin Zimmer

At first sight, Donetsk is a rather typical old industrial region. Its economy is based on coal-mining, metal and steel production, machine building, and chemicals. Production and employment are dominated by large enterprises, many of which depend on state subsidies. Although the regional economy is no longer regulated by planning, regional and local administrations continuously intervene in economic processes, and personalized networks constitute the core of the political and corporate alliances.

The regional share in national production is steady at 20%; it accounts for a third of Ukraine's export revenue, due mainly to the metalworking industry. The growth of the region's GDP since 1999 has been mostly related to the steel sector, though this has so far been due to central policy that has favoured this sector and to a favourable situation on the world market and not down to any structural reforms. This one-sided economic development is mirrored by the character of dominant regional actors. The region is controlled by a power structure that is normally referred to as the "Donetsk Clan," comprising entrepreneurs and public officials.

Until the mid-1990s, the regional economy did not experience any structural reforms. All relevant companies remained state-owned and "red directors" played a decisive role. Gradually, private energy traders took control of key enterprises. The struggle over property redistribution intensified in 1995 and 1996, when privatization was officially promoted. The brutality of this conflict was demonstrated by various contract killings. In the middle of the 1990s, the Donetsk Clan was weakened and subject to interference from the centre and economic actors from Dnipropetrovsk. But since then, it has regained strength. After the appointment of Viktor Yanukovich as governor in 1997 the economic and political struggle took more civilized forms. Due to their loyalty to President Leonid Kuchma, the regional power elite were allowed to act in the region without much interference from the centre. While the use of direct force diminished considerably, control over the political infrastructure, over the discourse of regional identity, and over a large part of the regional economy increased. The clan effectively captured the entire region.

A Hand-Operated Economy

Although the regional economy is no longer regulated by planning and directives, it has not developed into an institution regulated by the free, competitive and rule-bound interplay of supply and demand. Instead of the market's invisible hand, a "hand-operated economy" has emerged in which the regional and local administrations continuously intervene in economic processes. Networks based on personal relations and particularistic trust have taken over coordination and set market entry and prices. Political power is both a guarantee and a precondition for economic success. Official development programmes

aimed at the revitalization of the regional economy have not contributed to structural change, but instead have been used for the enrichment of the regional business elite.

From 1997 until 2002, the development of the clan and the fate of the region were inseparably linked to two names: Viktor Yanukovich and Rinat Akhmetov. Since 1999, Ukrainian and some international media have increasingly portrayed Akhmetov as the head of the Donetsk Clan. Currently, his assets are assessed at more than US\$3 billion, making him Ukraine's richest man. He is also one of the main social and cultural sponsors in the region.

Personalized networks constitute the core of the political and corporate alliances, some of which have been formalized. The two leading financial industrial groups (FIGs) are the Industrial Union of Donbass (IUD) and System Capital Management (SCM). Both are diversified corporations. They have created vertically integrated structures along two production chains, coal-coke-metal, and coal-power generation-electricity distribution. These closed production cycles serve as low-cost inputs into metalworking enterprises and enhance the FIGs' competitiveness on the international market. The control of the value chain in heavy industry is absolute: from the mining of raw materials, their processing, steel production (together with the control of the gas and electricity supply), sales (via offshore firms), right up to refinancing via their own banks and laundered money from abroad, all elements are united within the FIGs.

Hostile Takeovers and Shadow Privatization

Until recently, the flagship of the regional economy was IUD, founded in 1995 with the blessing of the regional authorities. In 1996, this conglomerate was uncontrolled and weakened by the inter-regional conflict for the spoils in the division of the gas market. Apparently, Akhmetov took over without formally becoming a shareholder. In 2002, the total annual turnover of IUD and its subsidiaries — allegedly about 600 companies in eastern Ukraine — totalled more than US\$1.7 billion.

Rinat Akhmetov's role remained ambiguous for a long time, and he always denied his influence on IUD. In 2000, he founded the holding company SCM, in which he holds a 90% stake. He strove to pull out a sizeable share of his assets from IUD's structures and to transfer them to SCM, mostly in a rather opaque matter. These assets included the strategically important Khartsysk Pipe Factory, Azovstal (one of Ukraine's biggest steelworks), as well as First Ukraine International Bank, several coking plants, and machine building companies. Before acquiring the shares, SCM received the consent of the Anti-Monopoly Committee and subsequently brought about decisive changes in the management in order to officially authorize the transfer of shares.

However, SCM holding is also growing by way of shadow privatization, including in the energy market and physical infra-

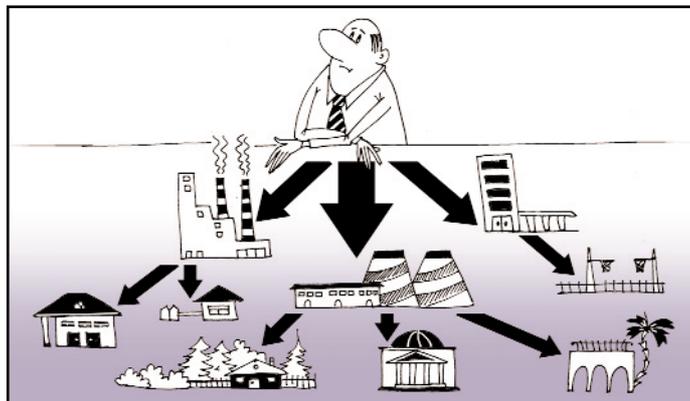
structure. When taking over state-owned companies the following pattern is regularly adhered to: first a front company is founded. This company then, by way of an opaque process, obtains shares in a state-owned enterprise or otherwise gains control over it, usually stripping it of its assets. After a while SCM, normally with the consent of the Anti-Monopoly Committee, becomes the majority shareholder of the front company or takes over its shares. In this way, SCM legally becomes the owner of the formerly state-owned company, while remaining unrelated to the dirty business that took place before.

This economic empire also incorporates offshore companies, which purchase comparatively low-priced raw materials and semi-finished products on the Ukrainian market and resell them at higher prices on the world market. Consequently the profits never reach Ukrainian territory.

Since the end of the 1990s, the regional FIGs have expanded their activities and ownership relations beyond the administrative borders of the Donetsk region, aiming to complete their production cycles in heavy industry. The actors' intention to completely control the production cycles seems rational as it allows them to concentrate the profits within the FIGs, to conceal them by nontransparent cross ownership and to evade taxes. Moreover, closed production cycles render them less dependent on suppliers that are hard to control. The economic expansion within Ukraine, including privatization and hostile takeovers, was only possible with guarantees from political and/or administrative actors who actively advocate their interests. There were several rushed privatizations before the 2004 presidential elections. Most of them were boring in the sense that, as a rule, the winner was known before the announcement of the results of the tender. The regulations for the tender were tailored to a specific bidder, virtually excluding other viable competitors. Steel mills such as Kryvorizhstal, ore enrichment companies, and major profitable coalmines ended up in the hands of the Ukrainian oligarchs, and especially in Akhmetov's. Some of these privatizations are currently under review by the new government.

Going Westward?

A relatively new tendency is the expansion into Western markets. With the enlargement of the EU, Ukrainian steel producers feared losing markets in Central Europe. Furthermore, access to the EU market is hampered by fierce competition and preferential treatment towards western producers. In reaction, some Donetsk actors forced their way into central European markets through property acquisition and direct investment. In 2003, IUD — in cooperation with its Swiss partner Duferco — won a tender for 80% of the shares of the Dunaferr steelworks in Hungary, defeating strong competitors from Russia and India. IUD's endeavours in Poland were more ambiguous. IUD's proposal in a tender for the privatisation of the Huta Czystochowa steelworks reached the top of the ranking, but the company was not accepted as future owner. This led to diplomatic conflicts between Poland and Ukraine. At the end of March 2004, the Polish government temporarily suspended the privatization process. In 2005, IUD won the new tender.



This incident reveals one of the problems of the Ukrainian FIGs. Their insufficient transparency and bad reputation concerning business conduct, has become a stumbling block in such institutional settings in which they can not influence state decisions. Such negative experiences might have repercussions on the FIGs.

The economic sectors controlled by the FIGs, IUD and SCM, are capital intensive and require high investment. One might assume that the FIGs will be forced to forego profits and to attract real foreign investment. In addition, they have expanded into more productive sectors such as food processing and services. These developments have been interpreted as signs of changing interests as they require stable and enforceable legal rules. So far however, the FIGs have applied their traditional strategies: hostile takeovers and shadow privatization, that both depend on clientelistic ties to patrons in key administrative positions. As external incentives continue to play such an important role, the question remains open whether the FIGs will change due to their own internal incentives. Ukraine's aspirations towards accession to the World Trade Organization and expansion into EU markets (as owners and not as traders) signal a general desire for fuller integration into the world market, increasing the pressure to adapt to the international standards of corporate governance and to create more transparency. In addition, the actors in this are exposed to new cultural and institutional settings so that processes of learning and adaptation are to be expected. Akhmetov himself has realised this in advance. He has hired foreign consulting companies to create more transparency in SCM. His step forward into Western markets, however, has yet to be made.

Much depends on future political developments. Since the Orange Revolution, the new government has attacked powerful FIGs. Boris Kolesnikov, one of Akhmetov's major allies, was arrested and Akhmetov's offices were searched. It is not yet clear how far reaching the changes will be and whether the oligarchs will come to informal agreements with those in power. After the dismissal of the former Prime Minister Yulia Tymoshenko's government in September 2005, the chances for such agreements seem to have improved again.

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Economic Reforms and Productivity-Enhancing Reallocation in Ukraine and Russia

David Brown, John Earle

How do economic reforms affect resource reallocation processes and their contributions to productivity growth? We study the consequences of enterprise privatization and liberalization of product and labor markets, and imports in Russia and Ukraine.

Analyzing interfirm reallocation of output, labor, capital, and an input index with annual industrial census data from 1985 to 2001, we find that Soviet Russia displayed low reallocation rates that bore little relationship to relative labor and multifactor productivity across firms. Since reforms began, resource flows have increased in both countries, and their contributions to aggregate productivity growth have become substantial both through increased flows from less productive to more productive firms and through higher exits of less productive entities — i.e. through creative destruction. Among the factors relevant to policy that may explain firm-level variation, privatization is estimated to have positive effects on productivity-enhancing reallocation, but there is less evidence of such effects from domestic product market competition, labor market competition, or import penetration.

Well-functioning market economies appear to exhibit rapid rates of resource reallocation across production units, a process with the potential to contribute significantly to economic growth. Under central planning, however, most business decisions — output, product variety, prices, technology, wages, investment, exit and entry — were either specifically planned or indirectly controlled. Enterprises had strong incentives to meet planned output targets, but little incentive to contain costs, to innovate, or to produce goods of value. There was no effective competition, and imports were tightly regulated. Thus, the usual factors that might be supposed to influence reallocation and productivity were largely absent.

During transition, the extent to which enterprises actually adjust and improve productivity in response to changes in their environment is likely to depend on the strength of competitive pressures, the objectives of the state or new owners, the effectiveness of corporate governance by the owners, and the information conveyed by prices and wages. These factors in turn are influenced by the specific policies of liberalization, privatization, and stabilization that were adopted to initiate the transition to a market economy.

The pace and design of economic reforms differed substantially between Russia and Ukraine. Ukraine has by all accounts followed a more gradualist path of slower liberalization, privatization, and stabilization than its larger neighbor for most of the period since the end of 1991. In the late 1990s, policy reforms in Ukraine appear to have been catching up with Russia's, according to the aggregate statistics and the evaluations of international organizations. The clearly different pattern of policy choices in the two countries suggests an interesting comparison. If a quicker and more effective implementation

of transitional policies tends to stimulate productivity-enhancing reallocation, then Ukraine's gradualist policy is likely to be reflected by a slower increase in the contribution of this factor to productivity growth. Due to the greater levels of inside ownership and less rapid liberalization in Ukraine, the effects of private ownership and of product and labor market competition are also likely to be stronger in more rapidly reforming Russia.

Our dataset includes annual observations from 1985 to 2001 for the Russian firms and from 1992 to 2000 for those in Ukraine, taken from annual industrial census data. This permits us to analyze the effects of reforms on a set of firms both before and after the policy changes. At the beginning of transition, in 1992, the data account for 90.5% of officially reported industrial employment in Russia and 94.1% in Ukraine.

Our analysis finds that:

- Soviet Russia had extremely low rates of interfirm reallocation and a negligible contribution of reallocation to aggregate productivity growth. While central planning may have functioned adequately in a static environment requiring little active reallocation of resources, it was much less effective in dynamic responsiveness to shocks requiring learning and selection — weeding out less efficient activities and promoting those that have become more productive.
- Liberalizing reforms in Russia and Ukraine have brought substantial increases in resource reallocation and in the productivity-enhancing consequences of the reallocation process. The overall patterns are quite similar for the two countries, despite the differences in their reform policies.
- After privatization took place, there was a sharp jump in the contribution of privatized firms to productivity-enhancing reallocation in Russia, but no such effect can be detected in Ukraine, where privatization was carried out much more gradually and with a stronger bias towards insider giveaways.
- Our examination of the effects of competitive pressures from product and labor markets on overall productivity shows little contribution from competitive pressure in either economy, except possibly from local labor markets.

Thus, the microeconomic evidence is consistent with the view that reforms have stimulated enterprise-level restructuring and reallocation in both countries, and that the reallocation process has become productivity-enhancing. In the early transition, the reallocation effects served to reduce the magnitude of productivity decline, and more recently they have accounted for a major fraction of productivity growth.

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Productivity and Efficiency in Ukraine

Valentin Zelenyuk

A series of studies on the patterns of productivity and efficiency in Ukraine has shown that of all transition countries, Ukraine has had the largest drop in average labor productivity. This has been attributed to deterioration in efficiency. On the regional level, the possession of valuable natural resources, levels of capital and foreign direct investment (FDI) are all factors that put a region among the better performers. An abundance of labor, and alcohol and tobacco consumption are associated with lower efficiency. At the firm level, local private companies, on average, are unsurprisingly more efficient than state-owned firms but also more efficient than firms with foreign-owned shares.

Cross-Country Comparison: Ukraine vs. Other Countries

An analysis of economic growth and its sources for 85 countries, including Ukraine, for the period 1992-2000 (Badunenko, Henderson and Zelenyuk, 2005) shows that while Ukraine experienced both technical change and capital deepening on a level similar to most of its neighbors (about 30% and 6%, respectively), it had the largest drop in average labor productivity, with a 42% decrease (see Table 1). This drop was mainly due to deterioration in efficiency — the increase of the gap between real GDP and its projection onto the estimated world 'best-practice score.' Almost all transition countries have experienced efficiency deterioration, which led to massive underutilization of existing capacities, however, efficiency change was the largest in Ukraine, sliding by about 58%! In 1992, Ukraine was only about 25% efficient relative to the world's 'best-practice score'. By 2000, its efficiency score dropped further to about 11% and was the lowest among its neighbors.

What about the economic performance of regions within Ukraine? How different are the East and the West of Ukraine

(divided by the Dnipro river) and the industrial and the agricultural regions in their levels of economic performance?

Cross-Regional Comparison: East vs. West

Despite significant differences in worker income between the East and West of Ukraine, as well as agricultural and industrial Ukraine, our analysis (Demchuk and Zelenyuk, 2005) concludes that in terms of distribution and average efficiency levels, the difference between the performance of these groups was insignificant. That is, although there are more or less efficient regions in both groups, on average these groups utilize their given resources on a similar level of efficiency. Econometrically, we were also able to identify the most important factors determining the level of efficiency. Among the positive determinants of efficiency was the level of capital, FDI per capita in the region and the wealth of the region in the base period. Among the negative determinants of efficiency levels we found such indicators as the size of the labor force and the consumption of alcohol and tobacco.

What about from a microeconomics perspective? How did firms — state and private, local and foreign — perform during the bumpy road to a market economy?

Cross-Firm Comparison: State-Owned vs. Private, Local vs. Foreign

In another recent work (Zelenyuk and Zheka, 2005) we find that local private companies are, on average, the most efficient, while state ownership of a company is positively and significantly correlated with levels of inefficiency.

Somewhat unexpectedly, we also found that the level of foreign ownership in a firm was positively correlated with levels of inefficiency. This result is quite intriguing. Indeed, a common

perception is that foreign companies are likely to be superior in terms of efficiency to the local ones. Possible explanations for this could be that despite having more advanced technologies, some foreign companies might not be as efficient as local ones in dealing with the hidden obstacles of a poor business climate in a transition economy. In addition, politically powerful local business groups may find it beneficial to create artificial entry barriers for FDI through excessive bureaucracy and political instability. The scandals around

Table 1. Changes in income per worker and its sources in select transitional countries

Country	Efficiency in 1992, %	Efficiency in 2000, %	Income per worker change, %	Efficiency change, %	Technical change, %	Capital deepening, %
Belarus	28	23	17	-20	34	10
Czech Republic	40	31	9	-22	32	7
Estonia	33	38	58	14.8	10	26
Hungary	45	40	37	-11	26	22
Russia	33	22	-9	-34	33	3
Ukraine	25	11	-42	-58	31	6

Source: selected from tables in Badunenko et al. (2005).

the privatization of Kryvorizhstal steel plant and other gigantic state industries might be good examples of this.

Concluding Remarks

Before the collapse of the Soviet Union, Ukraine was one of its richest republics. The economic disorganization following the collapse, the lack of important economic reforms during the first years of transition and slow reform progress afterwards, made Ukraine stagnate for almost an entire decade. The recent “miracle” of rapid economic growth (12.1% in 2004 and on average, about 8.4% annually in the past five years) is just a normal recovery that, coming on the back of a huge economic downturn, might look enormous. In fact, it is often forgotten that the recovery is quite far from complete: the official real GDP, capital investment and real wage in 2004 relative to that in 1990, are only about 61%, 56% and 50%, respectively! This means that just in order to reach the GDP level of 1990 by 2010, Ukraine's real GDP should grow at the rate of more than 10% annually. This requires enormous productivity growth.

In conclusion it might be worth noting that in the past 15 years Ukraine has had one of the lowest inflows of FDI per capita among the transitional economies. A large portion has

come from offshore zones, mostly Cyprus (but with Ukrainian origin), as well as from Russia, and therefore has not had such a spillover effect on productivity as western FDI is expected to bring. So while the “miracle” of productivity growth in the last five years was driven mostly by local capital, the miracle of productivity growth in the next 5 years should be driven significantly by FDI inflow from the West and by its spillover effect, unless the political climate frightens this FDI away to other countries. In fact, the recent radical change in the Ukrainian banking industry is preparation by foreign financial institutions to accommodate such increase of FDI inflow from the West. The recent acquisition of the largest Ukrainian enterprise, Kryvorizhstal, by a foreign owner is the first big leap in FDI influencing Ukrainian economic performance.

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Doing Business-2006 in Ukraine

In the World Bank survey Doing Business-2006, Ukraine ranked 124 out of 155 countries on ease of doing business, significantly below Russia (79), Moldova (83), Kyrgyzstan (84), and Kazakhstan (86). While the country fared well on enforcing contracts (39), getting credit (75), and trading across borders (79), it lagged behind in the areas of property registration, investor protection, and tax payment procedure.

In fact, in terms of paying taxes Ukraine ranks 151. Ukrainian firms must make 84 payments, spend 2,185 hours to comply with tax requirements, and pay 51% of the firm's gross profit in taxes (see table). While the total tax payable is similar to the average paid in countries in the European and Central Asian region (50.2%), the number of payments and hours far exceeds the region's averages.

Protecting investors is an important condition for business development. For this factor, the indices vary between 0 and 10, with higher values indicating greater disclosure, greater liability of directors, greater powers of shareholders to challenge the transaction, and better investor protection. On this last index, Ukraine compares unfavorably to all other Commonwealth of Independent States (CIS) countries, including Kyrgyzstan (5.7), Russia, and Kazakhstan (both 5).

In enforcing commercial contracts, Ukraine compares fairly well with its peers in Central and Eastern Europe and the CIS. It takes fewer days to resolve a dispute than in Bulgaria, Czech Republic, Hungary, and Kazakhstan. Costs in court and attorney fees, or the costs of an administrative debt recovery procedure in Ukraine are much lower than in Russia, Slovenia, and Kyrgyzstan. ■

Doing business in Ukraine, selected indicators, 2005

Country	Starting a Business				Protecting Investors		Paying Taxes		Enforcing Contracts		
	Procedures (number)	Time (days)	Cost (% of income per capita)	Min. capital (% of income per capita)	Disclosure Index	Investor Protection Index	Payments (number)	Time (hours)	Procedures (number)	Time (days)	Cost (% of debt)
Ukraine	15	34	10.6	183	1	2.7	84	2,185	28	269	11
Region's average	9.7	36.5	13.5	49.1	4.5	4.8	46.9	431.5	29.6	393	17.4

Source: World Bank, *Doing Business*, <http://www.doingbusiness.org>

Reform Scenarios

Our results suggest that the proposed series of reforms could materially boost Ukraine's sustainable growth rate. The IMF staff's current *baseline scenario*, which envisages a medium-term annual growth rate of about 5%, assumes a moderately successful reform effort so that, by 2015, Ukraine will have the institutional quality enjoyed by current EU candidate countries such as Romania. In a *low-case scenario*, however, an ineffective or incomplete reform effort would allow efficiency levels to improve only slightly over the next decade, resulting in an average growth rate as low as 2% per year.

In a *high-case scenario*, on the other hand, full implementation of the authorities' EU-centered reform agenda is assumed. In this scenario, we assume that by 2015 Ukraine will have met all the chief requirements for EU membership and so have the institutional quality and efficiency currently enjoyed by recent accession countries such as Poland and Hungary. This corresponds to an effective doubling of efficiency, which in turn implies an average annual growth rate of about 8.5% over the coming decade.

Conclusions

Despite Ukraine's enviable resources and relatively well-developed infrastructure, per capita income remains very low.

Having inherited a Soviet framework that was ill-suited to the needs of a market economy, Ukraine has been slow in establishing the market-enhancing institutions needed to use its resources more efficiently.

However, the new authorities appear to be poised to tackle the lag in institutional development, and have articulated a wide-ranging program of reforms. This program has been anchored operationally within a broader strategy of greater integration with the EU and global markets.

Our results suggest that this approach is both timely and appropriate, and that a successful reform drive could bring about a significant boost in living standards over the next decade. Given the size of the gap between Ukraine's current output and its long-term potential, and given the experience of other countries, a successful effort could well boost Ukraine's trend growth rate to about 8.5% per year. By raising Ukraine's overall efficiency, successful reform might thus allow a doubling of per capita income within a decade — perhaps placing Ukraine alongside recent "growth miracle" countries.

Andrew Tiffin is an economist at the International Monetary Fund. The article is based on the chapter "The Efficiency Cost of Weak Institutions," forthcoming in Ukraine—Selected Issues (IMF, 2005). The views expressed in this article are those of the author and should not be attributed to the International Monetary Fund, its Executive Board, or its management. ■

Ukraine's Accession to the WTO

Ukraine has been seeking membership of the World Trade Organization (WTO) for over a decade and now appears to be reaching the end of accession negotiations. A lot has been done but still there's a long way to go and some obstacles remaining.

- Ukraine has already introduced many changes to bring its trade regime into conformity with WTO norms. Over 200 existing and draft laws relevant to WTO accession can be listed. However, to complete accession negotiations, Ukraine will need to concentrate on completing legal and institutional reforms. The major ones remaining are standards, intellectual property rights and agricultural subsidies.

- Passing the remaining legislation will require the direct involvement of Ukraine's top political leadership. Mobilizing political constituencies behind these legal reforms and providing stronger internal support for the negotiation team are the key ingredients to completing accession negotiations.

- Ukraine has reportedly addressed most members' concerns about tariffs and other market access barriers. About 95% of proposed tariffs on Ukraine's goods have been accepted by other WTO members. Nevertheless, interventions in the sugar trade and export duties on metal scrap, hides, and certain agricultural products continue to

pose obstacles to completing accession negotiations. Export restrictions represent a second market access dispute. Ukraine employs export taxes, outright bans, minimum prices, and customs fees that act as additional export taxes.

It should be kept in mind that WTO membership is not an end itself and institutional reforms should be implemented for Ukraine to benefit economically from WTO membership. What will it take to exploit these benefits?

- Ukraine must increase its capacity to conduct effective commercial diplomacy, including improved trade policy coordination across ministries, better communication between the executive and legislative branches, and institutionalized public management.

- Ukraine will need to preserve the trade liberalization accomplished during the accession process.

- Ukraine will need to undertake substantial administrative and institutional improvements to benefit from WTO regulatory obligations, such as codes on intellectual property rights, standards and customs.

Based on the World Bank's Ukraine Trade Policy Study: <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/UKRAINEEXTN/0,,contentMDK:20555497~pagePK:141137~piPK:141127~theSitePK:328533,00.html> ■

The Rise and Decline of Economic Populism after the Orange Revolution

Anders Aslund

Ukraine's Orange Revolution was an exhilarating and joyful event. It was a classical liberal revolution for democracy and freedom and against corruption. More than a million people gathered in Kyiv's cold winter. Viktor Yushchenko became the democratically elected president, promising freedom from fear and corruption. Since Yushchenko was sworn in as president on January 23, 2005, foreign policy has turned to the West, aimed at integration into the European Union and the World Trade Organization; and domestic policy has been characterized by democratization and freedom. Economic policy, however, has been little short of disastrous.

The victors from Independence Square entered government not keen on listening to advice. The Orange Revolution was carried out by a broad alliance, rendering the government chaotic and disunited. The big political aim was to perform well in the parliamentary elections in March 2006, and the conventional wisdom was that the voters would favor populist measures.

An extraordinary administrative chaos erupted. No fewer than 18,000 officials were appointed within four months, while a large number of state agencies were abolished or merged. The number of deputy ministers was reduced from about ten in each ministry to about three. As the deputy ministers had formed the brain trust of the government, their exclusion weakened its intellectual capacity. Furthermore, the regional governors, who in Ukraine are appointed, have all been replaced. Many new governors were ousted immediately, as various crimes were uncovered, showing how difficult it is to find qualified and reasonably honest staff in pervasively corrupt Ukraine.

Government and Parliament Too Politically Diverse

The work of the government was complicated by the breadth of the coalition in the Orange Revolution. Prime Minister Yulia Tymoshenko, perhaps the foremost revolutionary leader, became prime minister and dominated government policy. The second most important group in the cabinet was the socialists, who obtained four portfolios, including the State Property Fund, the Ministry of Agricultural Policy and the Ministry of the Interior. A third group consisted of big businessmen allied with Yushchenko, notably Petro Poroshenko, who became Secretary of the National Security and Defense Council. A fourth group of true Yushchenko loyalists focused mainly on foreign affairs. Finally, a sprinkling of industrialists was present, notably First Deputy Prime Minister Anatoly Kinakh. This government was too diverse to work, and the prime minister developed a habit of attacking ministers ad hominem in public. Little surprise then that the

government collapsed in early September after less than eight months.

The parliament was even more diverse and disorganized, with 14 loose party factions trading a few parliamentarians every week. Reputedly, two-thirds of the 450 deputies are dollar millionaires. Most are businessmen pursuing their interests in parliament. Such an amorphous and self-interested parliament can hardly be serious about legislating reforms. For now, any politically sensitive legislation is out of bounds until the parliamentary elections in March 2006, when Ukraine will move to fully proportional elections.

Economic policy could hardly have been worse. Prime Minister Tymoshenko surprisingly opted for a populist and statist approach to the economy. The results have been immediate and devastating. In 2004, Ukraine enjoyed economic growth of 12.1%; in the first eight months of 2005, the growth rate plunged to a mere 2.8%. Moreover, the growth rate fell significantly almost every month, from 6.5% in January (over January 2004) to 1.6% in August (over August 2004). It is quite an achievement to bring an economic boom to stagnation in just half a year. How could things turn so sour so fast?

Reprivatization Plans a Blow to the Economy

The biggest blow to the economy has been the new government's foggy plans for reprivatization. During the election campaign, Yushchenko advocated the renationalization of Ukraine's biggest steel mill, Kryvorizhstal, to be followed by a new privatization. The goal was to undo the sale of the mill to Ukraine's two biggest oligarchs in a sweetheart deal made last year. For months, top Ukrainian officials publicly discussed the number of flawed privatization deals to be reversed, ranging from half a dozen to 3,000, and how this would be done. The government has tried to recover many enterprises through the courts, and has drafted a broad law that could undo much of Ukraine's privatization. The new acting prime minister, Yuriy Yekhanurov, wants to end the Kryvorizhstal dispute and get on with the re-privatization of the plant. Meanwhile, the property rights of thousands of enterprises are in limbo. In Kyiv, rumors abound that oligarchs connected to the old regime are trying to sell their enterprises to Russian business executives and are preparing to escape the country. Naturally, executives have cut investment, and economic growth has come to a screeching halt.

To make matters even worse, the new socialist minister of privatization opposed privatization in principle, asking rhetorically: "What is so bad about renationalization?" Tymoshenko concurred in a recent newspaper interview: "The biggest enterprises, which can easily be efficiently managed, must not be

privatized, and they can give the state wonderful profits as an owner." This sounds like state capitalism.

In the election campaign, the old regime doubled pensions, saddling Ukraine with the highest pension costs in the world as a share of national income. The new Ukrainian government has added to this excessive burden by raising minimum salaries sharply and state wages by no less than 57%. To finance these and other huge social expenditures, the government is scrambling to find more revenue. A lot of discrete tax exemptions have, sensibly, been abolished, but the overall tax pressure has risen dramatically, from 36% of GDP last year to probably 42% of GDP this year. Meanwhile, Yushchenko continues to talk about his plans for sharp tax cuts. Notably, he wants to reduce the high social taxes from 37.5% of the payroll to 20% over five years.

Incredibly, this new regime, brought to power by the middle class and small entrepreneurs, has abolished the simplified taxation that served those segments of society so well. The obvious result would have been that tens of thousands of small entrepreneurs would have had to close their businesses or flee into the underground economy. Fortunately, strong public opinion forced the reversal of this decision. What is more, in the election campaign, Yushchenko demanded that the lawless tax police be abolished and that the tax administration be forced to obey the law. But Tymoshenko cheered the tax police on and declared that the performance of the regional governors would be judged by their ability to collect taxes.

During the populist presidential campaign last fall, inflation surged to 15% a year with increasing public expenditures, loose monetary policy and an inherited large current account surplus. Fortunately, a relatively tight fiscal policy kept inflation at this level. The predominantly Russian oil companies have increased their prices as world market prices have risen. Tymoshenko imposed strict price controls on gasoline and forced the remaining state oil companies to supply it at below market price. Not surprisingly, oil supplies declined, and gasoline shortages ensued. Fortunately, President Yushchenko refused to tolerate these policy malpractices and on May 19 liberalized gasoline prices.

Tymoshenko also tried to control the price of meat for some time. The price controls were accompanied by abuse of private producers and praise of state companies. But when Yushchenko stopped the price control for gasoline, the state interference in the meat market also ceased. The prime minister, however, did not stop her state interventions. During the summer she insisted on a minimum state procurement price and maximum sale price for grain and bolstering state trade in grain. Instead of talking about reforming state monopolies, Tymoshenko talked about their reinforcement. In an additional effort to squeeze business profits and boost state revenue, she wanted to boost railway tariffs for metals by 100%, but settled magnanimously for a hike of only 50%.

Orientation to the West

Ukraine's foreign economic policy has been somewhat shielded from this populism, and it has been characterized by

a stark reorientation to the West. Ukraine has indicated that it is only interested in that part of the Common Economic Space (CES, formed in 2003 together with Russia, Kazakhstan and Belarus) that concerns free trade, while the CES aims for much more, including a customs union and a monetary union, as in the EU. One of the most immediate international ambitions of the new Ukrainian government is to accede to the WTO this year. Late in the day, the Tymoshenko government started pushing through a score of draft laws needed for WTO entry, but it managed to only get just over half of them through parliament in July. The question is whether the government will be able to push through the rest this year so that Ukraine can finally join the WTO. Ukraine has also concluded an action plan with the EU as a part of the new EU European Neighborhood Policy. It contains many concrete steps to be taken both by the EU and Ukraine. The demands on Ukraine amount to sensible reforms to which few would object. The EU offers might not be very generous, but they do foresee improvements in market access and substantial exchanges in the sphere of education and science.

The contrast between the declarations of the Orange Revolution and Tymoshenko's government policy could hardly be greater. In an editorial on Yushchenko's first 100 days, the *Kyiv Post* points out that "while Yushchenko is making grand statements abroad, the rest of the government does not seem to follow his lead."

The economic affects of this policy are evident, with growth falling month by month. The investment and construction boom has been succeeded by real decline, which has driven the economic contraction. Foreign trade has done comparatively well, but for the last few months the previously solid trade surplus has been eliminated as imports have risen sharply, while exports are growing more moderately. Ukraine's current economic problems are caused by domestic economic policy, even if falling prices for steel exports and rising prices for Ukraine's energy imports are aggravating the problem.

Fortunately, this populism is now over at least for the time being, though the big question is what the voters will say next March. Yekhanurov has his work cut out. In a short period, he needs to accomplish many things. First of all, he is strongly committed to putting an end to the harmful reprivatization campaign. Second, a long prepared draft omnibus law abolishing some 3,600 regulations is ready to be sent to parliament. Third, the remaining WTO legislation needs to be acted on. Fourth, a reasonable budget for next year must be passed. Finally, Yekhanurov might be able to push through some financial legislation prepared long ago and lying waiting in parliament. Although world market prices for Ukraine's main export product, steel, have declined substantially, there is still hope for a resumption of sound economic growth.

No doubt, Ukraine's economic policy will improve with the change of government, but the verdict of the voters in the parliamentary elections in March is difficult to predict.

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Investment Climate in Ukraine in the First Half of 2005: Reasons for Concern

Irina Akimova

Contrary to the expectations raised by the Orange Revolution, the business climate in Ukraine remains unattractive for foreign investors. Despite some progress in economic policy, including the strengthening of European integration efforts and improvements in regulation, much remains to be done in the areas of macroeconomic and financial legislation, as well as in securing property rights, fighting corruption, and safeguarding against state intervention in market mechanisms.

Although foreign direct investment has continued to grow in 2005 and reached US\$192 per capita, its share of GDP decreased from 2.6% in 2003 to 2.1% in the first half of 2005 (see Table 1). The major part of FDI comes from Cyprus, the Virgin Islands and the Russian Federation, while investors from the EU countries remain cautious. Ukraine's demand for investment is mainly satisfied by domestic sources, whose share in gross capital investment increased from 87.2% in 2003 to 89.6% in the first half of 2005.

Three main factors influenced the government's investment policy in the first half of 2005:

- A pre-election mood. Parliamentary elections, scheduled for March 2006, reduced opportunities for undertaking serious structural reforms and provoked an outburst of economic populism incoherent with a good investment policy.
- Fiscal issues dominating the economic policy agenda. A huge pension bill equal to 16% of GDP was inherited from the previous government. Additional social obligations taken on by the government contributed to a further growth of budget expenditures in 2005.
- Lack of a comprehensive strategic reform program. Former Prime Minister Yulia Tymoshenko's government often acted like a fire brigade. A wide diversity of interests within the government made reaching consensus on economic policy difficult. Differences in economic ideology between President Victor Yushchenko and the former prime minister were among the reasons that led to a political crisis and the dismissal of the Ukrainian government in September 2005.

As a result, the government's investment policy was inconsistent, contradictory and unpredictable. Good intentions to improve the investment climate were not supported by action, and declared liberal goals clashed with illiberal methods of implementation.

Some Progress Achieved

However, the strengthening of European integration efforts is, among other things, one recent positive development in economic policy, and has signaled Ukraine's willingness to do business according to international standards. Ukraine has signed an action plan with the EU, and made considerable progress towards accession to the World Trade Organization. Ukraine's accession to NATO has also become a firmer policy aim. Furthermore, Ukraine has reconsidered its strategy towards participation in the Common Economic Space (in which Belarus, Russia and Kazakhstan are members) in accordance with the European integration requirements.

In its efforts to improve regulation the state authorities have revised over 6,000 rules, examining their compliance with state regulatory policy. A draft law on the simplification of enterprise registration procedures has been approved. This, together with the successful implementation of "one-stop" registration will contribute to lowering the entry barriers and administrative costs of doing business in Ukraine.

Significant Investment Risks Remain

There remain, however, many investment risks. These primarily include persistent corruption, a worsened macroeconomic situation, insecurity of property rights, direct state intervention in the economy, a problematic tax policy, and delays in adopting modern financial legislation.

The dismissal of the Ukrainian government in September of 2005 signaled the failure of the anti-corruption campaign that had been launched by the president after the Orange Revolution. Anti-corruption measures included replacement of thousands of

civil servants at the central and regional level and a significant increase in public sector salaries. However, little attention was given to solving the conflict of interests of civil servants, many of whom continued to be heavily involved in business activities. The court system still lacks transparency and independence from political and business interest groups.

Table 1. Investment indicators for Ukraine, 2001-2005

	2001	2002	2003	1st half 2004	2004	1st half 2005
Growth of gross capital investment, % year-on-year	20.8	8.9	31.3	32.2	28.0	8.5
FDI inflow, mln USD	680.3	916.5	1,322.6	667.2	1,559.5	707.5
FDI growth, % year-on-year	14.7	34.7	44.3	-6.2	17.9	33.4
FDI as % of GDP	1.8	2.2	2.6	2.5	2.4	2.1
FDI as % of gross capital investment	9.1	11.3	12.8	13.0	11.9	10.4

Table 2. Select macroeconomic indicators for Ukraine, 2001-2005

Macroeconomic indicators	2001	2002	2003	2004	1st half 2005	2005 (forecast)*
GDP growth, % year-on-year	9.2	5.2	9.6	12.1	4.0	5.5
Industrial output growth, % year-on-year	14.2	7	15.8	12.5	5.0	...
CPI inflation, % year-on-year	6.1	-0.6	8.2	12.3	6.4	12.5
Public sector debt to GDP ratio, %	36.6	33.6	29	24.7	22.9	...
Current account balance, % of GDP	3.7	7.5	5.8	10.5	...	7.2
Consolidated budget deficit, % of GDP	0.3	-0.7	0.2	3.4	-1**	2.5

Notes: *Based on the IMF's forecast updated in August.

**The IMF concluded that the consolidated budget including off-budget funds performed with a deficit equal to 1% of GDP in the first half of the year.

The current macroeconomic situation in Ukraine looks less favorable than a year ago (see Table 2). GDP growth slowed to 4%, and the low inflation of 2001-2002 has shot up into double figures. According to the International Monetary Fund, in 2005 Ukraine's GDP is expected to grow by only 5.5% while the Corruption Perceptions Index will reach 12.5%. Attempts to combat inflation by revaluing the national currency have not been very successful so far, as they have not been supported by a significant fiscal adjustment. Most likely, Ukraine's fiscal deficit will reach 2.5% of GDP in 2005, higher than the expected 1.7%.

The area of greatest concern is the security of property rights. Reprivatization of enterprises has become a hot political topic. Though the president has backed away considerably from the former prime minister's initial intentions to revise the results of about 3,000 privatization deals, the issue is far from settled. Despite adopting a memorandum on the security of property rights, signed by the president, former prime minister, and the speaker of parliament in June 2005, and declaring an intention to announce an amnesty for most privatization deals, no law on this has been adopted so far. This leaves the question as to the number of potential revisions open. At the same time, contradictory court decisions on the privatization of Kryvorizhstal, Siverodonetsk's "Azot" plant and Nikopol Ferroalloy Plant raise doubts about the transparency of court procedures and negatively affect investors' perceptions of Ukraine.

Other illiberal economic policy measures have included state interference in the market price for meat, sugar and gasoline, which has resulted in product shortages. Though these measures were criticized by the president and later abolished, they delayed Ukraine in being granted market economy status.

Developments in tax policy and financial legislation have also been rather disappointing. No attempts have been made to address the conflicting provisions of the Commercial and the Civil Codes, or to push forward the adoption of long awaited corporate legislation that is of crucial importance for creating a favorable business climate. Contrary to government promises, the tax burden increased from 18.3% of GDP in 2004 to 22.1% in 2005. To ease the tax burden the government has abolished tax privileges in free economic zones and attempted

to move away from a simplified system of taxation for small businesses though this was later reversed.

Difficult Tasks Ahead

The new government has a difficult task in restoring Ukraine's image in the international investor community and in laying down a basis for future reforms.

- Firstly, the reprivatization campaign should be stopped and the majority of privatization deals granted amnesty, leaving only a few cases for court consideration. Ensuring transparency and the political independence of courts is of crucial importance. Development of a convincing privatization strategy in the medium term is another step necessary for gaining investors' confidence.

- Secondly, all remaining legislation needed for the WTO accession should be passed by the Parliament as soon as possible.

- Thirdly, abolishing or changing over 3,600 regulatory acts is vital for the improvement of the business environment. This should be followed up by ensuring easy access to regulatory information across sectors conducting regulatory impact analyses of new legislation.

- Fourth, macroeconomic stabilization needs a prudent fiscal policy. Therefore, the 2006 budget should be based on realistic macroeconomic assumptions and contain modest social expenditures. Although the development of new tax proposals for lowering the tax burden is important, a good tax system also requires stability. Past practices of making numerous amendments to tax laws after the adoption of the Budget Law are to be halted.

- Fifth, direct state intervention in market prices should be ruled out. A sound competition policy has to become a government priority.

- Finally, pushing forward the adoption of long prepared financial and corporate legislation will lay the foundation for resuming growth in the future.

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Formation of Social Capital in Central and Eastern Europe

Jan Fidrmuc and Klarita Gerxhani

Social capital is important for the economic, social, and political development of a country. A study of social capital in 28 European countries shows that social capital in Central and Eastern Europe lags behind that in Western Europe. The gap should gradually disappear as these countries catch up with the West in economic development and quality of institutions.

Social capital is defined as trust, cooperative behavior, and networks between groups. Developed countries, such as the EU member states, are generally characterized by a high density of economic transactions among different groups, well-established institutions, a high level of generalized trust and participation in civil associations, and a bottom-up structure of economic transactions. On the other hand, developing countries, including the EU candidate countries, have a larger underground economy, more corruption and state weakness, a low level of generalized trust and participation in civil associations, and a top-down structure of economic transactions.

Our measures of social capital utilize Eurobarometer surveys carried out between 1998 and 2001 in 15 EU member states and in 13 countries that were all candidates for EU membership at the time. The latter group included Bulgaria, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia, Slovenia, and Turkey. Ten of these countries became members of the EU in May 2004.

With the exception of Cyprus, Malta and Turkey, the candidate countries were all post-communist countries. According to the recent theory of missing social capital, "positive" social capital was destroyed by the communist dictatorship and "negative" social capital was built up. This negative social capital took the form of underground activities, corruption, or organized crime. The gap created by the sudden destruction of old institutions and the creation of new ones provided a favorable environment for the persistence or even further accumulation of negative social capital throughout transition.

Higher Stock of Social Capital in the West

The Eurobarometer surveys feature questions that can be used to gauge three aspects of social capital:

1. Civic participation, captured by membership in voluntary organizations, where one learns to interact with other people in a cooperative manner to achieve a shared objective.
2. Density of social networks, or ties between individuals. Formal networks (such as alumni associations) may partially overlap with membership in voluntary organizations. Informal networks embody informal relations among friends, family members, colleagues, and the like. Social networks in

our study are those one can rely on in need, e.g. to find a job, to borrow money, or generally when one is feeling depressed (the Table below only provides measures for this last aspect).

3. Philanthropic generosity, or altruism, i.e. giving money or goods or giving up one's time to help the poor and socially excluded.

Trust is the most commonly used empirical measure of social capital. Typically, trust is defined as the extent to which people find strangers trustworthy. This measure is not used in our study due to the unavailability of relevant data.

All the indicators, except altruism, show the EU member countries have on average a higher stock of social capital than the candidate countries (see Table). Given that the vast majority of the candidate countries are post-communist countries, this observation seems to confirm the assertion that communism destroyed social capital by discouraging social interactions outside one's immediate network of friends and family.

Social and Human Capital are Complementary

Social capital is a productive asset that takes time, effort and often a financial outlay to accumulate. As a first step, we relate the individual stock of social capital to various individual-level socio-demographic characteristics: gender, age, marital status, education, occupation, residency in urban vs. rural areas, and income. We also account for country-specific factors.

- The individual-level determinants of civic participation appear similar in the candidate and member countries of the EU. Education is particularly important: respondents with secondary or university education or current students are more likely to actively participate in voluntary organizations than those with primary education. Civic participation also increases with income, and seems to follow a hump-shaped path over an individual's lifetime. Thus, in the EU member countries it peaks around the age of 50, and subsequently declines. The unemployed, retirees, housepersons, and females tend to display significantly lower levels of overall civic participation.

- The results are very similar as regards access to social networks. The most notable difference is the effect of age. In both member states and candidate countries, older individuals tend to have more limited access to social networks. Women have an easier time finding consolation when depressed and financial relief when in need of money, but are less likely than men to find a job using their social contacts.

In summary, most of our findings show not only consistency across our two measures of social capital, but also similarity in the candidate and EU member countries. The positive relationship between education and the stock of social capital may indi-

cate that social and human capital are complementary — individuals who acquire a high stock of one also invest in the other.

EU Member and Candidate States Similar

In addition, we also consider aggregate determinants of social capital such as economic development and the quality of institutions. Individuals in countries with poor institutions may be discouraged from investing and, in turn, will acquire less generalized social capital than their counterparts in countries with a better institutional environment.

Thus, we take account of aggregate indicators of economic development and institutional quality. These include: GDP per capita, the Gini coefficient of income inequality, the Transparency International corruption-perception index, the average of indexes of political freedom and civil liberties reported by Freedom House, the economic freedom index compiled by the Fraser Institute, and average economic growth over the preceding three years. To account for the gap in the average stock of social capital in the candidate countries relative to EU members, we also include a candidate country dummy in the regressions.

The most interesting finding is that once aggregate economic development and institutional quality are controlled for, the candidate countries are no longer different from the EU members with respect to their stock of social capital. In fact, the candidate countries even display significantly higher active participation in voluntary organizations than one would expect given their level of economic development and institutional quality.

Measures of social capital (selected) in some countries

Average Participation		Network: Depressed		Altruism: Money	
Sweden	2.00	Ireland	0.93	N. Ireland	1.29
Denmark	1.78	Netherlands	0.92		
Netherlands	1.70	Spain	0.92	Malta	1.22
Czech Rep.	0.94	Slovakia	0.90	Netherlands	1.09
EU Average	0.91	Czech Rep.	0.86	Romania	1.08
Great Britain	0.88	EU Average	0.86	Great Britain	0.92
Slovakia	0.86	Poland	0.83	Poland	0.89
Slovenia	0.70	Belgium	0.81	Lithuania	0.89
CC Average	0.55	Hungary	0.80	EU Average	0.84
Germany East	0.54	Slovenia	0.78	CC Average	0.73
Italy	0.49	CC Average	0.78	Hungary	0.65
Lithuania	0.48	Estonia	0.77	Germany East	0.60
Latvia	0.47	Romania	0.73	Latvia	0.59
Turkey	0.43	Turkey	0.71	Germany West	0.57
Poland	0.35	Bulgaria	0.70	Czech Rep.	0.45
Romania	0.29	Cyprus	0.70	Estonia	0.41
Bulgaria	0.18	Greece	0.69	Bulgaria	0.32

Note: Average participation is the average number of voluntary organizations in which respondents actively participate. The maximum possible value is 11. Network: Depressed variable takes the value of 1 if the respondents feel she has someone (besides the members of her immediate household) to rely on when feeling depressed, and 0 otherwise. Altruism: Money variable measures whether the respondent contributed money during the preceding 12 months to help poor or socially excluded people. It takes values of 0 (never), 1 (less than once a month) and 2 (more than once a month).

The impact of country-specific economic and institutional conditions is in line with expectations. Higher per-capita income is associated with more frequent civic participation. Individuals in countries with high income inequality and especially widespread corruption tend to acquire less social capital. Economic freedom seems to encourage investment in social capital.

These patterns are very intuitive. Income inequality reflects the intensity of social conflict in a country. Socially polarized countries, unsurprisingly, end up with lower investment in generalized social capital. Rampant corruption and extensive regulation of the economy reduce the returns on any kind of investment, whether it is in social capital or in other productive capacities. Therefore, both formal (economic freedom) and informal (corruption) institutions matter for individual acquisition of generalized social capital.

The results thus reveal that while the stock of social capital at the individual level is affected by very similar factors in both groups of countries, the differences in individual-level determinants cannot fully account for the gap at the aggregate level. Once we also include aggregate measures of economic development and quality of institutions, however, the gap disappears. This indicates that the low average stock of social capital in Central and Eastern European countries can be attributed to the lower level of economic development and the lower quality of institutions in candidate countries. The effect of corruption seems to be particularly important.

Conclusion

Although convergence in formal institutions between the EU member states and the candidate countries has to a large extent been accomplished, there remains a mismatch between the quality of formal institutions and the existing informal institutions in the candidate countries. This lack of correspondence, embodied in the form of corruption and other predatory activities, may be the underlying reason of the persisting significant gap with respect to social capital.

The expectation is that EU enlargement will foster greater openness and encourage the adoption of sound economic policies in the candidate countries. This will, in turn, discourage rent-seeking, create rewards for leadership based on performance, enhance public trust in the state's actions, and promote civic spirit. Thus, once Central and Eastern European countries catch up with the West in terms of economic development and institutions, they are very likely to close the gap in social capital as well. For this to be possible, however, a gradual harmonization of formal rules and informal norms between the two groups of countries should be of primary importance.

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Believe but Verify? Russian Views and the Market

D. Andrew Austin, Tatyana Kosyaeva, Nathaniel Wilcox

What are the attitudes of Russian students towards the market mechanism? To what extent do they believe markets work? Russians, like Americans, become more willing to believe that markets operate according to economic principles once they see evidence from a market experiment. Popular support for market reform is probably based on a complex set of views and judgments. Russian social attitudes play their own role.

Market-oriented policy is hard to sustain unless citizens believe market outcomes are efficient and market processes are more than random fluctuations. Citizens who doubt that the market follows the predictable patterns set out in economic theory are unlikely to welcome reforms based on this theory. For example, Marshall Goldman argues that Russians, because of their history, are not "economic men," and treating them as such could only lead to poorly designed economic policy. He also attributes flaws in Russian privatization and economic reform in large part to a historic mistrust among Russians of market institutions. By contrast, Shiller, Boycko and Korobov claim, "Soviet and American respondents were basically similar in some very important dimensions" including, "their understanding of the working of markets." For example, 90% of Russians and 86% of New Yorkers surveyed agreed that "people work better if their pay is directly tied to the quantity and quality of their work."

To find out if Russians believe markets work as economists say they do we investigated the attitudes of Russian students towards the market using a classroom market experiment and a set of survey instruments. Young Russians in Novosibirsk and St. Petersburg were asked about their views on a specific market institution, the double auction, rather than about hypothetical situations. The double-auction is a simplified version of trading rules used by open-outcry trading pits such as the Chicago Mercantile Exchange and is widely used in experimental economics.

The experimental protocol was simple. After a brief introduction we handed out a sociodemographic survey. The rules of the double-auction were then explained to students and a "no-money" practice round was played. One student was handed a sealed envelope with predictions drawn from supply and demand theory. A second survey was distributed, asking students to say how likely it was that the predictions for average price, quantity traded, and total trading profits would match the results for the double-auction's last round. For example, students were asked "How likely is it, in your opinion, that the theory of supply and demand will predict, within an interval of 30 rubles, the average trading price in the last trading round?" Possible responses were: "100%," "Very Likely," "Likely," "Unlikely," "Very Unlikely," and "0%." After the last round, predictions and trading results were compared. Finally, we asked students how likely it was that supply

and demand theory would predict double-auction results in a hypothetical future session using questions phrased in the same way as those asked before the double-auction.

Our approach measured the extent to which the subjects believed markets work and how attitudes changed after seeing a market-like experiment. Seeing the double-auction in action had a strong effect on beliefs, leading to much less skepticism about economic theory's ability to predict outcomes. These changes were broadly similar to changes in attitudes among US subjects, who also become less skeptical about economic theory after seeing the double-auction work.

However, the patterns of changes for Russian and US subjects were different. While on average subjects became more willing to believe that economic predictions were likely to be correct, the change in beliefs were not uniform.

- Russians from entrepreneurial or Orthodox households started out relatively more skeptical of economic theory, but became relatively more likely to think that economic predictions would be correct. Perhaps those who have seen the marketplace from the vantage point of their family's firm find it hard to believe that markets are governed by simple economic principles.

- Russian women, like American women, began with greater skepticism than men about economic theory. After seeing the double-auction, the difference between Russian women and men disappear. By contrast, American women remained more skeptical than men.

- Those who graduated from general secondary schools were relatively more skeptical of economic theory, relative to those who graduated from a more selective school such as a lyceum, gymnasium or special language school.

Other factors, which might have been expected to affect attitudes about how markets work, had little measurable effect. For example, measures of family income and political orientation had little or no effect, implying that differing views about markets do not simply fall along lines of rich vs. poor. Instead of asking about cash income, we used the market value of the best family car and the type and destination of family vacations, as many Russians still receive important in-kind benefits, such as subsidized housing. Subjects described their family's economic situation using five categories ranging from, "We barely make ends meet; there isn't enough money for daily necessities" to, "We can buy really expensive goods: apartments, dachas, SUVs, etc." However, none of these measures of income had a measurable effect on attitudes.

In the US, we found conservative students were significantly more willing to believe that economic theory could predict outcomes. However, what the terms "right" and "left" or "conservative" and "liberal" mean in Russian politics is usually far from clear. Therefore we developed two new scales of political orientation from a battery of questions drawn from political science research, which were constructed using sur-

veys we collected from Tomsk, Ekaterinburg, Novosibirsk, Slaviansk-na-Kubani, and St. Petersburg. One scale measured probusiness attitudes. A typical question used in this scale was: "Most businessmen do important work and therefore, deserve high payment for it." The other scale captured views concerning fairness and workplace relationships. A typical question used in this scale was: "Workers and managers have conflicting interests and are essentially enemies." While both scales had reasonable psychometric properties, neither was strongly related to views about how markets work. Those who cared more about fairness and identified more with workers than with managers were slightly more skeptical of economic theory before seeing the double-auction, but this effect disappeared in the post-auction results. These results suggest that even though young Russians may orient themselves along political dimensions in orderly ways, differences in political orientation are just not strongly correlated with other views.

- The results of this research suggest any differences in attitudes towards markets between Russians and Westerners probably stem from divergent issues associated with markets, not from divergent views about how the market works. Russians, like Americans, become more willing to believe that markets operate according to economic principles once they see evidence from an experimental market. However, not all Russians or all Americans change their views to the same extent, with some subgroups showing more willingness to change their views. Of course, while this classroom experiment changed views about the market mechanism, whether or not it changed views of the real world or the probability that imperfections, distortions or manipulations prevent real markets from reaching competitive market outcomes is not easy to determine.

- Popular support for market reform is probably based on a complex set of views and judgments. Russian social attitudes play their own role. The Soviet-era catchphrase "whoever doesn't steal from his employer steals from his family" reflected a rational response to communism. However, that view of stealing is profoundly unhelpful in the development of well-functioning markets. Regardless of whether these attitudes stem from the Soviet experience or from the preindustrial past that Goldman stresses, mistrust or contempt of public institutions and the strong reliance on friends and family ties hinder the expansion of the role of markets.

- Both the "Russians are different" and "Russians are just like Westerners" camps should agree that deep and irreversible public support for market reforms must include a clearer understanding of how markets work. If the costs of public misunderstandings of the market are high, then so are the policy benefits of better public understanding. If Russians can be persuaded that markets work according to well-understood principles and deliver efficient outcomes, as our results suggest, then the potential exists for creating greater public support for a wider role for the market.

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Too Much of a Good Thing? Credit Booms in Bulgaria, Romania, and Ukraine

Christoph Duenwald, Nikolay Gueorguiev, and Andrea Schaechter

Rapid private sector credit growth, as experienced in Bulgaria, Romania and Ukraine, represents a welcome expansion from initially low levels, and may be beneficial for growth and efficiency. However, it also brings the risks of macroeconomic and financial crises. Policymakers face the dilemma of how to minimize those risks while still allowing bank lending to contribute to higher growth and efficiency.

The banking sector in all three countries is still relatively small despite the large number of banks and rapid asset growth over the past four years. Relative to GDP, Bulgaria's banking system — consisting of 29 domestic banks and 6 foreign branches — is the largest, with total assets of 46% of GDP. The assets of Ukraine's 158 banks amount to 37% of GDP. However, many of the banks are small, and most are affiliated with corporations. Romania has 32 banks and 7 branches, with assets of 35% of

GDP. Foreign ownership dominates in Bulgaria and Romania. In Ukraine the share of foreign-owned banks is much smaller, reflecting the difficult business environment. State ownership is limited to two or three banks in each country.

Macroeconomic Stability and Growth behind Credit Booms

The common factors behind the sharp credit acceleration in all three countries are successful postcrisis macroeconomic stabilization (including single-digit or near-single-digit inflation) and robust growth (between 5 and 8% in the past five years), restoration of confidence in the banking sector, and sizable foreign exchange inflows.

The ongoing credit boom reflects a significant lift from the depressed levels of postcrisis bank lending and is thus part of a

process of financial deepening. The following factors are especially important:

- The newly privatized banks have been keen to boost profitability and market share. With high capital adequacy ratios, banks managed to increase profitability by shifting the composition of their assets toward loans. In Bulgaria and Romania, this has been actively encouraged by the banks' foreign parents, which are domiciled in less profitable mature markets. In Ukraine, the lack of other investment opportunities has forced banks to expand their loan portfolios in pursuit of higher profits.

- The ability of banks to fund loan expansion has been boosted by strong capital inflows, mostly through the banking system, amid high global liquidity, low interest rates, and increased confidence associated with Bulgaria's and Romania's prospective European Union (EU) accession and Ukraine's large current account surpluses.

- The greater supply of credit has been matched by increased demand from both businesses and households. For businesses, a newfound confidence in the future has boosted investment intentions and demand for credit. Household demand for durables and real estate has increased from previously depressed levels due mainly to more household confidence in the ability to service debt, and partly to more flexible terms for bank offers on new products. In Bulgaria and Romania, the share of household loans has surged to one-third of total loans while it is still much lower in Ukraine (16%) (see Table 1).

- Bank credit to the public sector has declined substantially, reflecting small general government fiscal deficits or even surpluses and the availability of ample external financing and privatization revenue.

Rapid Bank Lending Contributes to Growth...

There are various channels through which financial development can contribute to economic growth. These include

Table 1. Selected Credit Indicators, 2000 and 2004

	Bulgaria		Romania		Ukraine*	
	2000	2004	2000	2004	2000	2004
Real credit growth (in %, year-on-year, deflated by CPI)	4.5	40.4	7.9	40.5	28.6	16.9
Credit flows, in % of GDP	1.7	11.5	0.6	5.6	4.7	6.7
Credit stock, in % of GDP (year-end)	12.2	35.4	9.3	17.9	12.3	27.1
• households	2.3	11.5	0.5	5.1	0.6	4.4
• private companies	9.3	23.2	7.5	11.5	10.6	21.9
• state-owned enterprises	0.6	0.7	1.4	1.3	1.1	1.9

Sources: Bulgarian National Bank; National Bank of Romania; National Bank of Ukraine; and IMF staff estimates.

*During the tumultuous presidential elections in late 2004, the banking sector lost substantial amounts of deposits and had to temporarily reduce lending.

improving the allocation of capital, sharing risk, and pooling savings and raising the efficiency of financial intermediation. Indeed, by easing financing constraints, increased bank lending can contribute to higher investment and consumption, and, ultimately, a higher standard of living. From a structural perspective, the increase in financial intermediation in the three countries can therefore be considered beneficial.

...but Also Poses Macroeconomic Risks...

At the same time, rapid bank lending also entails risks for macroeconomic and banking sector stability. When they materialize, these two risks are typically mutually reinforcing, creating boom-bust cycles in credit and asset markets and large swings in macroeconomic fundamentals. Moreover, these risks may also be causally linked. Abrupt corrections of macroeconomic imbalances have in some instances triggered financial sector distress, while the latter has caused economic disruptions.

If left unchecked, a rapid increase in credit can boost domestic prices and wages - which at an unchanged nominal exchange rate could reduce international competitiveness — and heighten external vulnerabilities. Indeed, in characterizing emerging market credit booms, the IMF (2004) notes that there is almost a 70% probability that a credit boom will coincide with either a consumption or investment boom, and that credit booms are often associated with banking and currency crises.

Both Bulgaria and Romania have seen widening trade deficits, owing to a rapid growth in imports. These shifts have coincided with the rapid increase in bank lending. Consumer price inflation has remained relatively tame in both countries, partly reflecting lower food prices, and nominal effective exchange rate appreciation in Bulgaria has offset the impact of higher oil prices.

The results of our econometric analysis suggest that each percentage point of GDP of additional credit leads to a deterioration in the balance of goods and nonfactor services (with a one-quarter lag) of about 0.4 percentage point of GDP for Bulgaria and 0.7 percentage point of GDP for Romania.

...and Risks for Banking Sector Stability

Rapid credit growth can trigger banking sector distress through macroeconomic imbalances and deterioration of loan quality. Numerous studies have found that periods of significant and accelerating credit growth often preceded banking crises. The likelihood of a banking crisis following a lending boom is estimated to be as high as 20%. Prominent examples include the Scandinavian banking crises in the early 1990s, Mexico's banking crisis in 1994, and the Asian financial crisis in 1997-98.

While the level of credit in all three countries is still much below that of many of these prominent crisis countries, the speed of credit expansion in Bulgaria and Ukraine has reached levels comparable to them. Calculating an equilibrium level of credit, based on a

country's economic and institutional fundamentals and comparing it with the current level of credit shows that in the case of Bulgaria, the gap between the estimated equilibrium ratio and the actual has been narrowing very rapidly. In 2001, before the credit boom got into full swing, the credit-to-GDP ratio was 14.5%, by the end of 2004 it had reached about 35.5%. Thus, the credit-to-GDP ratio rose by about 7 percentage points on average per year, a pace that has been associated with banking crises in other countries. In Romania and Ukraine, the credit-to-GDP ratio has risen more slowly, at 2.5 and 4.25 percentage points, respectively, on average during the same period.

However, despite the ongoing credit acceleration, banks in Bulgaria and Romania are well capitalized and liquid. In contrast, Ukrainian banks suffer from large shares of related-party lending and NPLs, while profitability has remained low (Table 2). Another concern is poor asset diversification due to the lack of other investment opportunities - about two-thirds of banks' total assets in Ukraine are loans, higher than in Bulgaria (56% of total assets), Romania (47%).

Policy Options

The menu of available policy options includes macroeconomic policies, regulatory and supervisory policies, administrative measures (such as controls on capital inflows), and market development measures, or a combination of the above policies. The authorities in the three countries understand the risks associated with the credit booms and have responded in varying ways and degrees to both offset and moderate rapid credit growth.

- *In Bulgaria*, policy options are constrained by the currency board arrangement. The main response has been a tightening of fiscal policy, both through higher revenue and expenditure restraint. A host of monetary measures have been implemented — notably moral suasion, a tightening of reserve requirements, and prudential supervision. Most recently, quan-

titative restrictions on credit have been imposed. The tightening of reserve requirements last year does not appear to have reduced credit growth, although such growth may have been even higher otherwise. It is too early to assess the impact of the quantitative limits on credit expansion that took effect on April 1, 2005, but a significant diversion to other forms of financing (nonbank/cross border) is likely. Looking ahead, it is possible that further fiscal tightening will be necessary should the monetary measures prove ineffective in preventing a further widening of external imbalances.

- *In Romania*, a combination of fiscal policy, monetary policy, and prudential measures has been used to both moderate and offset credit growth. Fiscal policy has been consistently tightened, with the general government deficit narrowing from 3.2% of GDP in 2001 to 1.1% in 2004. The National Bank of Romania (NBR) tried interest rate hikes in 2003 but had to reverse course in 2004, as falling inflation and large capital inflows made high real interest rates both unjustifiable and untenable. Moreover, these hikes merely changed the composition of credit in favor of foreign currency loans without reducing the overall credit flow. As the boom occurred mostly in loans to households, the NBR tightened households' eligibility for credit by lowering the ceiling on the maximum monthly payment-to-net income ratios, standardizing the downpayment for mortgage loans at 25%, and strengthening the required guarantees/collateral. Finally, the reserve requirement on foreign currency-denominated bank liabilities was increased and extended to liabilities with residual maturity longer than two years. These measures did reduce credit growth somewhat, but a further fiscal tightening is likely to be necessary in the period ahead to support efforts on the monetary side.

- *In Ukraine*, the focus was on bank regulatory and supervisory measures. The National Bank of Ukraine (NBU) raised the minimum capital adequacy ratio, strengthened the definition of capital, tightened loan classification rules, raised provisioning requirements for foreign currency-denominated loans, tightened related-party lending regulations, and put in place a new risk assessment methodology for its supervisors. These measures were aimed at strengthening bank resilience to shocks. Credit growth decelerated during 2004 (even excluding the sharp drop during the political crisis), but it is unclear to what extent this can be attributed to the NBU's responses. Looking ahead, further progress in strengthening bank regulation and supervision, as well as the institutional environment, is needed, with particular focus on related-party lending.

Table 2. Prudential Indicators of the Banking Sector, 2000 and 2004 (percent)

	Bulgaria		Romania		Ukraine	
	2000	2004	2000	2004	2000	2004
Capital adequacy ratios	35.6	16.1	23.8	418.8	15.5	16.8
Nonperforming loans / total loans ^{1/}	17.3	6.9	6.4	8.1	29.6	30.0
Return on assets	3.1	2.1	1.5	2.5	-0.1	1.1
Return on equity	22.5	20.6	12.5	19.3	-0.5	8.4
Liquid assets / total assets ^{2/}	26.0	31.6	-	63.6	20.8	16.7

Sources: Bulgarian National Bank; National Bank of Romania; National Bank of Ukraine; and IMF staff estimates.

^{1/} Loan classification rules were tightened between 2000 and 2004. Moreover, the National Bank of Ukraine estimates that about 94% of loans classified as substandard, and included in NPLs, are being serviced.

^{2/} Liquid assets are assets with residual maturity of up to three months.

Christoph Duenwald, Nikolay Gueorguiev, and Andrea Schaechter are economists in the European Department of the International Monetary Fund. Full text of their paper can be viewed at <http://www.imf.org/external/pubs/ft/wp/2005/wp05128.pdf>. The views expressed in this paper are those of the authors and should not be attributed to the International Monetary Fund, its Executive Board, or its management. ■

Greenfield Academics

Jody Lanfrey Ono

For transition and developing countries, new research environments can signal reform and innovation.

From an investor's perspective, building research-based think tanks has turned out to be one of the most low-risk, high-return forms of capacity-building. A new research institute can start up on about a half a million dollars per year, sometimes less. Even if institutions need to be able to offer recruits contracts of at least three years to be able to recruit internationally, as in the West, the sums involved are still not high. When the group produces good work and interesting evidence, project funding can begin to offset a good part of the seminal investment very quickly. Long-term financial stability is often more elusive, and strategies for how to develop partnerships, integration with other initiatives, or contributions to endowments must be in place early on.

Still, the critical factor in building successful new research institutes is not money, but people. With more and more young talent from transition countries joining top PhD programs in the U.S. and Europe, it is getting easier to find those who want to return to their home countries to create good environments to do research. The make-or-break issue for the startup is the commitment of the researchers to stay and build something unique for the long-term. While they may be willing to make an initial commitment, the institute builders and the work environment must provide incentives to stay, and to remain in research. Very soon the recruits will need colleagues, local partners, and a visible career path; all of which they must be able to value on an equal level as the hard work they put into educating themselves.

Academic entrepreneurs have created such conditions, for example, in Prague (CERGE-EI and Charles University), in Moscow (CEFIR and the New Economic School), and in Beijing (CCWE and Tsinghua University). In Ukraine, thanks to seminal funding from the Swedish International Development Agency and working with the Economic Education and Research Consortium Ukraine, the Kyiv Economics Institute has a core faculty in place and is looking to expand it through the international job market this year. In these settings, young academics are building a professional future that includes research, teaching, and mentorship; all of the options they would have at Western institutions. And though it has not come automatically, they have been able to make an impact on policy by accurately interpreting the local demand for and receptiveness to advanced research on specific reform issues.

Greenfield academics are sparking reform in academia in transitional and developing countries. In these countries, but sometimes also in the West, academia has had the role of proposing economic or political reforms without going through much reform itself. Bringing back young, highly trained talent for academic careers helps build up the skill base in these countries in advanced analysis and original research. Strengthening the skill base in turn makes it easier to attract more talent to the country.

One of the main benefits of greenfield academics is the set of clearly defined objectives and shared values among returning graduates. Because they subscribe to largely the same international standards of selection and review (e.g. common recruitment practices and refereed journal publication), the new generation of academics finds cross-border communication easier and bases for collaboration more natural. Shared systems of review simplify efforts to measure progress, and introduce constructive forms of competition for institutional and research funding.

Another big benefit is the observable effects of academic startup packages. There are top research centers around the world, beyond the West, with their own goals and aspirations. They need not be islands of excellence, but can set examples of the principles and incentives involved in building research environments for other initiatives.

Young researchers based in emerging economies are publishing more in international journals and the academic and policy dialogues between and among these countries are picking up. At a Global Institute* conference in Beijing this December, leading young Chinese and Russian scholars will present new work on key bilateral issues such as migration, trade, politics, the investment climate, and more, in academic sessions and in roundtables with top government reformers from both countries.

By now, most are able to make concrete associations with the terms "capacity-building", "institution-building", and the catch-all "technical assistance". For the past 15 years at least, a host of programs has funded a proliferation of activities aimed at upgrading skills in emerging economies. The quality of these interventions has been uneven, and the lasting effects hard to measure. In particular, for middle-income countries like the new EU member states, India, Russia, Brazil or China, development needs and the effects of growth have been changing. And, moreover, changes in Western development policies will mean that soon these countries will not qualify, or more importantly not desire, to participate in traditional assistance programs.

There are clear signs that academia, as much as other parts of society, can help make reforms sustainable and produce innovation. For transitional and developing countries, as in the West, it can make the link between research and economic development come alive. These countries need to harness the positive effects of development assistance and foreign investment, especially those that can contribute to shaping continued economic development. Providing domestic, unconditioned support that secures the financial stability and political independence of homegrown, world-class research centers could be one such effect. Or even better, governments could encourage the role of the corporate sector in funding independent research.

*Jody Lanfrey Ono is Executive Officer of SITE in Stockholm. *In partnership with the Brookings Institution, Washington DC, SITE is developing The Global Institute, an alliance of top think tanks in emerging economies. ■*

Millennium Development Goals Publication Gives Mixed Report for ECA

A new World Bank report, "Millennium Development Goals: Progress and Prospects in Europe and Central Asia," measures how far countries of the region have come toward attaining such internationally agreed goals as halving extreme poverty by 2015, reducing maternal mortality, achieving universal primary education, and arresting the spread of HIV/AIDS. While Europe and Central Asia's (ECA) progress toward attaining the Millennium Development Goals (MDGs) is generally promising, it is also uneven. Growth in ECA since 2000 has raised the likelihood that some countries will meet several MDG targets, but health targets are the least likely to be met. The full report can be downloaded at <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/0,,contentMDK:20635333~pagePK:146736~piPK:146830~theSitePK:258599,00.html>

Second Annual ECA Education Conference Held in Croatia

The Second ECA Education Conference was organized by the World Bank and cohosted by Croatia's Ministry of Science, Education and Sports and the University of Zagreb, in Dubrovnik, from October 2 to 4. There were 160 representatives from 30 ECA countries present at the conference, including ministers from participating countries and international experts in tertiary education.

The main topics of the conference were Quality Assurance in Tertiary Education, Financing Higher Education, and Linkages between Higher Education, Research, and Industry. At the conference, Croatian ministers presented an overview of tertiary education in Croatia and the initial findings of the Organization for Economic Co-operation and Development's Thematic Review of the Tertiary Education Country Report for Croatia.

European Union Opens Membership Negotiations with Turkey

The Turkey Country Office issued the following statement on October 3 after the official opening of negotiations between the European Union and Turkey: "Turkey has today crossed the bridge to Europe. This date will go down as one of the most important days in Turkey's history. The opening of accession negotiations with the EU represents an historic moment for Turkey and the EU. The negotiations will be long and cover many difficult subjects; however the end result will bring great benefits to Turkey, the EU, and the wider world. The World Bank applauds the decision of the EU Council of Ministers to approve the Framework Agreement and looks forward to supporting Turkey and the EU during the accession process."

Poverty Report Brings Mostly Good News for ECA

Some 40 million people were lifted out of poverty in Central and South Eastern Europe and the countries of the former Soviet Union during 1998-2003 as a result of rapid growth and narrowing inequality, according to a new World Bank report entitled "*Growth, Poverty, and Inequality in Eastern Europe and the Former Soviet Union*." Yet most of the poor and vulnerable in the transition countries of the region are in large middle income countries such as Kazakhstan, Poland, Russia, and Ukraine. Those most at risk are the young, residents in rural areas and in secondary cities. The unemployed, people with little education, and those belonging to underprivileged minorities, such as the Roma are also at great risk. Most of the poor are working poor. The authors provide several prescriptions to ensure that continued growth works for the poor. The report can be downloaded, along with multimedia content, at <http://www.worldbank.org/ecapovertyreport>

President Wolfowitz Visits Russia

World Bank Group President Paul Wolfowitz visited Russia from October 18 to 20 as an official guest of the Russian Government. It was his first visit to the country since becoming president. Mr. Wolfowitz's trip was focused on the country's role in the global economy and its contribution to the development agenda as the country prepares to chair the Group of Eight next year. He also took the opportunity to learn about the challenges the country is facing and how the partnership with the World Bank Group is helping to address them. The focal point of his trip was a meeting with Russian President Vladimir Putin, and Mr. Wolfowitz also met with private sector representatives, regional government leaders, and people who have benefited from World Bank projects. For in-depth information on Mr. Wolfowitz's visit, go to <http://www.worldbank.org.ru>

World Bank Helps Turkey Prepare for Future Earthquakes

In the wake of the deadly Pakistan earthquake, the World Bank signed a EUR 310 million loan with Turkey on Seismic Risk Mitigation and Emergency Preparedness. The objective of the project is to improve the city of Istanbul's preparedness for a potential earthquake by enhancing the institutional and technical capacity for disaster management and emergency response, strengthening critical public facilities for earthquake resistance, and supporting measures for better enforcement of building codes and land-use plans. The project follows previous World Bank assistance to Turkey in response to the devastating 1999 Marmara earthquake, in which over 17,100 people died. The current project aims to be proactive rather than reactive. For more information, visit <http://www.worldbank.org/projects>.

Public Information Centers Celebrate United Nations Day

Country Offices around ECA held events commemorating the 60th anniversary of the United Nations (UN), in the run up to October 24, United Nations Day. The events emphasized the respective countries' cooperation with the UN, as well as the World Bank's work with the UN to reduce poverty.

World Bank Supports European Union's SEE Energy Agreement

The EU and Balkan states signed a treaty on October 25 extending energy liberalization to South Eastern Europe, in a move to encourage greater investment in the region's infrastructure. The agreement is the first multilateral treaty to cover all countries in South Eastern Europe, including Albania and the former Yugoslav states, minus Slovenia. It aims to bring down energy bills by encouraging increased competition and to attract more investment to a region where blackouts are still common after infrastructure was damaged during the Balkan war in the 1990s. The World Bank has agreed to provide a billion dollars in fast-track loans to assist investments throughout the region, which will provide new opportunities for companies in the EU. Implementation of the treaty will result in the countries of the region becoming part of the EU's internal market in a key economic sector before their accession to the EU.

Job Opportunities Report Points to Persistent Unemployment

A new report by the World Bank, "Enhancing Job Opportunities in Eastern Europe and the Former Soviet Union," analyzes employment outcomes in 27 transition countries since the fall of communism. It reveals that most transition countries lack job opportunities, and employment can be spurred only by policies that enable enterprise restructuring and improve the investment climate. The report urges countries to boost their investment climates in ways that stimulate firms to invest and create productive jobs. It also calls for steps to lower the cost of labor mobility by developing the housing and mortgage markets as well as improving access to lifelong learning opportunities. Sub-regional recommendations are also provided. The report can be downloaded, along with multimedia content, at <http://www.worldbank.org/ecallaborstudy>

EU8 Quarterly Report Indicates Continued Favorable Growth

The October issue of the EU8 Quarterly Economic Report indicated that economic performance remained broadly favorable in the eight Central and Eastern European countries that joined the European Union in May 2004. The Baltic countries and Slovakia continued growing strongly with domestic demand contributing importantly, while Poland fell somewhat off the pace. The report emphasizes that Central Europe and the Baltic States have taken important steps in recent years to strengthen the efficiency and sustainability of their pension sys-

tems. However, few countries have yet done enough to fully mitigate the risks stemming from prospective population aging. The full report can be downloaded at <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/0,,contentMDK:20268176~pagePK:146736~piPK:146830~theSitePK:258599,00.html>

World Bank Responds to Avian Flu Fears

After the initial outbreaks of avian flu in South East Asia spread into Europe, the World Bank and other donors met in Geneva from November 7 to 9, where they agreed on action steps and financing. The meeting supported an urgent resource request for US\$35 million to fund high-priority actions by the World Health Organization, the Food and Agriculture Organization of the United Nations, and the World Organization for Animal Health over the next six months. Surveillance, control and preparation work requires urgent funding. Additionally, funds from a new World Bank US\$300-\$500 million avian flu program are expected to start flowing to countries within weeks to help them combat the deadly virus. The funding mechanism — similar to that used by the Bank for funding its AIDS programs in Africa — would allow low-income countries immediate access to grants and soft loans from the Bank's lending arm, the International Development Association. For more information, visit <http://www.worldbank.org/avianflu>

Roma Decade Moves Forward at November Meeting

The Romanian government is hosting its first meeting as the chair of the International Steering Committee of the Decade of Roma Inclusion on November 17 in Bucharest. The eight Decade countries and donors such as the Open Society Institute and the World Bank will meet to assess progress since the Decade's launch in February and put forward concrete proposals for moving forward on the four Decade priority areas of education, housing, health, and employment. At a meeting of Decade Finance Ministers and donors at the World Bank on September 23, European Commissioner for Regional Policy Danuta Huebner promised Structural Funds for the three Decade countries that have joined the EU, as well as Pre-Accession Funds for the other five countries. For further information, visit the Decade of Roma Inclusion's website at <http://www.romadecade.org>

Firms Report Improved Business Environment

A new survey (the Business Environment and Enterprise Performance Survey, known as BEEPS) jointly conducted by the World Bank and the EBRD, shows that business conditions in Eastern Europe and the former Soviet Union have improved. According to a new survey of over 9,500 firms in 27 countries, the countries of Central and Eastern Europe and the former Soviet Union have made important strides in improving their business environments, although challenges remain. For more information, visit <http://www.worldbank.org/eca> ■

New Books and Working Papers

World Bank Publications

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Doing Business in 2006: Creating Jobs

September 2005, ISBN: 0-8213-5749-2 SKU: 15749

This is the third in a series of annual reports investigating regulations that ease doing business and those that constrain doing it. This edition focuses on job creation. New quantitative indicators on business regulations and their enforcement can be compared across 150 countries and over time. The report updates the indicators presented in previous reports and adds three new sets of measures: paying taxes, getting licenses, and trading across borders. The indicators are used to analyze economic and social outcomes, such as productivity, investment, informality, corruption, unemployment and poverty, and identify what reforms have worked, where and why.

World Bank Working Papers

<http://econ.worldbank.org/>

Thomas Rutherford, David Tarr, Oleksandr Shepotylo

The Impact on Russia of World Trade Organization (WTO) Accession and the Doha Agenda: the Importance of the Liberalization of Barriers against Foreign Direct Investment in Service Industries for Growth and Poverty Reduction

WPS3725, October 2005

Taking price changes from the Global Trade Analysis Project (GTAP) model of world trade, the authors use a general equilibrium comparative static model, which is computable for a small open economy, to assess the impact of global free trade and successful completion of the Doha Agenda on the Russian economy, and especially on the poor. They compare those results with the impact of Russian accession to the WTO on income distribution and the poor.

Branko Milanovic

Half the World: Regional Inequality in Five Large Federations

WPS3699, September 2005

The paper studies regional (spatial) inequality in the five most populous countries in the world: China, India, the United States, Indonesia, and Brazil in the period 1980-2000. They are all federations or quasi-federations composed of entities with substantial economic autonomy. Two types of regional inequal-

ities are considered: Concept 1 inequality, which is inequality between mean incomes (GDP per capita) of states/provinces, and Concept 2 inequality, which is inequality between population-weighted regional mean incomes.

Lev Freinkman, Alexander Plekhanov

What Determines the Extent of Fiscal Decentralization? The Russian Paradox

WPS3710, September 2005

The paper provides an empirical analysis of the determinants of fiscal decentralization within Russian regions in 1994-2001. The conventional view that more decentralized governments are found in regions and countries with higher income, higher ethnolinguistic fractionalization, and higher levels of democracy is not supported by the data. A more refined analysis points to the link between decentralization and the structure of regional government revenue: access to windfall revenues leads to a more centralized governance structure. The degree of decentralization also depends positively on the level of urbanization and regional size and negatively on income and general regional development indicators such as the education level.

Felix Eschenbach, Bernard Hoekman

Services Policy Reform and Economic Growth in Transition Economies, 1990-2004

WPS3663, July 2005

The authors find that reforms in policies in former centrally planned economies toward financial and infrastructure services, including telecommunications, power, and transport, are highly correlated with inward foreign direct investment. Controlling for regressions commonly used in the economic growth literature, they find that measures of services policy reform are statistically significant explanatory variables for the post-1990 economic performance of transition economies. These findings suggest services policies should be considered more generally in empirical analyses of economic growth.

Thorsten Beck, Luc Laeven

Institution Building and Growth in Transition Economies

WPS3657, July 2005

Drawing on the recent literature on economic institutions and the origins of economic development, the authors offer an explanation of the political economy of variations in institution building across transition economies. They identify dependence on natural resources and the historical experience of these countries during socialism as major determinants of institution building during transition by influencing the political structure and process during the initial transition years.

William Davidson Institute Working Papers

<http://www.wdi.bus.umich.edu/>

Nauro F. Campos, Francesco Giovannoni
The Determinants of Asset Stripping: Theory and Evidence from the Transition Economies
 WP No. 786, August 2005

During the transition from a planned to a market economy, managers and politicians succeeded in maintaining control of large parts of the stock of physical capital. This paper applies models, measures, and investigates this process empirically. The authors argue that asset stripping is driven by the interplay between a firm's potential profitability and its ability to influence law enforcement. Econometric results for about 950 firms in five transition economies provide support for this argument.

Margaret Maurer-Fazio, James Hughes, Dandan Zhang
Economic Reform and Changing Patterns of Labor Force Participation in Urban and Rural China
 WP No. 787, August 2005

The authors employ data from the Chinese population censuses of 1982, 1990, and 2000 to examine reform era changes in the patterns of male and female labor force participation and in the distribution of men's and women's occupational attainment. Very marked patterns of change in labor force participation emerge when the data are disaggregated by age group, marital status, sex, and rural/urban location. Women have decreased their labor force participation more than men, and urban women much more than rural women. Single young people in urban areas have decreased their labor force participation to continue their education to a much greater extent than single young people in rural areas. The urban elderly have decreased their rates of labor force participation while the rural elderly have increased theirs.

CERGE-EI Working Papers

http://www.cerge-ei.cz/publications/working_papers/

Eugen Kovac
Speculation and Survival in Financial Markets
 Working Paper 276, September 2005

Yan Chen, Peter Katuscak, Emre Ozdenoren
Why Can't a Woman Bid More Like a Man?
 Working Paper 275, September 2005

Jakub Steiner
Coordination Cycles
 Working Paper 274, September 2005

Frantisek Brazdik, Viliam Druska
Too Large or Too Small? Returns to Scale in a Retail Network
 Working Paper 273, September 2005

Radim Bohacek, Michal Kejak
Optimal Government Policies in Models with Heterogeneous Agents
 Working Paper 272, September 2005

Paul J.J. Welfens, Anna Wziatek-Kubiak (Eds.)
Structural Change and Exchange Rate Dynamics: The Economics of EU Eastern Enlargement
 September 2005, 288 pages

Edward M. Graham, Nina Oding, Paul J.J. Welfens (Eds.)
Internationalization and Economic Policy Reforms in Transition Countries
 September 2005, 341 pages

Michael McFaul, Kathryn Stoner-Weiss (Eds.)
After the Collapse of Communism: Comparative Lessons of Transition
 September 2005, 272 pages

Emilio Colombo, Luca Stanca
Financial Market Imperfections and Corporate Decisions: Lessons from the Transition Process in Hungary
 August 2005, 174 pages

CASE Studies and Analyses

www.case.com.pl

Olga Pavlova, Oleksandr Rohozynsky
Labor Markets in CIS Countries
 No. 311, October 2005

Inna Golodniuk
Financial Systems and Financial Reforms in CIS Countries
 No. 306, September 2005

Vladimir Dubrovskiy, Oleg Ustenko
Business Climate in CIS Countries
 No. 307, September 2005

LICOS: Center for Transitional Economies at Katholieke Universiteit, Leuven

<http://www.econ.kuleuven.be/LICOS/DP/DP2005.htm>

Joze P. Damijan, Andreja Jaklic and Matija Rojec
Does External Knowledge Induce Firms' Innovations? Evidence from Slovenia
 Discussion Paper No. 156/2005

The paper analyzes whether, and to what extent, a firm's ability to innovate is induced by the firm's own R&D activity or by factors external to the firm. The paper finds that, firstly a firm's own R&D expenditures as well as external knowledge transfer, such as national and international public R&D subsi-

dies, foreign ownership and intrasector innovation circulation enhance its ability to innovate. Secondly, innovations as a result of the firm's R&D contribute substantially to the firm's overall productivity growth. And third, foreign ownership has a double impact on the firm's TFP growth — it first enhances the firm's ability to innovate and then it additionally contributes to the firm's TFP growth via superior organizational techniques and other channels of knowledge diffusion.

Etleva Germezi and Johan F. Swinnen
Human Capital, Market Imperfections, Poverty and Migration: Evidence from Albania

Discussion Paper No. 157/2005

The paper analyzes the determinants of Albanian migration based on a survey of rural households. The study confirms that migrants are mostly young, male, and single. Regional variations in migration reflect a combination of cultural and economic factors, including migration costs. However, migrants are not found to come from the poorest rural households.

Pavel Ciaian and Johan F. Swinnen
Labor Market Imperfections and Agricultural Policy Impacts in the New EU Member States: A Partial Equilibrium Analysis

Discussion Paper No. 158/2005

Crt Kostevc
Performance of Exporters: Scale Effects or Continuous Productivity Improvements

Discussion Paper No. 159/2005

This paper asks whether, in addition to good firms self-selecting themselves into export activity, multinational production exporting further improves their performance compared with non-exporters. The estimations performed on the Slovenian sample indicate that more productive firms tend to self-select into more competitive markets, while there is no conclusive evidence of learning by exporting.

Other publications

Samuel Fankhauser, Sladjana Tepic
Can Poor Consumers Pay for Energy and Water?

EBRD Working Paper No.92, August 2005

<http://www.ebrd.org/pubs/econo/WP0092.htm>

This paper takes a detailed look at the affordability of electricity, district heating and water for low-income consumers in transition countries. It finds that affordability is particularly a problem in the Commonwealth of Independent States and in the water sector. The paper also found that delays to tariff reform have little impact on affordability.

John Nellis and Nancy Birdsall (eds.)
Reality Check: The Distributional Impact of Privatization in Developing Countries

Center for Global Development Publication, October 2005

<http://www.cgdev.org>

This new edited volume brings together a comprehensive set of country studies on the effects of privatization on people. It answers the overarching question: who are the winners and losers of the wave of privatizations that swept across the developing world in the 1980s and 1990s?

Claude Merand and Mary M. Shirley (eds.)

Handbook of New Institutional Economics

2005 Springer, pp. 884

New Institutional Economics (NIE) has skyrocketed over the last three decades. Since the term was first coined by Oliver Williamson in 1975, the subject has exerted increasing influence over scholarly research. NIE studies institutions and how institutions interact with organizational arrangements. According to Douglass North's definition, new institutionalists aim to understand the process of economic change, as well as social or political change, by understanding human incentives and intentions and the beliefs, norms and rules that they create in pursuit of their goals. For new institutionalists, the performance of a market economy depends upon formal and informal institutions and modes of organization that facilitate private transactions and cooperative behavior. NIE focuses on how such institutions emerge, operate and evolve, and how they shape the different arrangements that support production and exchange, as well as how these arrangements act in turn to change the rules of the game.

This first handbook of NIE provides an overview of recent developments and broad orientations. One branch of NIE, covered in this handbook, focuses on the macro institutions that shape the functioning of markets, firms and other modes of organization: the state and the legal system. Another branch concentrates on the micro institutions that govern firms and their contractual relations. New institutionalists are also very much concerned with the interactions between the state and the firm. Increasingly, institutional economics has also focused on how institutions, both macro and micro, change; how they emerge, evolve and die. Because NIE is addressing new questions or new aspects of old questions and does not give new answers to the traditional questions of economics — resource allocation and the degree of utilization — its future is being shaped by new methodologies and a multi-disciplinary approach. This handbook will be of interest to economists, political scientists, legal scholars, management specialists, sociologists, and others wishing to learn more and gain insight into progress made by institutionalists from other disciplines.

This compendium of analyses by some of the foremost NIE specialists — including Ronald Coase, Douglass North, Elinor Ostrom, and Oliver Williamson — summarizes the developments in the subfields of New Institutional Economics, and raises questions that leaders in the field consider crucial, and supplies scholars with tools for exploring answers to these questions. ■

Allied Social Science Associations Annual Meeting

January 6-8, 2006, Boston, USA

The American Economic Association (AEA), in conjunction with approximately 50 associations in related disciplines, is holding a three-day meeting to present papers on general economic subjects. Over 450 scholarly sessions are to be held. In 2006, for the second time, the AEA is posting conference papers presented at the 2006 ASSA Conference on the AEA website.

Information: <http://www.vanderbilt.edu/AEA/anmt.htm>

Conference on Public Services and Management: Designs, Issues and Implications for Local Governance

January 13-14, 2006, Toulouse, France

The conference aims to gather researchers in a field which lies at the boundaries of economics, management and policy studies, as well as practitioners involved in the day-to-day management of public services. Topics to be addressed by the conference include:

- Public versus private ownership of infrastructure
- Local governments and their relationships with the private sector
- Public-private partnerships in developing countries
- Design of and bidding for concession contracts
- Private finance initiatives: issues and perspectives

Information: http://idei.fr/conference/ppp_2006.html

Annual Bank Conference on Development Economics (ABCDE)

January 18-19, 2006, St. Petersburg, Russia

Opening Address: Francois Bourguignon, Senior Vice President and Chief Economist, World Bank

Keynote Addresses: Anders Aslund, Carnegie Endowment for International Peace; Yegor Gaidar, Institute for the Economy in Transition

Lunch Speaker: Gur Ofer, Hebrew University

- *Growth After Transition: Is Rising Inequality Inevitable?* "Inequality and Growth in Transition," Pradeep Mitra and Ruslan Yemtsov, World Bank; "The Opening of Latin America: Consequences for Inequality," Guillermo Perry, World Bank;

- *Economic Space.* "Can Economic Policy Overcome Geographic Disadvantage in Eastern Europe and the FSU?" Karolina Ekholm, Stockholm School of Economics; "Similar Patterns of Convergence and Divergence in India and China," Xiaobo Zhang, Kiran Gajwani, Ravi Kanbur, International Food Policy and Research Institute;

- *Governance.* "State vs. Market in Latin America and the World", Mariano Tommasi, LACEA; "Public and Private Responses to Government and Market Failures," Erik Berglof, EBRD; "Privatization: What Have We Learned?" Sergei Guriev, NES, Moscow, and Bill Megginson, University of Oklahoma;

- *Judiciary Foundations of a Market System.* "Judiciary

Foundations in the General Context of Development," Matthew Stephenson, Harvard University; "Judiciary Foundations in Transition Countries," Cheryl Gray, World Bank.

Information: <http://www.worldbank.org/research/abcde>. For sessions contact Boris Pleskovic, Research Manager, Development Economics, World Bank, tel.: 202 473 1062, fax: 202 522 0304, email: bpleskovic@worldbank.org; for logistical information contact Leita Jones, Program Assistant, tel.: 202 473 5030; fax: 202 522 0304; email: Ljones2@worldbank.org.

VII International Scientific Conference "The Modernization of the Economy and the State"

April 4-6, 2006, State University - Higher School of Economics (SU-HSE), Moscow, Russia

The conference is organized by SU-HSE with the participation of the World Bank and the IMF. Topics of the workshops and round tables will include:

- The state, public governance and civil society
- Institutions and the demand for law; effectiveness, efficiency and the modernization of state institutions
- Education, science, innovations and the modernization of economy
- Social processes and social policy
- The Political Economy of Reforms; economic and social cooperation between business and the public authorities.

Information: http://www.hse.ru/temp/2006/04_0406_conf.shtml. Please send an application for presentations by December 10, 2005 at: interconf@hse.ru. Application form: www.hse.ru/lic7.

Promoting Democratic Values in an Enlarged Europe: The Changing Role of the Baltic States from Importers to Exporters

May 5-6, 2006, Tartu, Estonia

The conference aims to facilitate the learning of transition processes, using the experience gained in the Baltic states of applying European democratic principles to a democratic transition and integration with Europe. Four panels are planned:

- Exporting democratic values to the Baltic states: external influence on the democratic transition in the Baltic states, and the EU's role in democracy building ;
- Internalizing and consolidating imported values: the impact of externally guided democratization principles upon nation building;
- Transforming from a importer to an exporter of democracy: defining the role, the capability and the interests of the Baltic states in the democratization of the Newly Independent States (NIS);
- Analyzing expectations and needs in the target countries (NIS).

Information: <http://www.ec.ut.ee/conf06/callforpapers.htm> ■

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