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# Beyond Transition

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## From the Editor:



Dear Reader,

Several years ago Ricardo Caballero and Arvind Krishnamurthy proposed a theory suggesting that the world economy suffers from a shortage of saving instruments, which is the major cause of global imbalances, low interest rates, deflation, the high popularity of US assets and other global financial markets irregularities. The shortage of saving instruments also makes the world economy vulnerable to financial bubbles. When the main theme for this issue of *BT* was being selected, we did not expect the issue to be published at the time of global financial turmoil, caused by the bursting of one of such bubble. The review of financial systems in transition and developing countries, which we present to you in this issue, confirms the original hypothesis of Caballero and Krishnamurthy that emerging markets do not provide enough saving instruments, and, more generally, do not provide adequate financial services to their populations.

The issue starts with a review of the situation in the banking sector. The excellent survey of the banking sector in 58 countries described by Demirguc-Kunt documents various barriers to banking, such as physical access, affordability and eligibility. The next article, written jointly by Levine and Demirguc-Kunt, shows that the abolishment of such barriers and financial development disproportionately benefit the poor and small businesses. Wachtel and Haselmann look at the risk taking behavior of various types of banks, while Cull and Martinez Peria find empirical evidence of the catalyst effect of banking crises, which stimulate the entry of foreign banks. Pyle, Schoors and Karas discuss the ability of depositors to discipline banks using the example of Russia. Recent trends in the development of the banking sectors in Armenia and Georgia are described in the articles by Dabla-Norris and Floerkemeier, and Billmeier and Ding, respectively.

De la Torre, Gozzi, and Schmukler provide a review of the effects of stock market liberalizations, enforcement of insider trading laws, the introduction of fully automated trading systems, privatizations, pensions and other institutional reforms on financial market development. Such measures, along with macroeconomic stabilization, economic growth and a favorable situation on global financial markets, have led to an impressive increase in capitalization and the strengthening of institutions in a number of transition and developing economies. Gorjaev and Zelenyuk provide illustrations of such remarkable changes using, respectively, the examples of Russia and Ukraine. In contrast, the Czech stock market, which grew artificially large after privatization programs, has shrunk in size due to a massive delisting of firms, as described by Fungacova, who does not recommend other countries to follow the Czech example.

Overall, the long-term development of financial markets seems to be related to characteristics of the political system and underlying historical factors. In line with the original hypothesis of Caballero and Krishnamurthy, Ju and Wei demonstrate that weak domestic financial institutions encourage the outflow of savings and discourage inward foreign direct investments. Therefore, improving domestic financial institutions should be a priority for all countries, interested in increasing benefits from financial globalization.

In the New Findings section of this issue I would like to draw your attention to the EBRD survey of values in transition (Sanfey, Steves and Teksoz) and the World Bank's analysis of the economic impact of aging in transition countries (Chawla, Betcherman, and Banerji).

*Ksenia Yudaeva, Managing Editor*

# Barriers to Banking

Higher barriers to banking, including physical access, affordability, and eligibility, are negatively correlated with economic and financial development

*Asli Demircuc-Kunt*

The minimum amount to open a checking account in Armenia is equal to almost 11% of GDP per capita, while no minimum amount is required in Georgia. The fees for transferring US\$250 internationally are almost US\$28 in Moldova but only US\$3.2 in Belarus. While most people in the developed world take access to banking services for granted, price and non-price barriers prevent large parts of the population in developing countries and emerging markets from accessing and using formal banking services.

Financial exclusion can retard economic growth, increase poverty and inequality and moreover, generate persistent income inequality or poverty traps. Previous research has established the importance of banking sector depth for GDP per capita growth, productivity growth, poverty, firm growth and entry rates.

We survey the extent of barriers to the banking services across three dimensions — physical access, affordability, and eligibility in the five largest banks, which constitute at least 30% of the market in terms of total loans or total deposits, in 58 countries, including 15

countries from Eastern Europe and Central Asia (see Table 1).

Physical access refers to the number of points of service delivery and their convenience. Affordability refers to the costs in terms of minimum balances and fees that bank clients need to pay to obtain financial services. Finally, eligibility refers to the criteria (documentation or other requirements) that determine who can access financial services and who cannot.

## Barriers to Banking Significant in Some Countries

Our data show that variations in barriers to banking are substantial in different countries. While banks in 18 out of the 58 developing countries (such as Croatia, Lithuania and Turkey) do not impose any minimum balances for checking accounts, such balances are higher than 10% of GDP per capita in Armenia. There is a high correlation between the amounts needed to open and to maintain checking and savings accounts, although on average the amounts are significantly lower to maintain than to open an account.

Furthermore, the cost of transferring a small amount of funds internationally (a typical transfer of US\$250) on average across all surveyed countries amounts to US\$15.82, yet it stands at a low of US\$3.2 in Belarus and at a high of US\$28 in Lithuania.

Many factors effectively prevent large parts of the population from accessing banking services including the number of documents required to open an account for a new client (at least three in Turkey), the minimum amount of loans for small and medium-sized companies (a whopping 2,480% of GDP per capita in Georgia), and the cost and time to make a decision on a consumer loan.

## Financial and Economic Development Negatively Affected

As expected, we find that higher barriers to banking are negatively correlated with economic and financial development. On the other hand, lower barriers are associated with greater financial sector outreach:

- Banks in countries with a higher demographic branch penetration demand lower minimum balances and fewer documents to open accounts, set lower minimum SME loan amounts, are quicker at processing loan applications, and charge lower fees for using ATM cards.

- Banks in countries with higher loans per capita are more likely to accept applications outside headquarters, in particular, by phone or Internet, and take fewer days to process SME applications.

- Banks in countries with more deposits per capita demand lower minimum balances and lower fees, require fewer documents to open such an account, set lower minimum amounts for consumer and SME loans, charge lower fees for consumer loans for using ATMs, and are faster in processing loans.

- The share of adults with access to a financial account is higher in countries where banks demand lower minimum balances and fees on savings and

**Table 1. Financial Market Indicators for Selected Countries from Europe and Central Asia**

Country	Private Credit to GDP, %	Number of branches per 100,000 people	Number of loans per 1,000 people	Number of deposits per 1,000 people
Albania	8.8	2.11	4.42	161
Armenia	6.1	7.59	41.23	111
Bosnia Herzegovina	n/a	3.86	114.09	429
Bulgaria	30.5	13.87	73.85	1351
Croatia	52.6	23.36	n/a	n/a
Czech Republic	30.3	11.15	n/a	1923
Georgia	8.3	3.14	n/a	n/a
Hungary	43.5	28.25	n/a	n/a
Lithuania	22	3.39	58.86	1166
Poland	n/a	8.17	773.87	n/a
Russia	n/a	2.24	54.11	1892
Slovak Republic	29.7	10.28	n/a	n/a
Slovenia	42.1	2.19	n/a	n/a
Turkey	16.9	8.50	264.51	1114

checking accounts, where they demand fewer documents to open such accounts, where the consumer and SME minimum loan amount is lower, where loans are processed more quickly, where loan applicants are more likely to be able to use non-traditional channels, and where ATM fees are lower.

Our correlations suggest that barriers to banking go hand in hand with less physical access to banking offices and lower use of deposit and credit services by households and firms. However, some barriers seem to be more constraining

*Policy reforms, such as improving the general infrastructure and securing a free media are as important as financial sector reforms*

than others.

Minimum account balances and account fees, minimum loan amounts, documentation requirements, reduced number of delivery channels for loan products and lengthy loan processing times seem to constitute true hurdles to accessing formal banking services. At the same time, loan fees, fees for international wire transfers and the use of ATM cards and geographic access barriers to opening deposit accounts are either not significant barriers because they can be circumvented through technological advances or they are not properly measured with our methodology, as they are not correlated with lower financial sector penetration rates.

### Financial Exclusion — the Effects of Banking Barriers

In computing the share of the population that is excluded due to checking account fees, we assume that people can-

not afford to spend more than 2% of their annual household income on financial services fees. While in terms of this, checking and savings accounts are affordable for almost the entire population in many countries, including all ECA countries, the fees observed in 10 countries in Africa and Asia effectively prevent at least 30% of the population from using such accounts.

Similarly, the requirement of a physical address or of a formal sector job as eligibility criteria to open an account excludes a lot of people in countries,

where a large percentage of the population lives in rural areas and works in the informal sector.

### What Explains Barriers across Banks and Countries?

Which policies might be more effective at reducing banking barriers? We find that:

- Bank size and thus economies of scale are important factors explaining barriers. Larger banks have fewer barriers for consumers and SMEs.

- The quality of physical infrastructure, which is associated with the costs of doing business for banks, can explain cross-country variation in many barriers to banking. Banks in countries with more power outages require higher minimum balances for savings accounts, require more documents to open accounts, impose higher minimum loan amounts, charge higher fees on consumer loans and for international wire transfers, and take longer to process SME loan applications.

- Factors traditionally associated with the development of the financial sector such as upgrading credit registries and improving the contractual framework are associated with lower barriers mostly for deposit services but, surprisingly, less so for lending services.

- Lower barriers to deposit services in the banking system are associated with greater foreign bank presence. Although we find

that foreign banks themselves seem to charge higher fees than other banks, in foreign dominated banking systems fees on checking accounts are lower. Further, it is easier to open bank accounts, both in terms of the required documents and the geographic access. On the other hand, in systems that are predominantly government-owned, bank customers face greater restrictions in terms of where to apply for loans and the time it takes to have applications processed is longer. Government-owned banks, whose existence (despite efficiency problems) is often justified as providing access to the underserved groups, do not seem to have significantly lower access barriers compared to private banks.

- More contestable systems, measured by a higher share of new bank license applications rejected, are associated with lower barriers.

- Banks in countries with a less restrictive regulatory framework, less supervisory power and more reliance on private monitoring have fewer barriers.

- Non-financial factors, such as having an efficient infrastructure and free media, are also strongly associated with lower barriers.

Overall, although we cannot infer causality from cross-country data, our results show that traditional financial sector policies such as the upgrading of credit information systems and improvements in the contractual environment are likely to be associated with lower barriers, but more on the deposit side than on the lending side. However, non-financial sector policy reforms are equally important; these include improving the general infrastructure and securing a free and vibrant media for lowering barriers.

**Table 2. Barriers to Accessing Consumer Loan Services**

Country	Locations to submit applications (out of 5)	Min. loan (% of GDP/capita)	Days to process loan application
Albania	2.03	214.29	9.64
Armenia	2.00	14.74	4.83
Bulgaria	3.42	14.24	4.88
Croatia	3.43	3.90	2.42
Czech Republic	3.13	10.22	1.00
Georgia	2.46	34.53	3.31
Hungary	3.29	4.77	5.66
Lithuania	4.25	6.31	2.41
Slovak Republic	3.64	10.26	1.75
Slovenia	2.13	1.13	1.13

*Asli Demircuc-Kunt is Senior Research Manager, Finance and Private Sector, in the Development Research Group of the World Bank, Washington, DC. The article is based on her presentation "Barriers to Access: Measurement and Impact" at the ABCDE conference in Slovenia, May 2007, and her 2006 paper jointly with Thorsten Beck and Maria Soledad Martinez Peria "Banking Services for Everyone? Barriers to Bank Access and Use around the World", available at [http://go.worldbank.org/KXNIZEVDB0\(WPS 4079\)](http://go.worldbank.org/KXNIZEVDB0(WPS 4079)). This work and other related research is summarized in the forthcoming World Bank Policy Research Report "Finance for All? Policies and Pitfalls in Expanding Access".* **BT**

# Finance and Opportunity

Financial development disproportionately helps the poor and small firms

Ross Levine and Asli Demirguc-Kunt

Are a person's economic opportunities determined by individual skill and initiative, or are his/her horizons shaped by parental wealth, human capital and social networks? In considering these age-old questions, we analyze the role of the financial system in shaping economic opportunities and affecting the transmission of poverty and income inequality across generations.

It is difficult to overestimate the potential welfare implications of enhancing economic opportunities in general and those of the poor in particular. Almost 3 billion people — about half of the earth's inhabitants — live on less than US\$2 per day. Many live in the same impoverished conditions as their parents and grandparents.

Financial market imperfections — such as information and transaction costs — are a keystone of virtually all theories of persistence in relative incomes across generation. For example, financial market imperfections determine the extent to which the poor can borrow to invest in schooling or physical capital. Financial market imperfections also determine the extent to which comparatively talented, but poor, individuals can raise external funds to initiate projects.

The theories generally take financial market imperfections as given and unalterable. Yet, economic conditions, technological change, and financial sector policies and innovation can all affect the level and evolution of financial market frictions. Depending on laws and policies, financial contracts, markets, and institutions may ameliorate or intensify the adverse effects of financial market frictions on economic opportunities.

## Two Common Public Policy Alternatives

Theoretical models have stressed two public policy strategies for reducing the persistence of income differences across generations:

- *Income and wealth redistribution policies*, which reduce the impact of parental wealth on the economic oppor-

tunities of their progeny. Redistributive policies, however, create disincentives to work and save, and are directly linked with equalizing outcomes, not simply equalizing opportunities.

- *Public education policies*, which reduce inequality of economic opportunities.

Financial development policies that expand individual economic opportunity create positive incentive effects, while avoiding the tensions associated with redistributive policy attempts to equalize outcomes. Moreover, financial development policies that reduce credit market imperfections help the poor to borrow in order to invest in human capital accumulation, thereby improving their economic opportunities.

## Finance Can Disproportionately Help the Poor

What does empirical evidence tell us about the linkages between the operation of the financial system and distribution of income and poverty?

A lot of studies find that financial development, as measured by financial depth (such as credit extended to the private sector divided by GDP per capita) accelerates aggregate economic growth, and that aggregate growth, the income of the poor, and inequality are interlinked. Thus, if financial development does not intensify income inequality (too much), financial development will reduce poverty by boosting overall economic growth. If, however, financial development intensifies income inequality, then this income distribution effect could negate — or even reverse — the poverty-reducing effect of financial development. Financial development might disproportionately help the poor, by affect-

ing poverty through two channels: overall growth and a flattening of the distribution of income.

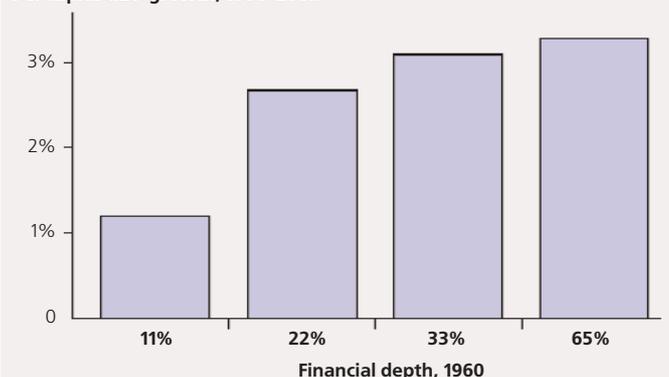
Indeed, research on Gini coefficients finds that financial development is associated with lower levels of income inequality. For example, we have found that financial development boosts the growth rate of the income share of the poorest quintile, thus helping the poor above and beyond the impact on aggregate growth. About 40% of such impact is the result of reductions in income inequality, while the remainder of the impact is due to the effect of financial development on aggregate economic growth.

How is finance related to actual poverty, and not just to income distribution? Several cross-country studies have found that financial development is negatively correlated both with poverty and the growth rate of poverty. For example, a recent study finds that about half of the impact of financial development on the headcount measure of poverty is due to financial development accelerating economic growth, and the other half is due to financial development reducing income inequality.

Financial market imperfections help sustain income inequality and poverty traps by hindering the ability of the poor to accumulate income-enhancing human capital. Various international studies show that lack of access to credit:

### Finance Boosts Growth

Per capita GDP growth, 1960–2005



- Forces poor households to reduce their children's education, especially in case of transitory shocks;
- Reduces average secondary school enrollment rates;
- Encourages child labor.

### Finance Boosts Small Firm Growth Disproportionately More

Moreover, financial constraints hinder efficient investment. To the extent enterprises cannot access finance to undertake promising investments, this is likely to exacerbate inequalities and lead to poverty traps. In many developing countries small and medium enterprises face difficulties accessing finance, due to the absence of credit information and connections. Research in this area shows that:

- A greater proportion of firms financed their growth externally in countries with more developed financial systems and more efficient legal enforcement;
- The growth of smaller firms is significantly more constrained by financing obstacles, particularly in countries with less developed financial systems;
- Financial development boosts the growth of small firms disproportionately more.

In the presence of credit constraints, the biggest firms may not be run by the best entrepreneurs, but rather by the wealthy, which has adverse implications for economic efficiency and income inequality. Thus, a CGE model developed by Caselli and Gennaoli in 2002 shows that efficiency costs of this misallocation of talent leads to large productivity losses and can explain as much as 50% of cross-country differences in total factor productivity.

Microfinance — specialized institutions that serve the poor — seeks to overcome the obstacles keeping the poor from accessing finance. Yet while microfinance programs increase access to financial services to those participating in the program, they are very costly to operate and typically require extensive subsidies. Moreover, in developing countries it is not only the poor, but also the middle class who lack access to financial services. Hence, the attention of the development community is currently shifting to improving access for all underserved groups. Focusing on broader access more generally is likely to have higher pay-offs in terms of poverty reduction.

### Conclusions

Clearly, lack of access to finance is especially binding on the talented poor and the micro and small enterprises that

lack collateral and credit histories. Without access, poor individuals and small enterprises need to rely on their personal wealth or internal resources to invest in their education, become entrepreneurs or take advantage of promising growth opportunities.

Existing evidence on financial development, inequality and poverty is encouraging. However, most of the macroeconomic literature uses financial depth measures instead of indicators that would capture broad access, and microeconomic studies use financial wealth to proxy for credit constraints. Better measurement and evaluation of impact can help research make progress in understanding which financial services are important in promoting growth and poverty reduction. These results will in turn influence the design of policy measures and financial sector reforms to broaden access.

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## Financial Indicators for Selected Countries in Europe and Central Asia, 2005 (including the regional comparator)

	Banking Sector – Size Index	Banking Sector – Efficiency Index	Banking Sector – Stability Index	Equity Market – Size Index	Bond Market – Size Index
Czech Republic	5.275	4.265	4.426	n/a	4.916
Estonia	5.265	6.092	3.981	n/a	n/a
Georgia	4.314	3.990	4.499	n/a	n/a
Hungary	5.418	5.545	4.633	n/a	6.430
Kazakhstan	4.907	5.593	2.887	4.758	n/a
Poland	4.970	5.343	5.358	5.075	4.658
Romania	3.581	3.613	5.111	4.805	n/a
Russia	4.848	5.351	4.380	6.174	3.890
Slovak Republic	5.091	4.855	5.454	4.605	n/a
Ukraine	5.028	5.352	2.344	4.707	n/a
Turkey	4.350	5.198	5.378	6.308	5.008
<b>Europe and Central Asia</b>	<b>5.989</b>	<b>4.990</b>	<b>4.622</b>	<b>6.081</b>	<b>6.615</b>

*Index values range from 0-10, with a higher score indicating greater sophistication.*

*The full descriptions of indicators comprising each index can be found at [www.financial-indicators.org](http://www.financial-indicators.org).*

*Source: The World Bank Group*

# Risk Taking by Banks in Transition Countries

Banks in transition countries have learned how to manage their risks by now

*Paul Wachtel and Rainer Haselmann*

At the start of the 21st century banks in transition countries look very much like banks elsewhere. They are by no means problem-free but they are struggling with the same issues as banks in other emerging market countries.

What is the current risk behavior of banks in transition countries and how is it affected by the environment? As known, the institutional environment differs considerably among these countries. The new EU members have been obliged to establish creditor rights and ensure proper law enforcement, while many of the other countries have not been exposed to the same external pressures for reform, and their institutions offer, on average, less protection for lenders.

Using information from the EBRD's 2005 BEPS survey of bank managers in 20 transition countries and balance sheet and income data prepared by BankScope, we examine the relationship between the quality of institutional environment and risk-taking by banks. As there is no ideal single measure of risk, we relate various measures of bank risk — solvency, liquidity, default probability and credit risk among others — to the size, location, ownership, institutional settings and management characteristics of banks.

## No Excessive Risk Takers

We find that there are some noticeable differences in balance sheet characteristics among bank ownership groups and across regions. State-owned banks have more capital, larger loan loss reserves and more short term loans than the others. Domestic banks make less use of contingent liabilities and are less liquid, while foreign banks maintain less equity than the others. EU banks have smaller solvency ratios and loan loss reserves but they maintain more liquid assets. Finally, there is clearly an inverse relationship between the solvency ratio and bank size or market share. Also, very large banks and those with shares over 10% make fewer short term loans than others.

The estimated default probability is lower among EU banks, foreign banks and large banks (both in terms of size and share). Nevertheless, these differences are not large. The credit risk measure varies somewhat with bank size and is higher for small banks, since these banks generally provide a larger fraction of lending for small and medium-sized companies. Government-owned, small banks, and banks in South Eastern Europe have a considerably higher capi-

*Under bad institutional settings, banks lend less to households and small firms*

tal to risk adjusted asset ratio than their competitors, which might well reflect a desire to signal their creditworthiness.

Our findings suggest that banking markets are relatively homogenous and no clear groups of banks with excessive risk taking can be identified.

## No Link between the Level of Risk and the Environment

If size, location and ownership do not matter that much, could a bank's taste for risk depend instead on its perceptions of the banking environment?

Interestingly, we find no clear pattern between estimated default probability and the institutional environment. When bankers have better perceptions of the quality of law and when the laws are objectively better, the default probability is higher. This suggests that bankers are willing to take on risky lending when the legal environment for dealing with bad loans is better. However, better perceptions of the courts and better law enforcement are associated with lower default probabilities.

Overall, evidence for a relationship between banks' risk and their institutional environment is not very strong, yet there is one exception. Banks that have access to a credit registry clearly show a lower probability of default. Overall, this does not mean that the institutional set-

ting is unrelated to banking risk. One reason for our finding could be the specific nature of banking risk. Bank lending involves uncertainty and an efficiently functioning bank needs to take on risks. Under bad institutional settings, banks are less active lenders and mostly lend to borrowers about whom they can easily obtain information, such as large enterprises and the government. Such lending is, however, less risky than lending to more opaque borrowers, like households

and SMEs. This could explain why we do not find a clear pattern between a solid institutional environment and banks' probability of default.

Nevertheless, all our indicators, no matter whether they are based on subjective surveys or bankers' own perceptions, show that banks operating in a poor environment tend to keep a higher capital risk adjusted assets and solvency ratio, thus adapting to their environment by adjusting their capital. Furthermore, banks that take on more risk also actively manage that risk by creating a risk management department or obtaining credit histories from their borrowers. Such banks also tend to hold more capital. This implies that banks are aware about the level of risk they take on.

Thus, we conclude that banks in transition countries have learned how to manage their risks by now and basically operate and manage risk as banks in other developed markets.

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*Paul Wachtel is Professor of Economics at Stern School of Business, New York University; Rainer Haselmann is Chair of Economics at University of Mainz. Full text of the paper is forthcoming in Comparative Economic Studies, 2007, and is available at SSRN: <http://ssrn.com/abstract=990018>. The authors appreciate financial support for this work from the Japan Europe Cooperation Fund and EBRD.*

**BT**

# Foreign Bank Participation and Crises in Developing Countries

In countries that suffered a banking crisis foreign participation increased by 7.5 to 11.3 percentage points

Robert Cull and Maria Soledad Martinez Peria

Since the mid 1990s, due to a growing trend across countries towards globalization and financial integration, banking sectors in many developing countries have experienced some important transformations. Key among them has been a rapid increase in the degree of foreign bank participation. Between 1995 and 2002, the average share of banking sector assets held by foreign banks in 104 developing countries rose from 18% to 33%.

What are the causes and implications of foreign bank presence in developing countries and its links with banking crises? We explore these issues using data on the share of banking sector assets owned by foreign banks in 104 developing countries, with a special emphasis below on Eastern European and Central Asian countries (ECA).

Between 1995 and 2002, foreign bank participation increased primarily in Eastern Europe and Central Asia, Latin America, and Sub-Saharan Africa (see Figure). By 2002, close to 40% of assets in all three regions were in the hands of foreign banks. At the same time, both the absolute and relative increase in the share of assets held by foreign banks have been most significant in ECA, where it roughly tripled from almost

13% in 1995 to 39% in 2002. Latin American countries followed, with foreign bank participation nearly doubling in 2002 compared to 1995.

The entry of most foreign banks in ECA countries resulted from the privatization of state-owned banks following the fall of communism. The largest five foreign banks with operations in the region are Belgian KBC Bank, Austrian Erste Bank and HVB Group, French Societe Generale and Italian Unicredito Italiano. There are some regional specificities: large Scandinavian banks have the markets of the Baltic States, Greek banks are present in the Balkan countries, while Austrian banks control large shares of banking assets in most of the countries, except for the Baltic States.

The increase in foreign bank participation over the last decade was also quite pervasive. Out of 25 countries in ECA, the share of assets held by foreign banks increased in 22 of them (see Table). The increase was particularly spectacular in Lithuania and Slovakia, where the share of assets controlled by foreign banks rose by over 70 percentage points. Relative to the starting levels of foreign bank presence, Romania also experienced a significant increase in foreign bank participation, while in countries such as Azerbaijan, Serbia, Uzbekistan, and Turkey, it remained insignificant.

while in countries such as Azerbaijan, Serbia, Uzbekistan, and Turkey, it remained insignificant.

## The Catalytic Role of Crises?

Banking crises are a fact of life in developing economies. Since the mid-1990s, 77 episodes of crises have taken place in 72 developing countries, including in 21

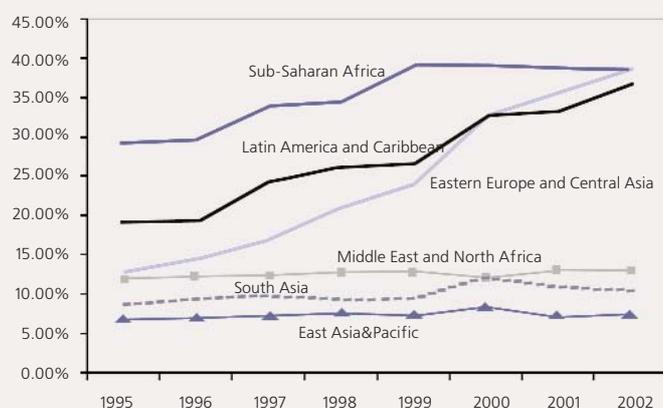
ECA countries. Crises represent enormous challenges to policy-makers. The costs of dealing with crises, such as paying for deposit losses, recapitalizing banks, and building banking systems that are more resilient to shocks, can be very large. For example, in Turkey they amounted to 30% of GDP (in 2000-2003) and in Indonesia were as high as 55% of GDP (in 1997-2000). Moreover, most crises have macroeconomic roots and take place in environments where governments have already difficult fiscal situations. The average budget deficits to GDP three years before and three years after crises in ECA were -3.94% and -4.18%, respectively. Running budget deficits before the start of crises would hamper the governments' ability to deal with the cost of these events subsequently.

Yet, crises also represent opportunities for developing countries since they prompt governments to think differently and creatively about the problems they confront. In many developing countries, crises have encouraged governments to deregulate their banking sectors and to allow the entry of foreign banks. A measure of banking sector restrictions produced by the Heritage Foundation shows that with the exception of Asia, countries that have experienced crises tended to be more open subsequently than countries that never experienced a crisis.

Many studies have discussed the catalytic role that crises can play in promoting foreign bank participation in developing countries. Indeed, our estimations show that countries that had at least one banking crisis from 1995 to 2002 tended to have more foreign bank participation than those that did not. Our estimations show that foreign participation increased by 7.5 to 11.3 percentage points between 1995 and 2002 for countries that suffered a banking crisis.

Our results indicate that foreign banks did not reduce their participation in crisis years, moreover, there was a steep increase in foreign participation after crises had passed. This implies that foreign banks

Foreign Bank Participation across Regions, 1995–2002



Data source: Micco, Panizza, and Yanez

### Foreign Bank Participation in Selected ECA Countries, 1995 and 2002

	1995	2002
<b>Europe &amp; Central Asia</b>	<b>13.0%</b>	<b>35.7%</b>
Bulgaria	8.2%	51.7%
Croatia	9.8%	42.1%
Czech Republic	14.2%	58.7%
Estonia	80.7%	72.7%
Hungary	22.4%	58.7%
Kazakhstan	12.6%	20.0%
Latvia	17.8%	38.8%
Lithuania	18.9%	91.3%
Macedonia, FYR	28.4%	41.8%
Poland	3.7%	49.3%
Romania	0.0%	26.5%
Russia	2.0%	15.6%
Slovak Republic	8.7%	81.5%
Slovenia	6.8%	25.8%
Ukraine	0.0%	6.8%

Source: Micco, Panizza, and Yanez (2006)

Note: Table shows the share of assets (% of total banking sector assets) held by foreign banks

could be acquiring cheap —most probably distressed — domestic banking assets as a result of crises, which could be viewed as beneficial by regulators.

### Lower Private Credit Levels

Did greater participation of foreign banks coincide with increased provision of credit to the private sector? We find that in the aftermath of crises, high foreign bank participation levels are associated with lower private credit levels. Does this imply that foreign banks pull back from lending as a result of crisis? This is not necessarily the case because, as noted above, it could be that foreign banks are acquiring distressed banks with relatively weak loan portfolios. Many of those loans are written off in restructuring exercises prior to the sale of banks to foreign investors, and thus the reduction in private credit is a mechanical accounting exercise rather than a reflection of slow post-crisis credit growth.

We cannot, however, rule out the possibility that new entrants are simply poor intermediaries for the private sector. In environments where foreign banks are better established, there is no such reduction, and private credit is at higher levels before, during, and after crises. Our results support the idea that, in the aftermath of crises, better established foreign banks provide more credit to the private sector than recent foreign entrants, which have acquired distressed banks. One might also expect that the competitive pressure stemming from stable foreign participation would enhance banking sector efficiency.

*Robert Cull and Maria Soledad Martinez Peria are Senior Economists at Finance and Private Sector Development Research Group, the World Bank, Washington, DC. Full text of their paper can be viewed at: <http://go.worldbank.org/2DQT70LK00> (WPS No. 4128).*

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## Financial Sector Development in South Eastern Europe

In transition countries in general and in South Eastern Europe (SEE) in particular, financial markets are substantially smaller than in established market economies, as measured by the financial intermediation ratio. Nevertheless, if regulations were appropriately set, effects on growth could be expected. We examine whether the development of financial markets has played a significant role for real GDP per capita growth in four SEE countries — Bulgaria, Croatia, Romania and Turkey — during 1995-2005, using a production function approach. The influence of the financial sector on the economy can be measured via total domestic financial intermediation (TFI), defined as the sum of domestic or private credit, market capitalization of domestic shares and outstanding domestic bonds.

Compared to neighboring Greece, the level of financial intermediation is still low in the four countries, with the highest level achieved by Croatia (see Table). Stock market capitalization contributes very little to financial intermediation in all countries.

The results of our estimations show that the potential contribution of the financial sector to economic growth in the four countries has not been fully used. As TFI showed rather

negative effects in the short term and with lags was only mildly positive, we suggest that the different financial segments play different roles at the stage of development that these SEE countries are in. Domestic bonds stand out as maybe playing an important role in economic development for the SEE countries over the last ten years, whereas private credit and the stock market had no significant influence on growth.

The fact that government issues dominate bond markets is a salient structural feature of these markets. As previous research indicated, governments may play an important role in developing financial markets at an earlier stage of a country's development, when capital is scarce.

The insignificance of private credit might be due to the high level of bad loans to the private sector, while for the stock markets this is most probably due to their underdevelopment; both suffered from a prolonged weak legal environment during the transition years.

As for non-financial intermediation variables, only capital stock growth proved to be significant and positively related to economic growth. This could be explained by the large capital scarcity in transition countries. These capital flows stem mainly from FDI, with foreign bank entry playing a major role, and also some portfolio investment.

### Financial Intermediation 2005, in % of GDP

	Domestic credit	Private credit	Stock market	Bonds	TFI
<b>Bulgaria</b>	43.62	44.49	5.12	22.21	71.82
<b>Croatia</b>	73.54	60.80	35.25	55.36	151.40
<b>Romania</b>	19.29	11.50	19.82	9.12	40.44
<b>Turkey</b>	56.55	26.15	44.60	50.77	121.52
<b>Greece</b>	113.65	84.84	67.97	99.48	252.30

Source: IFS, BIS, BSE, World Federation of Exchange, SSE

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# Sophisticated Discipline in a Nascent Deposit Market

Increases in real interest rates by poorly capitalized banks result in fewer deposits

Alexei Karas, William Pyle, and Koen Schoors

Depositors may penalize banks for undertaking excessive risks, performing poorly or otherwise jeopardizing the value of their assets. By withdrawing funds or requiring deposit rate premiums from less stable institutions, the depositors' actions have the potential to increase allocation efficiency and mitigate moral hazard. But this discipline only materializes if depositors possess both the willingness and ability to monitor their banks.

When depositors are experienced and mechanisms for disseminating financial information are reliable, this is not as much of a concern. However, in settings in which these features are under-developed, such as in Russia, the ability to discipline banks has been open to question.

## Short History of Liberalized Deposit Markets

Russians' experience with liberalized deposit markets has been brief. In the early 1990s hundreds of private commercial banks entered its new, largely unregulated, deposit market. At that time bank deposits, particularly those of households, were held almost exclusively by the state savings bank. But lax entry policies contributed to the quick development of a competitive market for deposits. By early 1994, on the back of heavy advertising and relatively high interest rates, private banks had captured over half of the household deposit market. The era's mix of liberalized deposit rates, naive depositors and over-burdened regulators proved dangerous. A system-wide liquidity crisis in 1995 led to bankruptcies of some of the country's largest private retail banks. Their failures followed by only a year the collapse of several high-profile pyramid schemes, the largest of which contributed to the loss of savings of up to ten million Russians.

The image problem of private banks was furthered by the macroeconomic crisis of 1998, when the Russian government devalued the ruble and defaulted on its

bond obligations. Because of their exposure to hard currency liabilities and ruble-denominated assets, including government securities, a number of banks were driven into insolvency. Again, many of the largest players on the retail market proved unable (or in some cases, unwilling) to meet their obligations to depositors.

## Developed Capacity to Discipline

Drawing on a database from the pre-deposit-insurance stage of Russia's transition, we investigate depositors' ability to monitor and discipline private, domestic banks. Our data allow us to distinguish depositors by legal status — i.e., non-bank firms, banks or households — which may convey information about willingness and ability to impose discipline. Relative to households, for instance, firms might either have better access to or more appreciation for the financial information released by banks. Inter-bank deposits may be less sensitive to risk than the deposits of households or firms, since a relatively high percentage may represent stocks of short maturity, whose value is less threatened by the risk of institutional failure.

The results of our estimations show that even though the deposit market in Russia is young and the supporting institutional and informational infrastructure is relatively immature, the country's depositors have developed the capacity to identify and discipline weaker banks. Banks' net deposit inflows, specifically, are highly sensitive to bank capitalization, liquidity and changes in loan quality, particularly after the 1998 crisis.

Yet, our evidence for price discipline — when depositors "demand" higher deposit rates from less stable institutions — is weak. The absence of price discipline may, however, be interpreted as a subtler, more sophisticated form of discipline exhibited by depositors if they view the deposit rate as a signal of bank stability. So viewed, banks cannot necessarily

expect to increase the net inflow of deposits by raising deposit rates. More than just compensating for observable risk, raising rates may carry the suggestion of additional — unobserved — bank risk.

Our estimations indeed show that after a certain point, increases in real interest rates produce negative returns with respect to deposit attraction. This effect is particularly pronounced for poorly capitalized banks.

If depositors are confident in a bank's ability to meet deposit withdrawals, on the basis of its capital-assets ratio, they are more apt to view its rate increases as coincident with increases in the expected return on their deposits, and increase their supply of deposits accordingly. But a bank, which has already given depositors reason for suspicion due to its lower capitalization, does not have the same ability to translate the rate increase into a corresponding inflow of deposits.

Bank size has little effect on the results: both large and small banks are subject to depositors' sophisticated discipline, with large banks enjoying a higher switching point (11% vs. 5% for smaller banks), above which increases in real interest rates produce negative returns.

## Conclusion

Russian depositors were effectively forced to become relatively quick learners and sophisticated discipliners during the 1990s. However, as Russia moves forward with the introduction of widespread deposit insurance, it will face real costs in terms of reduced market discipline and subsequent moral hazard incentives.

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*William Pyle is Associate Professor of Economics at Middlebury College, US; Koen Schoors is Professor of Economics at Ghent University, Belgium; Alexei Karas is a Ph.D. student at the Department of Economics, Ghent University, Belgium. Full text of the authors' paper is available at: <http://ssrn.com/abstract=965452>. BT*

# Bank Efficiency and Market Structure in Armenia

Consolidation of the banking sector may be important for realizing economies of scale

*Era Dabla-Norris and Holger Floerkemeier*

As in other transition countries, the structure of Armenia's banking system has undergone significant changes over the past decade. Bank restructuring and privatization has been accompanied by consolidation, the market entry of foreign banks, an overhaul of the legal framework, and the strengthening of prudential regulation and supervision. As a result, the number of banks has fallen from 74 in 1994 to 21 currently. All banks are now privately owned. Foreign participation in the banking system increased following the removal of limits on foreign ownership, and foreign banks now account for 60% and 70% of loans and deposits, respectively. However, with one key exception, foreign investors are mainly from other CIS countries and Armenian diaspora individuals.

Despite reforms and prolonged macroeconomic stability and economic growth, financial intermediation remains low by regional standards (see Figure). At the same time, interest rate spreads have remained persistently high and well above those in most transition countries, averaging over 12% since 2003.

High interest rate spreads are an impediment to financial intermediation, as they discourage potential savers with low returns on deposits and increase financing costs for borrowers, thus reducing investment and growth opportunities.

## Foreign Bank Entry Has Not Resulted in Lower Spreads

Using a panel dataset of 20 commercial banks, we analyze the determinants of Armenian banking sector efficiency; specifically, the role of bank characteristics, market structure, and macroeconomic factors in determining spreads and interest margins. Our results show that:

- *Interest spreads* are influenced by bank size, the extent of market power, overall market concentration, return on assets, liquidity, and loan portfolios, in particular the share of agricultural and consumer loans.

- *Net interest margins*, by contrast, are negatively associated with deposit market shares, possibly indicating aggressive pricing strategies of individual banks to gain market share. Furthermore, margins are decreasing in banks' capital adequacy, and increasing in the return on assets.

- *Macroeconomic factors* have a negligible impact on interest spreads.

- In contrast to the experience of other transition and developing countries, *the presence of foreign banks* has not yet directly contributed to lowering spreads and margins. However, foreign bank origin matters for banking efficiency, with the presence of the first-tier western bank having a spill-over effect in lowering

rationalization, for example through mergers and acquisitions and/or the entry of first-tier international banks, can help to reduce lending rates and spreads. Consolidation of the banking sector should, however, proceed through a market-driven process rather than through regulatory measures, such as further increases in minimum capital requirements, which are already high in relation to the size of the banking system.

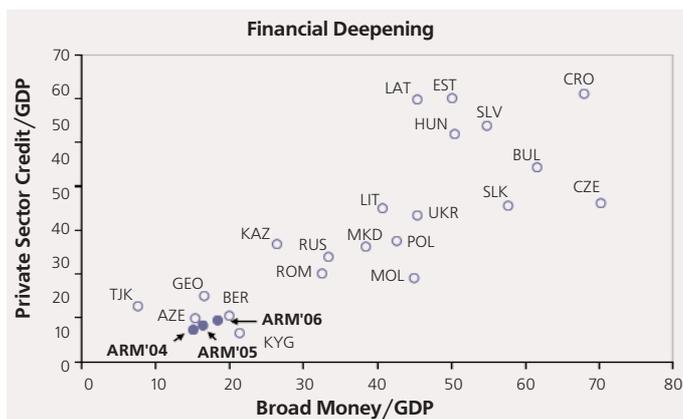
Another factor that would help to create a more competitive banking market and decrease market segmentation is improvement of information about borrowers for banks, and about banks for depositors. The introduction of a credit registry in 2003 and the establishment of a private credit bureau in 2007 have been important steps towards improving information sharing on the creditworthiness of borrowers. It will increase borrower discipline by reducing moral hazard, and mitigate the information monopoly that banks have over their existing clients, thus reducing bank switching costs.

At the same time, increased public information about banks as well as bank ratings by international rating companies could contribute to improving market transparency, the functioning of market forces, and depositor confidence. Banks should improve provision of information about current bank services and pricing, and regulations should require banks to regularly disseminate relevant market information. The Central Bank of Armenia could also publish regular non-market sensitive reports on banking supervision.

## Sector Consolidation Beneficial

Our empirical findings highlight the importance of bank size for realizing economies of scale. In this respect, a competition policy that fosters bank growth and cost

Regional Comparison: Financial Deepening, 2005



*Era Dabla-Norris is a Senior Economist, and Holger Floerkemeier is an Economist at the IMF, Washington, DC. The views expressed in this paper are those of the authors and should not be attributed to the IMF, its Executive Board, or its management. Full text of the authors' paper can be accessed at: <http://www.imf.org/external/pubs/cat/longres.cfm?sk=20981.0>*

# Financing Economic Growth in Georgia

Georgia is witnessing a credit boom, which could bring about sustained financial deepening

Andreas Billmeier and Shuang Ding

Georgia's output contracted sharply at the beginning of the transition period. Since 2001, however, economic development has accelerated and policies aimed at macroeconomic stability have allowed the economy to grow at almost 7% per year in an environment of modest inflation. After the Rose Revolution in 2003, economic reform gained fresh momentum, focusing on strengthening the country's fiscal position, addressing constraints in infrastructure, and improving the business climate.

However, until recently the economic expansion has not been accompanied by significant financial sector deepening. Monetization remains below 20% of GDP, and the financial sector remains small in comparison with more advanced transition economies (see Table).

The sector is dominated by the banking system, while the stock market remains small. There are currently 18 banks — all private, of which two are wholly foreign-owned banks. Despite the sharp decrease in the number of banks from the peak of 229 in 1994 — partly due to the new minimum capital requirement — the country is still considered to have too many banks relative to the size of the population and the economy.

The banking system is generally sound, but the interest rate spread remains high (at about 10% in 2005), which is mainly due to high operating costs, high reserve requirements, and perceived credit risk.

## Why Lagging Behind?

Our analysis concludes that financial intermediation in recent years has been impeded by:

- A difficult macroeconomic environment during the 1990s — characterized by periods of economic contraction, hyperinflation, and sharp exchange rate movements — has damaged public trust in the *lari* and retarded the pace of remonetization of the economy, limiting the size of commercial banks' balance sheets.
- The lack of loanable funds, as a large portion of the money is held in cash outside the banking system. Besides, the high reserve requirement implies that only 90% of the funds attracted by the banks are available for extending loans;
- Low demand for credit, until recently, owing mainly to the lack of profitable investment opportunities and high interest rates;
- Weak institutions, e.g. weak creditor rights, an inefficient judicial system, limited information about firms' performance, and lack of expertise in evaluating risk, which limits bank lending;
- Certain financial regulations, such as the ceiling on equity stakes in domestic banks by non-industry investors, and the current capital adequacy requirements;
- Market structure with many small and financially weak banks.

## Prepared to Catch Up?

Georgia has started to witness a credit boom — albeit from a very low level. During 2005, private sector credit increased to 15% of GDP from about 10% in 2004. The credit boom — accompanied by longer loan maturities, lower lending rates, de-dollarization, and simplification of loan applications — could bring about a period of sustained financial deepening, crucial for financing economic development.

The main contributors to the credit boom are the favorable economic conditions, an improved business environment, the awakening of an "entrepreneurial spirit", and — from the consumer side — an increased

demand for durables and real estate following the increase in income levels.

To promote sound financial intermediation over time, the authorities have already set in motion some of the required processes, such as:

- Setting up the credit information bureau;
- Seeking sovereign credit ratings from renowned rating agencies to improve access to external financing;
- Introducing a deposit insurance scheme to increase public trust in banks;
- Introducing legislation to eliminate the restrictions on bank ownership;
- Introducing new capital requirements to further reduce the number of small banks with weaker ratings.

However, more needs to be done to address the fundamental issues. The following measures are worth considering:

- Strengthening institutions and infrastructure, such as better protecting creditor rights, expediting court procedures and promoting international accounting and auditing standards and disclosure requirements;
- Consolidating further the banking sector to achieve economies of scale;
- Encouraging foreign entry, which can bring in much-needed capital, financial know-how, sound corporate governance practices, more competition;
- Streamlining regulations, while striking a delicate balance between safeguarding the integrity of the financial system and avoiding over-regulation.

In the meantime, the authorities need to be wary of the risks associated with rapid financial expansion and be prepared to deal with the fallout of the credit boom. Supervisory capacity should be strengthened to deal with a much larger and more complicated loan portfolio.

*Andreas Billmeier and Shuang Ding are economists at the IMF, Washington, DC. The views expressed here are those of the authors at the time of writing (March 2006) and should not be attributed to the IMF, its Executive Board, or its management. The full text of the paper can be accessed at: <http://www.imf.org/external/pubs/cat/longres.cfm?sk=19216.0>*

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Financial Sector Development, 1996 & 2005 (% of GDP)

	Banking system credit to economy		Monetization	
	1996	2005	1996	2005
<b>Georgia</b>	<b>3.3</b>	<b>15.0</b>	<b>6.7</b>	<b>16.5</b>
Kazakhstan	5.1	38.6	9.5	30.3
Poland, Czech Rep., Hungary (average)	36.5	39.0	49.7	55.4
Baltic states (average)	11.8	54.1	21.6	47.6

# Whither the Gains from Capital Market Reforms?

The reforms are associated with increases in stock market capitalization, trading, and capital raising

*Augusto de la Torre, Juan Carlos Gozzi, Sergio L. Schmukler*

Over the last two decades, a large number of countries, both developed and developing, have implemented significant capital market reforms, including stock market liberalization, improvements in securities clearance and settlements systems, and the development of regulatory and supervisory frameworks. These reforms, together with improved macroeconomic fundamentals and related reforms, such as privatization and pension reforms, were expected to foster domestic financial development.

Despite the intense reform efforts, the performance of local capital markets in many developing countries has been disappointing. Although some stock markets grew, the growth was not as significant as the one witnessed by the most advanced nations. Other countries experienced an actual deterioration of their domestic capital markets. Stock markets in many developing countries remain highly illiquid and segmented, with trading and capitalization concentrated on few stocks.

## Do Capital Markets Respond to Reforms?

We analyze how reforms have impacted on both the development of domestic stock markets and the internationalization of stock market activities (listing, trading, and capital raising). The reforms we study include:

- *Stock market liberalization*, whereby a government allows foreign investors to purchase shares in the local stock market and domestic investors to purchase shares abroad. This increases the pool of capital available to local firms, broadens the investor base, and reduces the cost of capital. The scrutiny by foreign investors may increase transparency and promote the adoption of better corporate governance practices.

- *Enforcement of insider trading laws*. For example, many countries introduced new standards in voting rights, tender procedures, and the structure of the board of directors. Some countries also enacted new insider trading regula-

tions and improved accounting and disclosure standards.

- *Introduction of fully automated electronic trading systems* to replace traditional trading floors. These systems may increase liquidity and improve efficiency by reducing transaction costs, increasing information availability, and providing affordable remote access to investors.

- *Privatization programs*, which have had a direct impact on domestic stock markets, as many governments carried out privatization sales through share offerings on local exchanges, as well as on internationalization, as many privatization sales involved offerings in international financial markets.

*After the liberalization, the stock market capitalization over GDP is 14.2 percentage points higher than before the reforms*

- *Structural pension reform*, i.e., shifting from a public defined benefit pay-as-you-go system to a privately managed funded defined contribution system. These reforms were expected to improve macroeconomic stability by reducing the demographic pressures of pay-as-you-go systems, inducing fiscal reform, reducing labor market distortions, increasing savings, and promoting capital market development.

- *Institutional reforms* in five major areas: government size, legal structure and security of property rights, access to sound money, freedom to trade internationally, and regulation of credit, labor, and business.

In the analysis we use three measures of domestic and international stock market activity: market capitalization, value traded, and amount of equity capital raised.

## Reforms are Effective

Our estimations show that all the reforms are followed by increased domestic stock market development and internationalization. In the case of stock market liberalization, for example, the difference between the pre-liberalization

and post-liberalization periods in a country's stock market capitalization over GDP is 14.2 percentage points. Similar results are found for value traded domestically and capital raised domestically. All the reforms, with the exception of stock market liberalization, seem to be followed by increased trading activity in the local market. In the case of capital raised, only pension reform is not significant.

This suggests that reforms make local firms more attractive to foreign investors, who then grant them access to international markets at attractive terms.

Are the reforms followed by similar increases in domestic and international activity? Our results suggest that all the

reforms, with the exception of privatization and the introduction of electronic trading systems, seem to be followed by large increases in the share of trading that takes place in international markets. This runs contrary to the view that a poor domestic environment prompts firms to access international markets and that reforms reduce internationalization.

Thus, contrary to the claim that the reforms are not effective, our findings confirm that reforms are associated with increases in domestic stock market capitalization, trading, and capital raising. However, reforms are also associated with increased internationalization, and a higher share of activity in international markets.

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*Augusto de la Torre is Chief Economist, Latin American and the Caribbean Region, the World Bank, Juan Carlos Gozzi is Ph.D. student at Brown University, and Sergio L. Schmukler is Lead Economist in the Development Research Group, the World Bank. The paper has been published in the Journal of Banking and Finance, 31:6, pp. 1731-1754, 2007. For more information on the entire project, please visit: [www.worldbank.org/laccapitalmarkets](http://www.worldbank.org/laccapitalmarkets).*

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# The Mutual Fund Industry in Russia: Beyond the Stage of Initial Growth

Poor financial education and a limited number of stocks are holding back the industry's development

Alexei Gorjaev

Russian mutual funds date back to 1996, but it was only in the 2000s, with the recovery of the Russian stock market from the 1998 crisis, that these funds were given a major boost. High returns on Russian stocks — on average, over 40% a year after 1998 — contributed to the rapid expansion of the industry. While in 2001 there were 35 management companies offering 55 funds, at the end of 2006 investors could choose from among 587 funds and 282 management companies. During the same period, the assets under management increased from US\$30 million to US\$16 billion, or 0.5% of Russian GDP (for comparison, in the US this ratio is about 70%). Thus, the mutual fund industry demonstrates an impressive rate of growth, but still accounts for only a small segment of the Russian financial market.

## What Restrains Growth?

What is holding back the development of the asset management industry in Russia? One reason is the poor state of financial education in the country. During Soviet times, knowledge about financial investment was considered to be part of a market economy that was irrelevant in a country where the state assumed major risks connected with wages and pensions.

A lack of organizational failures and impressive yields since 1998 helped to attract new private investors to mutual funds, yet even now they account for a mere 2% of Russia's population — its most dynamic and educated groups. Oddly enough, the numerous slumps in the Russian stock market have played a positive role disabusing investors of the notion that easy money can be made through mutual funds and making them more risk-conscious.

Another restraining factor is that the Russian equity market is not highly developed. In spite of the impressive dynamics, a limited number of stocks is regularly traded, with the bulk of liquidity coming from a few blue chips like Gazprom and RAO UES. Moreover, liquid stocks are concentrated in several sectors of the economy, mainly extraction industries. As a result, mutual funds can hardly form a truly diversified portfolio and their returns are largely determined by Russia's country risk and other factors that are hard to quantify. Until recently, legislation effectively banned Russian funds from including foreign assets and derivatives in their portfolios.

At the end of 2006 only 23% of the Russian mutual funds were of the open type; that is, marking their price to the market daily. The remaining funds invest a large part of their portfolio into second-tier stocks, real estate and other illiquid assets. The choice of strategies is also limited: large funds usually hold a portfolio close to the market index whereas small ones actively rebalance their portfolios trying to time the market. In recent years, we have seen many index and sector funds emerging, but

their portfolios may turn out to be very different from what their names suggest.

## Qualified Assessment Needed

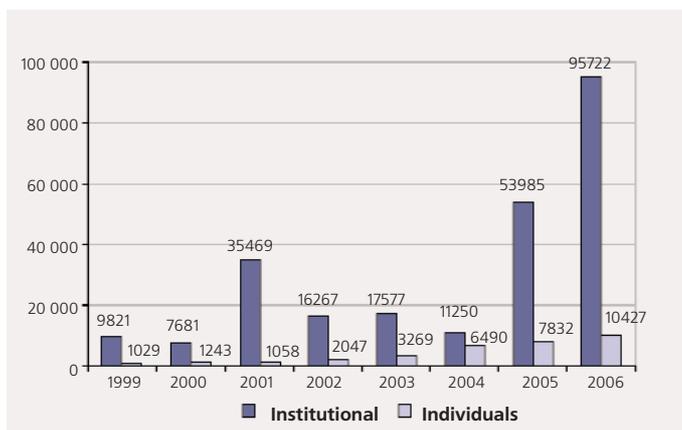
In the current environment, it is very important to have a qualified independent assessment of the performance of mutual funds, which would guide investors and give funds proper incentives for composing their portfolios. In the developed financial markets such assessment is provided by rating agencies, which divide funds into categories in line with their actual (not formally declared) investment strategy and rate them relative to other funds in the same category. A fund's performance should be adjusted for risk, since funds can easily outperform the market index with an aggressive strategy when the market is growing.

Unfortunately, until now Russia has had no fund rating system meeting these requirements. The mutual funds are usually divided into three broad categories: equity, bond and mixed funds, even though such a breakdown does not adequately reflect the investment risks. As a rule, funds are rated according to raw returns, or at best according to the Sharpe ratio (i.e. return per unit of total risk) or Jensen's alpha (i.e. the component of a fund's return unrelated to the market index). However, given the specifics of the Russian financial market, these measures do not always reflect the true added value that a fund provides to investors. A new classification and rating system is needed to evaluate the performance of Russian funds properly.

*Alexei Gorjaev is an Assistant Professor at New Economic School and Senior Researcher at CEFIR, Moscow. The article is based on the results of the author's research on mutual funds. The author has participated in the development of a new rating system of open-end mutual funds in Russia in collaboration with the National League of Managers and the Expert-RA Rating Agency.*

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Investors in Russian Mutual Funds



# Massive Delisting on the Prague Stock Exchange

Governments should be careful about which privatized companies to place on the stock exchange

Zuzana Fungacova

The Prague Stock Exchange (PSE), established in the early 1990s, was one of the first stock exchanges in the transition countries. Under the voucher privatization scheme, shares of all privatized companies were placed on the market by an administrative decision — thus, simply "thrown" at the market. In 1993, almost 1,000 share issues from the first wave of voucher privatization were traded on the PSE, and the number further increased following the second privatization wave in 1995. Lively trading on the PSE was the result of a liberal regulatory framework and a multiplicity of trading channels.

However, after the initial boom, the PSE experienced massive delisting, i.e. exclusion of a large proportion of the listed share issues from public trading, and virtually no initial public offerings. In 1997, 75% of shares were delisted from the PSE, mostly due to insufficient liquidity. At the same time, the number of domestic and foreign companies listed on the Warsaw and Budapest Stock Exchanges was growing.

Nevertheless, delisting in the Czech Republic was a necessary step, since companies that under standard conditions would be privately owned ended up as public after the voucher privatization.

## A Corrective Action?

Delisting may serve to correct wrong decisions made by privatization authorities and help make the market more transparent. However, it can also hurt minority investors, and coupled with few new listings may contribute to the shrinking size of the market, reducing investment opportunities in the home country.

Apart from the Czech Republic, massive delisting was also observed in other transition countries, which also had undertaken voucher privatization: namely, Bulgaria, Lithuania, and Slovakia. Although delisting has also occurred in developed economies, its magnitude has been much smaller in comparison to the market size than in transition countries.

## Determinants of Delisting

Our analysis of the delisting process in the Czech Republic, based on data on all firms privatized during both voucher privatization waves (1,664 medium and large non-financial companies), shows that factors crucial for delisting can be grouped as follows:

- *Pre-privatization characteristics* of the company: size, financial indicators, the industry it operates in and its willingness to report results;
- *Privatization-related factors*: timing of privatization (which wave), the ownership structure before and after privatization, especially the ownership share of the National Property Fund (NPF), and the average price of shares in privatization auctions;
- *Post-privatization factors*: development of the company's financial indicators and its growth opportunities.

## Possible to Identify Targets

The results of our estimation confirm that several factors could help to identify likely "delisting targets" even before the actual delisting took place. These include:

- The size of the company, with larger companies having a lower probability of delisting;
- Unwillingness to report financial results before privatization, which contributed to the increased probability of delisting;
- The proportion of shares held by the NPF, which indicated the state's future intentions towards the privatized company. An increase in the amount of shares owned by the NPF by 1% decreased the probability of delisting by 0.3%;
- The average price of shares in privatization auctions, with a higher price indicating greater expected future prospects and a lower probability of being delisted;
- The timing of privatization: the probability of delisting was 5.5% lower for companies privatized in the first privatization wave and 5.7% lower for

companies privatized in both waves, which confirms that more profitable firms were privatized first;

- The future prospects of a company, with higher growth opportunities indicating an increase in the probability of delisting.

Thus, not all of the privatized companies were suitable candidates for immediate placement on the stock exchange. Massive delisting could be prevented if the above factors had been taken into account. Moreover, companies not suitable for public trading, were not suitable for voucher privatization either.

The design and implementation of a voucher privatization program involving a large number of companies thus significantly influenced the emergence and the initial development of the stock market. Governments that decide on privatization programs should be very careful when choosing which companies to privatize, what methods to use and what criteria to apply to companies to be placed on the stock exchange.

If a proper filtering of companies had been done in the Czech Republic before placing newly privatized companies on the stock exchange, a more transparent and efficient stock market would have emerged after privatization. When comparing the Czech market to more gradually evolving stock markets in Poland and Hungary, one could conclude that massive delisting in the Czech Republic was one of the decisive factors causing the virtual lack of new listings on the PSE. In general our results indicate that in the case of emerging markets less seems to be more in the sense that it is better to start with fewer listed share issues, which fulfill standard listing requirements.

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*Zuzana Fungacova is Economist at the Bank of Finland. The paper was written at CERGE-EI, Prague, Czech Republic. Full text of the paper "Can the market fix a wrong administrative decision? Massive delisting on the Prague Stock Exchange" can be viewed at <http://www.cerge-ei.cz/pdf/wpl/Wp335.pdf>. BT*

# The Ukrainian Stock Market

Higher corporate governance standards could ease the liquidity problem of the stock exchange

*Valentin Zelenyuk*

The origins of the Ukrainian equity market date back to the privatization process in the early 1990s. The market stayed fairly underdeveloped for about a decade. It almost collapsed during the 1998 financial crisis, barely recovered after that and stagnated for another few years. However, it suddenly exploded in 2004, bringing more than 1000% to date. In July 2007, the Ukrainian stock market was ranked the best performing stock market in the world.

Most Ukrainians would be surprised to learn that there is more than one stock exchange in the country — there are actually a dozen licensed by the State Securities Exchange Commission, of

## *The Ukrainian stock market grew 1000% from 2004 to date*

which seven are located in Kyiv, and the rest are in the regions. The most dynamic of these is the First Securities Trading System (PFTS), which was founded in 1996 as an electronic over-the-counter (OTC) trading platform and then upgraded into a securities exchange in 2006. It now covers about 95% of the total trading volume of organized stock exchanges in Ukraine.

The Ukrainian equity market is often thought of as an emerging market, but in fact, by Standard & Poor's official classification, it is still a so-called "frontier market", which discourages many large pension and hedge funds from investing in it. On the other hand, when this status is upgraded, one can expect a large inflow of portfolio investments into Ukraine.

## **The Largest Frontier Market**

Currently, Ukraine's stock market capitalization is about US\$77 billion, making it the largest of Europe's frontier markets and even larger than some emerging markets, e.g. Hungary's. Yet it is almost four times smaller than that in Poland. It is also second biggest by market capitalization as a percentage of GDP, after Croatia, and similar to Poland. To Ukraine's advantage is the fact that a substantial number of the traded companies are fairly large by international standards, something that many Eastern

European countries lack. However, Ukraine's GDP is still fairly low. So, when measured by market capitalization per capita, Ukraine falls back to the second lowest place (US\$1,650), only ahead of Bulgaria (US\$529) and far behind Hungary and Poland (US\$4,900 and US\$7,600, respectively). Nevertheless, this suggests a great growth potential, especially when more Ukrainian companies go public and ordinary citizens start investing in the stock market.

Besides, the Ukrainian equity market is fairly diversified — especially in comparison to neighboring Russia. Indeed, while the majority of stocks are related to the iron and steel industry (the main

export of Ukraine) it is by no means a dominant sector on the PFTS (about 22%), with other sectors, such as banking (17%), power utilities (14%), oil and gas (11%), telecommunications (9%), pipes (6%), and engineering (5%) gradually expanding their presence.

## **Low Liquidity and Poor Corporate Governance**

Until recently, the market was characterized by poor corporate governance, with numerous examples of asset stripping and stock diluting. But things are changing rapidly and many companies are improving corporate governance and becoming more transparent. There have even been voluntary reversals of previous decisions, such as cancellations of earlier stock diluting. Most of these steps have been based on pragmatic considerations, as some companies are now striving to improve their image before going for IPOs on major international stock exchanges. Improvements in corporate governance practices were greatly appreciated by portfolio investors, and this pushed prices up sometimes by as much as 1000% since the beginning of 2007.

Low liquidity remains one of the main problems of the Ukrainian stock market, with an average volume on the PFTS amounting to only about US\$5.5

million per day in the first half of 2007. A small free float is another problem, which is also one of the reasons for the low liquidity. Even for some blue chips the free float does not exceed 2%.

## **Lucrative Opportunities**

There still exist several thousand companies where the state has a stake. Sooner or later, these will come to the market. Among the most lucrative state-owned assets is Ukrtelecom — the state monopoly in fixed-line telecommunication, whose market capitalization is estimated at about US\$4 billion.

About 60 Ukrainian equities can be purchased through ADR or GDRs, while about a dozen Ukrainian companies went further and carried out IPOs on international stock exchanges — most of them on AIM, the London Stock Exchange's market for smaller growing companies. Other companies have voiced similar plans, and 2008-2010 can become an era of massive Ukrainian IPOs abroad.

IPOs at major international stock exchanges require substantially higher standards of transparency which are hardly reachable for most Ukrainian companies at this point. This is one of the key reasons why most Ukrainian companies go for local listing — and this has helped the development of the local market. As Ukrainian companies get gradually accustomed to internationally accepted governance standards and go public internationally, the local stock market should also aspire to improve domestic standards in order to avoid becoming a market for junk stocks. Higher corporate governance standards, and increased transparency in particular, could also ease the liquidity problem on the Ukrainian stock exchange — by attracting more buyers to the market.

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# Political Credibility, Citizen Information and Financial Sector Development

Competitive elections and newspaper circulation have large effects on financial sector development

*Philip Keefer*

Governments prone to expropriation stifle growth on both sides of bank balance sheets: depositors are unwilling to risk their funds in expropriable bank accounts; bankers are unwilling to lend to those who might abscond with the funds under the protective umbrella of a sympathetic government; investors are unwilling to capitalize banks whose profitability is placed at risk by the prospect of government expropriation. Political economists have underlined the role of political checks and balances to ensure the credibility of government commitments not to expropriate actors in financial markets, while finance researchers have argued for the primacy of legal systems as guarantors of private rights.

We examine the role of political factors and the influence of a country's legal system origins on financial sector development using objective indicators for 66 to 117 countries (the sample size varies for different estimations) over the period 1975-2000. Specifically, we focus on:

- *The role of political checks and balances*, which serve as the source of credible commitments by governments with bankers and industrialists. The measure used in our test is how many political actors can block proposed legislation, i.e. whether formal institutions exist that can potentially constrain arbitrary behavior by the executive branch.

- *The role that political competition plays*, which can affect government incentives to cater to special interests at the expense of citizens at large. Here an index is used, which ranges from 1 (no elections held) to 7 (multiple parties competed for executive elections, with no one party getting more than 75% of the vote), with only the latter regarded as competitive elections.

- *The credibility of pre-electoral political promises and citizen information* about the actions of political decision makers. The measures include the continuous years of competitive elections and newspaper circulation, respectively.

- *The link between financial and the origins of the legal system* of a country. It has been argued that, in contrast to the French or socialist legal systems, the English common law tradition offered judicial protection of private property rights against predation by the state. The German and Scandinavian legal systems, though also in the civil law tradition adopted by the French, were consciously intended to be more amenable to change than the French.

*When citizens do not believe the promises of political competitors, financial sector development slows*

## Politics Has Large Effects

Our empirical investigation confirms that political checks and balances, and, to a lesser extent, competitive elections, have a significant influence on financial sector development (measured as total credit to the private sector). The magnitude of the effects is large: financial sector growth over the period 1975-2000 was two percentage points per year faster in countries with competitive elections in 1975 than in countries without. Results for political checks and balances are equally large.

This implies that although autocratic regimes may be able to reach credible bargains with bankers and industrialists sufficient to spur economic growth, such efforts are the exception rather than the rule.

Moreover, it is clear from our analysis that the effect of checks and balances impacts on the security of property rights, which is the sum of the risk of expropriation, the enforceability of contracts with government, corruption and bureaucratic quality.

The effects of politics on financial sector development extend beyond the formal institutions of competitive elections and political checks and balances. Both the continuous years of competitive elections and average newspaper circulation have large effects: a one standard

deviation increase in the initial number of continuous years of competitive elections is associated with an increase in the size of the financial sector in 2000 of as much as 25% of GDP. Results for newspaper circulation are still larger.

The results also underline the importance of a different kind of credibility for financial sector development. When average citizens do not believe the promises of political competitors to provide such public goods as secure property

rights or are unable to monitor the fulfillment of such promises, financial sector development slows.

## Legal Origins Substitute for Political and Historical Factors

Revisiting the debate about politics, legal origins and finance, we confirm the close relationship between legal origin and each of the political variables considered. Indeed, Scandinavian and German legal origins are associated with competitive elections and newspaper circulation. This certainly does not suggest that legal origins determine political systems, but rather that historical forces associated with colonial heritage drive both subsequent political development and the evolution of legal institutions. Legal origins are thus a good proxy for underlying historical and political factors that reflect the willingness of governments to favor broad over narrow interests in society. When this willingness is directly modeled, legal origins are no longer significant determinants of financial sector development.

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# Domestic Institutions and Financial Globalization

The stronger the country's property rights protection, the more likely it will benefit from capital mobility

Jiandong Ju and Shang-Jin Wei

Cross-border capital flows have been increasing in real value at a pace of about 6% a year since 1980, faster than those of the world's GDP and trade. The progress has been particularly rapid since 1990 (though with a temporary dip during 1997-2002). This reflects falling barriers to capital flows in many parts of the world. Yet, the composition of these flows varies across countries. Many developing countries are net importers of foreign direct investment (FDI) on the one hand, but net exporters of financial capital on the other, while many developed countries do the reverse.

Consider the example of China. Its large and growing current account surplus implies that it is exporting capital on net to the rest of the world, especially to the US. At the same time, it is a top recipient of FDI in the world. While traditional explanations for its large inward FDI center on China's cheap labor and large market, MIT political scientist Yasheng Huang suggested a novel hypothesis: the large volume of inward FDI is a reflection of China's inability to allocate its household savings efficiently through its financial sector, rather than its economic strength. FDI effectively serves as a tool for Chinese private firms to circumvent the inefficient domestic financial sector.

Two-way capital flows are certainly not unique to China. In 2004, a typical

emerging market economy imported US\$1,671 of net cumulative FDI per person, but exported US\$5,556 of net cumulative financial capital per person (see Table).

Using a simple theoretical framework we study the relationship between domestic institutions and patterns of international capital flows. Our model shows that two-way capital flows are a natural consequence of cross-country differences in the quality of financial systems and the strength of corporate governance. In other words, financial globalization allows inefficient domestic financial system and weak corporate governance to be bypassed through a combination of inward FDI and the outward flow of financial capital.

Our model also defines a notion of "effective capital abundance", whereby a country has either a high ratio of physical capital to labor or weak property rights. By reducing the profitability of investment, weak property rights protection discourages inward FDI and encourages the outflow of savings.

## Improving Domestic Institutions Should Be a Priority

Our model makes a surprising prediction: in a world free of any barriers to international capital flows, financial capital and FDI not only move in the opposite directions but also reinforce each other in a way that would lead to a complete bypass of inferior financial institutions and corporate governance. In a sense, the removal of barriers to capital mobility and reforms of domestic financial systems are substitutes. While the extreme proposition of a complete bypass effect may not be realistic, an open capital account may

partially make up for the shortcomings of a domestic financial system and corporate governance.

Our analysis points to the benefits and costs of capital account liberalization, which depend on a country's quality of financial institutions:

- From a world perspective, as inferior financial institutions are bypassed, savings in all countries are served by the best financial system, and capital is efficiently allocated across all countries. The world's welfare improves.

- A country with a strong financial system also gains: not only its domestic savings will receive a higher return, but also its financial institutions and entrepreneurs will reap greater reward.

- For a country with an inferior corporate governance/financial system the welfare effect is not clear-cut as it involves a trade-off between an efficiency gain from free capital mobility on the one hand and a revenue loss by its financial institution and local entrepreneurs on the other. The stronger the country's property rights protection, the more likely it would benefit from capital mobility.

It is often observed that many developing countries are wary about full capital account liberalization whereas the U.S. and other advanced countries are typically enthusiastic about advocating or even pushing for such liberalization around the world. Our study provides a way to understand this pattern. It suggests further that developing countries could improve the benefit/cost calculus of financial globalization for themselves if they make an effort to improve domestic institutions first.

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**Capital Flows in Developed and Emerging Markets, 1990-2004 (current \$/person)**

Year	Country Group	Per Capita Net FDI Outflows (average)	Per Capita Net Financial Capital Outflows (average)
1990	Developed countries	165	-1564
	Emerging markets	-756	1541
2000	Developed countries	1204	-2486
	Emerging markets	-1668	3680
2004	Developed countries	1120	-1382
	Emerging markets	-1671	5556

# From Red to Grey: a Third Transition

The combination of rapidly aging and relatively poor populations exists only in transition countries

Mukesh Chawla, Gordon Betcherman, and Arup Banerji

In 2025, more than one in five Bulgarians will be more than 65 years old — up from just 13% in 1990. Ukraine's population will shrink by a fifth between the years 2000 and 2025. And, also in 2025, the average Slovene will be 47.4 years old — among the oldest in the world.

Populations have been aging quite rapidly in many countries; yet the unique conjunction of rapidly aging and relatively poor populations exists only in transition countries. Indeed, because of this demographic "third transition" following the political and economic transitions, the only countries in the world with population declines of more than 5,000 people between 2000 and 2005 were 16 countries in Eastern Europe and the former Soviet Union — led by Russia, Ukraine, Romania, Belarus, and Bulgaria. No country faces as big an aging crisis as Georgia which is set to lose 800,000 people over the next two decades. And no other countries in the world face the dual challenges of a rapidly aging population and an incomplete transition to mature market institutions to deal with the adverse economic consequences of aging.

The economic impact of aging will be felt most through the rising proportion of the elderly — those aged 65 and older. The old-age share of the population will increase beyond 15% in 2025 in all but seven transition economies and Turkey.

## Growing Older Does Not Have to Mean Growing Slower

Will the changing demographics in the region mean a halt to economic growth, because older populations have shrinking labor forces and save less, with negative consequences for investment and capital accumulation?

Not necessarily, as in labor markets the reality is less demographically deterministic:

- The growth in labor productivity, which has been the single greatest contributor to increases in per capita income in the region, could swamp any effects of smaller labor forces;

- The impact of aging on the labor supply can be partially offset by increases in the labor force participation rates. Increasing the retirement age close to OECD levels (which, on average, are higher by four years for men and five years for women) and improving the ability to do more flexible, part-time work could increase the quantity of the labor supply;

- Intra-regional migration from younger countries can augment the labor forces of the aging countries, if political resistance is overcome.

In aging populations, aggregate saving — the key ingredient in creating capital and a key determinant of growth — is likely to decline because people save less as they grow older. However, the available data suggest that households and firms in transition countries in Eastern Europe and the former Soviet Union may eventually want to increase their savings as:

- The average saving rate declined in the late 1990s and early 2000s to about 15%. Convergence toward Western European levels of 24% would then imply the growth of future saving in the region;

- The share of both household and corporate savings is unusually low — or even negative, as in Bulgaria — compared with OECD countries. Most likely, this reflects an incomplete economic transition. Eventually, households and firms will stop running down assets and will want to replenish their savings to provide for retirement and to build precautionary cushions.

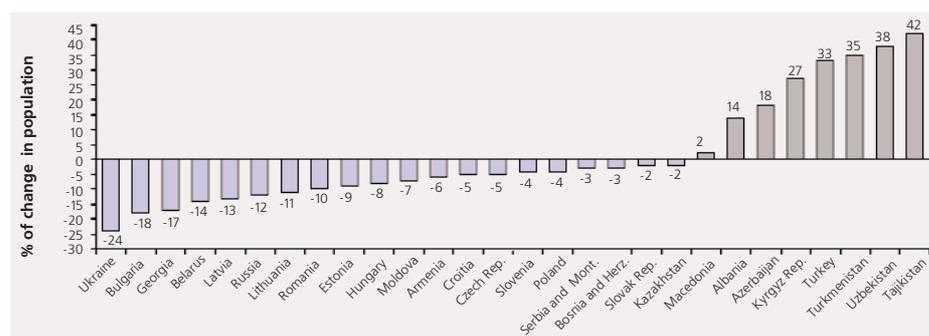
Besides, corporate and foreign savings should remain largely unaffected by aging. As financial markets, which are currently shallower than in OECD countries, deepen and the number and variety of savings instruments increase, individuals and corporations are likely to receive greater opportunity for formal savings matching their individual time horizons and risk profiles. Moreover, financial deepening and increased flexibility are also likely to boost overall productivity.

## Sensible Policies Can Ease Aging Spending Impact

There are widespread concerns that aging populations in ECA countries will exert new pressures on public spending, especially for pensions and health care. In addition, aging populations would have significantly higher health needs, simply because the greatest demand for medical care occurs in the later years of life. Another critical issue is long-term care for the very old, which either becomes costly as informal, family-based care declines or imposes opportunity costs if younger people have to spend time on care that they would otherwise spend working.

- *Reforming pension systems:* Under the simplest assumption that pension spending will go up in proportion to the rise in the percentage of the population older than age 65, pension spending by 2025 in Croatia, Hungary, Poland, Serbia, Slovenia, and Ukraine will rise above that of Italy (the highest OECD pension spender). Poland could have pen-

Populations in Most Countries Will Decrease between 2000 and 2025



sion spending as high as 22% of GDP, with Ukraine not far behind at 19%.

Fortunately, this is only a potential scenario. A recent EU study found that, on average, 47% of the projected demographic change could be mitigated by changes in policy, primarily raising and equalizing the retirement age between men and women and using consumer price inflation — rather than wage inflation — to index pensions after retirement. Calculations by the World Bank have produced similar results.

- *Affordable health care and long-term care.* The magnitude of medical and health cost increases will depend on whether longer life spans add healthy years or years of illness and dependency. We find that the use of health services will

### *The aging, late reformers in the former Soviet Union and the western Balkans face the greatest challenge*

increase as populations age but that the increase will, in most countries, be largely due to factors unrelated to aging, such as growth in GDP per capita, changes in the level of service, technological innovation, quality of services, and productivity.

At current benefit levels, public spending on health will increase significantly by 2020 (compared with 2005) only in Tajikistan and Uzbekistan, both young countries. Spending will modestly increase — by 2% of GDP — in Belarus, Bulgaria, Estonia, Poland, Romania, and Russia, and will actually fall in Armenia, Bosnia and Herzegovina, Croatia, and Turkmenistan.

However, new pressures on the provision and use of long-term care services will be very difficult to face for most ECA countries. Using a conservative assumption that only 5% of the elderly with disabilities will receive formal institutionalized care, and 5% will receive informal care (10% for new EU member states), expenditures on long-term care will double in almost all countries and will account for between 0.5% and 1% of GDP. If institutionalized care extends to 20% of the elderly with disabilities, expenditures will consume between 2% and 4% of GDP.

How, then, should policy makers respond to this public expenditure shock? Perhaps the most effective way to ensure better health and lower expenditures is by promoting healthier elderly populations. These measures include changes in lifestyle, especially promotion

of regular exercise and control of diet and weight; design of substantially less expensive public services; and support to informal caregivers, predominantly women, including provision of cash and service benefits to them.

- *Providing for lifelong learning:* Aging will exert at least two different pressures on education, with potentially opposite budgetary consequences. The shrinking school-age population will make some cost savings possible. If current trends continue, by 2025 all the countries except Tajikistan will have smaller school-age cohorts — by 30-50%.

A closer look, though, reveals that the savings may not be as large or as universal, because current coverage in education leaves significant room for improvement.

For example, the large declines in primary school coverage in Armenia, Bosnia and Herzegovina, and Turkmenistan have pulled gross enrollment rates in primary education well below 90%. So, improving coverage will lead to very fast growth in education enrollments in countries with young populations.

The second factor that can help to counteract the expected decline in expenditures is the imperative to invest in lifelong learning practices to improve productivity and better meet the needs of dynamic and flexible economies. The transition led to a serious disconnect between the skills provided by education systems and the skills needed by the market economy.

Education quality across region is not high. As measured by the OECD's PISA assessment, only some of the countries, such as the Czech Republic, Hungary, Latvia, and the Slovak Republic, have somewhat decent rankings, whereas the aging, late reformers, such as Russia and Serbia, do less well.

Moreover, formal programs of lifelong learning are almost nonexistent in the region. In principle, economic liberalization policies strengthen the incentives for employers to provide training for their employees, whereas productivity-related earnings dispersions strengthen incentives for individuals to seek training. However, legal proscriptions and onerous certification requirements — as well as the absence of positive inducements such as tax benefits — inhibit the

development of lifelong learning programs by private providers.

In summary, the blow to public expenditures coming from aging can be fairly small — if well-understood policy measures are put in place for pensions, if proactive measures are undertaken for financing long-term care, and if savings in public education expenditures are reoriented toward initiatives that boost productivity.

### **The Different Paths Ahead**

The requirements for reform on these issues vary for different countries in Eastern Europe and Central Asia. They depend on each country's individual aging profile and on the reform paths and timing that the countries choose in the decades ahead. The challenge is to be proactive in undertaking the particular reforms that are essential for meeting the shocks caused by aging populations.

- *The young, late reformers in Central Asia* — the Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan — have the easiest paths in dealing with aging: although they will need to face adjustments in education and, to some extent, in pensions because of population aging, their large pool of young residents will ease the pressure. Their major task is to complete the economic transition and further develop institutions.

- *The aging, early reformers of the European Union and Croatia* (and, to some extent, Albania) will find that the reforms already undertaken by them and their better-developed institutional capacity will help them deal proactively with the pressures of aging populations. But much will still depend on whether they have the political will to undertake difficult future reforms in pensions and long-term care.

- The greatest test is for the *aging, late reformers of the former Soviet Union and the western Balkans*. They face the twin problems of significantly aging populations and relatively underdeveloped institutions, with action needed on both.

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*Mukesh Chawla and Gordon Betcherman are Lead Economists, and Arup Banerji is Sector Manager, Human Development Economics in the Europe and Central Asia Region of the World Bank, Washington, DC. Full text of the report is available at: <http://go.worldbank.org/O0Q06F6QK0>. BT*

# Life in Transition: Current Attitudes

While nostalgia for the past remains, a sense of optimism about the future prevails

*Peter Sanfey, Franklin Steves and Utku Teksoz*

The transition from socialism to a market economy has transformed the lives of many people. What are people's perceptions and attitudes to transition? What are the current attitudes to market reforms and political institutions?

To analyze these issues, the EBRD and the World Bank have jointly conducted the comprehensive, region-wide "Life in Transition Survey" (LiTS), which combines traditional household survey features with questions about respondents' attitudes and is carried out through two-stage sampling with a random selection of households and respondents.

The survey explored four key areas in 29 countries: access to consumer goods and public services; people's views on how transition has affected their lives; attitudes to markets, democracy and the role of the state; and the issues of corruption and lack of trust. The main findings are broken down by sub-regions — contrasting Central Eastern Europe and Baltic States (CEB) with South-Eastern Europe (SEE) and the CIS and Mongolia (CIS+M).

## Material Well-Being

Prior to the start of transition, socialist economies were often characterized by a shortage of consumer goods and a lack of choice in the shops. The transition has opened up a new world of con-

sumer goods to people in the region, at least to those able to afford them. Access to credit and strong growth in financial markets has helped to fuel a strong consumer boom that is driving economic growth. However, the transition has highlighted the huge investment needed in public infrastructure, and that access to reliable services often remains problematic, especially for poorer people.

## Ownership of Consumer Goods

The survey investigates whether the so-called necessities of Western countries, such as a car or mobile phone, have also become commonplace in the transition countries. Responses reveal the strong degree of mobile phone ownership across the region, while access to other goods and services varies widely (see Graph 1). For example, in CEB nearly 77% of households have a bank account compared to only 10% in CIS+M.

Regarding public services, the regional variation is less marked. For example, there is virtually 100% access in all regions to electricity from the public grid.

Within each region there are important urban/rural differences in access to goods and services. It is particularly noticeable for some public services in CIS+M. Access to a fixed telephone line, for example, is close to 70% in urban areas compared with only about 22% in rural areas.

children born today will have a better life than their own generation. Perhaps people are being influenced by strong economic growth and a growing realization that there is no going back to the past.

Young people have a much more favorable view than older people. In CEB more than 50% of people aged 18-34 think that there is a better economic situation today than in 1989, with the share declining to about 35% of those aged 65 and over. Not surprisingly, those in the upper income bands are far more likely to agree that things are better today than before, both economically and politically, than those in the lower bands.

Where does this leave the overall level of happiness? More people declare themselves to be satisfied with life than dissatisfied, with things looking gloomy only in SEE, where living standards have dropped significantly. In general, young people feel satisfied with their lives, especially in CEB (65%) although this falls to just over 40% in SEE. Interestingly, people in the highest age group (65+) report on average the lowest levels of satisfaction in SEE and the CIS+M, in contrast to studies for non-transition countries that tend to show life satisfaction declining with age up to a certain point (usually in the 40s) and rising thereafter.

## Values and Priorities

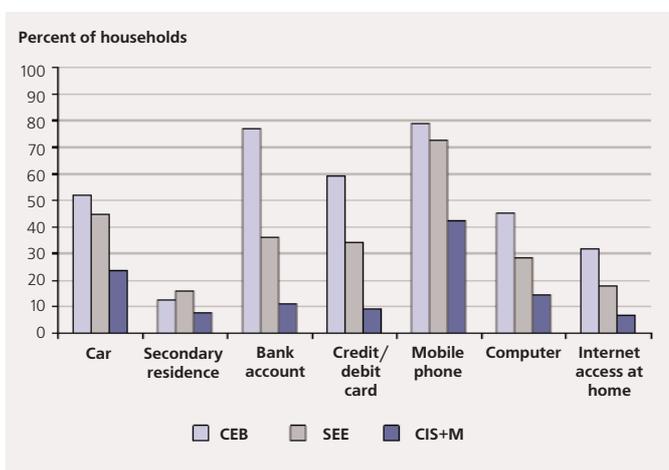
The process of transition has been fundamentally about promoting democracy and the market economy and reducing the all-encompassing role of the state in economic affairs. Have these values taken root? Overall, the survey shows moderately strong support for democracy and markets. Around 10% of respondents support a combination of a planned economy and authoritarian government, and about 20% of people believe that the form of political and economic system does not matter at all. Typically these are the elderly, women, those in lower income groups, as well as the unemployed.

Where does this leave the role of the state and where should government resources be targeted? Two sectors stand

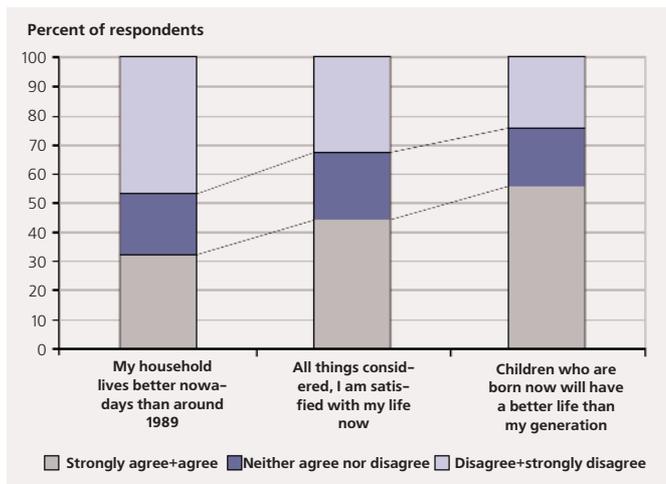
## Views on Transition

Regarding people's subjective experience of the effects of transition, there appear to be mixed feelings: on the one hand, there is some evidence of nostalgia for the past (see Graph 2). On the other, there is a sense of optimism, with 54% agreeing that

**Graph 1. Does Anyone in Your Household Have...**



Graph 2. Views on Transition



out as respondents' priority areas for investment by the state — health care and education, whereas housing, public infrastructure and the environment are generally viewed as less important areas.

### Corruption and Trust

According to the survey, 67% of respondents indicate that corruption is the same or worse than it was before transition began. The perception of worsening corruption seems to be particularly strong in SEE, where 75% of respondents believe that corruption is now as bad as, or worse than, in 1989.

government investment since unofficial payments are presumably seen by workers in these sectors as compensation for low salaries and general under-investment.

In line with the general increase in perceived corruption, general levels of trust in society have fallen during transition. While approximately two-thirds of respondents believe that people could generally be trusted before the beginning of transition, the proportion falls to less than one-third today. While general trust seems to have declined, trust in institutions differs widely. In general, people in the region place a high degree of trust in the armed forces, the presi-

The public health system stands out as the area where "irregular payments" are most common: more than 20% say that such payments are usually or always needed. Payments also seem to be quite common when dealing with the road police and in public education. The results for health and education help to explain why people see these areas as top priorities for further gov-

ernment investment since unofficial payments are presumably seen by workers in these sectors as compensation for low salaries and general under-investment. In line with the general increase in perceived corruption, general levels of trust in society have fallen during transition. While approximately two-thirds of respondents believe that people could generally be trusted before the beginning of transition, the proportion falls to less than one-third today. While general trust seems to have declined, trust in institutions differs widely. In general, people in the region place a high degree of trust in the armed forces, the presi-

### Conclusions

After more than 15 years of transition, the region stands at a crossroads. Overall, the message coming through from the survey is a positive one: the balance is clearly in favor of the optimists when it comes to seeing a better future ahead. And there is robust support for both democracy and the market economy. Young people tend to support these trends the most.

However, major challenges lie ahead, even in some of the most advanced countries in the region, including a strong urban/rural divide and scarcer private sector services in rural areas. And politicians face a particularly strong challenge in raising the level of public trust in institutions, such as the government and parliament, and in fighting corruption.

*Peter Sanfey, Franklin Steves and Utku Teksoz are from the EBRD's Office of the Chief Economist. The assessments and views expressed in the Report are those of the authors only and not necessarily those of the EBRD. The full text of the Report can be viewed at <http://www.ebrd.org/pubs/econolit.htm>.*

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## Russian Fiscal Policy: Challenges Ahead

In three years the budget surplus fed by high oil prices will disappear

*Yevsei Gurvich*

The period 2007 to 2010 will in many ways mark a macroeconomic turning point in Russia, witnessing a change in the external conditions of the development of the Russian economy and in the character of government policy.

First, the rapid growth of world commodity prices is expected to be replaced by their decline. The Urals oil prices, after growing by more than 2.5 times in the last three years, are expected to go down to US\$50 per barrel in 2010.

Second, the production and export of hydrocarbons will be lagging behind economic growth in Russia. Nevertheless the

massive inflow of foreign capital will further strengthen the ruble and thus reduce the share of export-oriented sectors in GDP. As a result, the share of the oil and gas sector in the country's GDP will plummet from 23% in 2006 to 13% in 2010. Accordingly, the size of the resource rent in the sector will drop almost by half from 19.1% of GDP in 2006 to 10.6% in 2010 (see Graph 1).

A sharp reduction of the relative weight of the oil and gas sector will significantly reduce the total budget revenue. This is due to the increased tax burden for both sectors (following the

recent tax reform) and eased burden for other sectors. As a result, in 2006 the tax burden on the oil sector was twice that on the rest of the economy, and on the gas sector it was 1.5 times higher. Accordingly, the drop in oil and gas revenues cannot be compensated by other sources, so that the total federal and enlarged budget revenue will drop by 5.4% of GDP in 2007-2010.

### Balanced 3-Year Budget

The drop in oil and gas budget revenue will be accompanied by tougher budgetary rules. A special regime will

now be applied to all the main oil and gas taxes except the profit tax.

Moreover, the division of the oil and gas revenues into disposable and saved categories will change. Up until now the size of disposable oil and gas revenues varied depending on the prices. Under the new rules, such revenues are fixed at 3.7% of GDP and are thus constant over time and independent of oil and gas prices. On the whole, this marks a transition from short-term and partial smoothing of the use of oil and gas revenues to their full and long-term smoothing.

At the same time, while in 2006 the saved oil and gas revenues equaled 7.5% of GDP, in 2008-2010 they will not exceed 1% of GDP. A combination of growing spending and diminishing revenues will result, within just three years, in a balanced budget — quite a change from a significant surplus of 7.4% of GDP. Most of the increase in spending will be channeled to public investments, government corporations and similar goals. That reflects the state's intention to promote the development of non-extractive sectors by increasing the economic growth base.

Given the poor track record of public investments in the past, a course for private-public partnerships has been adopted. Nevertheless there is a risk that increased spending may weaken macroeconomic stability in the long term. Previous international research has revealed that public investments and other support measures are beneficial for growth only if the quality of state institutions is high enough but yield no effect if the institutional quality is low, which is the case in Russia today.

### The Need for "Intensive" Spending Policy

Our estimations show that budget revenue will continue to decline beyond 2010. Based on the Energy Information Agency's forecast of the average oil price of about US\$45 per barrel of Urals oil in 2011-2020, federal budget revenue may drop to 16.5% of GDP by 2020. From 2008, a cap of 4.7% of GDP will be imposed on the non-oil and gas deficit, that is, net borrowing should not exceed 1% of GDP. The predicted maximum expenditure will then level out at about 18% of GDP (see Graph 2).

Thus, after 2010 a rapid increase of budget expenditures will have to give way to their gradual reduction. Furthermore, one has to take into account the growing need to support the pension system. Estimates show that although the pension system will be able to meet its obligations in nominal terms, too big a drop in the income replacement ratio is socially unacceptable. The replacement ratio already declined from 32% in 2002 to 25.8% in 2006. To prevent a further drop, the federal budget envisages an increase of transfers for labor pensions — but further increases are need to maintain the replacement ratio at least at the 2006 level.

The above assessments highlight the need to adopt an "intensive" spending policy instead of an "extensive" one. The extensive character of recent trends is also revealed by the nature of the national projects in public health and education where the allocation of additional resources failed to deliver substantial reform progress. Meanwhile, international experience shows that additional funding without improvement of the

institutional environment is not conducive to a higher quality of public service provision, while public sector reform can achieve the desired results without an increase in spending.

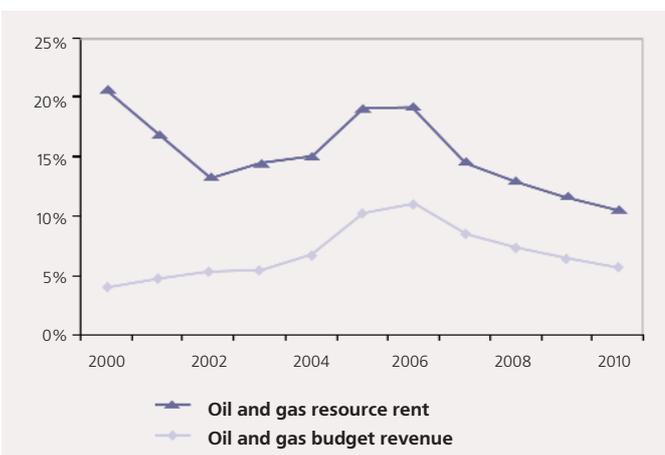
### Challenges Ahead

If public sector performance does not improve, two equally unattractive alternatives will remain. Limits on overall spending will lead to a degradation of the social sphere. If transfers to the Pension Fund remain at the 2010 level, the income replacement ratio will drop below 19% by 2020. To prevent it, the authorities may abandon tough budgetary rules by increasing borrowing and using more of the oil and gas revenues to finance current expenditure. But such a policy will merely delay the need to implement serious reforms and keep expenditures down. Besides, continued high spending creates serious macroeconomic risks: if world prices drop suddenly, or if investors are less ready to credit the government, it will not be able to fully meet its obligations. The crisis would not just slow down the economy, but would set it far back. The government therefore faces a serious challenge. If it succeeds, the macroeconomic and social conditions of development will remain favorable, but if it fails to improve the performance of the public sector, the prospects of further economic development will be put into question.

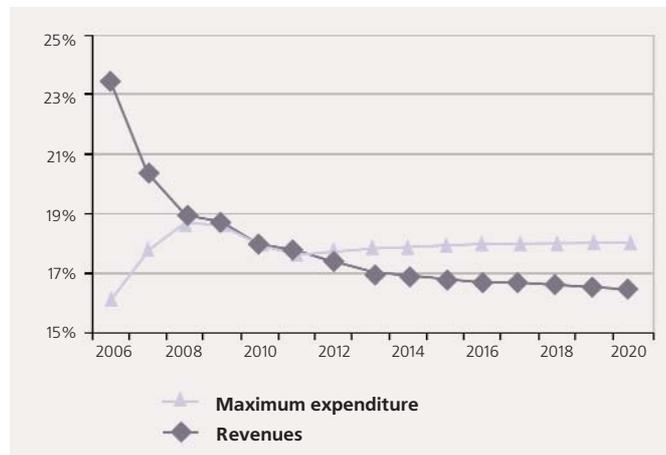
*Yevsey Gurvich is the head of the Economic Expert Group in Moscow, www.eeg.ru. The author has contributed this article to BT.*

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Graph 1. Oil and Gas Resource Rent (% of GDP)



Graph 2. Forecast of Federal Budget Parameters (% GDP)



# Economic Growth in Croatia: Potential and Constraints

Improvements to the business environment are critical to increasing Croatia's potential growth

*David Moore and Athanasios Vamvakidis*

Croatia's real GDP growth has averaged 4.75% over the past five years, below the average of nearly 6% achieved by peer countries in Central and Eastern Europe that recently joined the EU. With Croatia also on track to join the EU in a few years' time, the government aspires to higher growth as a means to catch up faster with living standards in the EU. But how can it realize its goals?

Our analysis finds that Croatia's potential growth rate is 4-4.5%. This

*A reduced state role in the economy and improvements in the business environment are needed for sustaining faster growth*

suggests that recent economic growth has exceeded the economy's potential and, consequently, that reforms are needed to raise the economy's overall productivity if Croatia is to avoid a slowdown.

## Many Natural Advantages

As for the factors supporting growth, Croatia has many natural advantages, including ready access to Central, Mediterranean, and Southeastern Europe, and a long and beautiful coastline that underpins the vital tourism industry. Croatia also compares favorably with other transition economies in terms of the openness of its economy, its well-developed banking system, strong public investment and infrastructure, and low inflation over the past decade. And with living standards well below those in the euro area, Croatia still has considerable scope for catch-up growth.

So what is holding growth back? Our analysis suggests that export performance, which has been weaker in Croatia than in its peers in Central and Eastern Europe, provides some clues. Over the past five years, Croatia's real exports of goods and services increased by an average 6% annually, significantly below the peer country average of over 10%. In a similar vein, Croatia has also done less well in terms of attracting new investors. Although total FDI in Croatia is close to the regional average, a disproportionate-

ly high share has come from privatizations or investment in the financial sector. The number of "greenfield" FDI projects — which are especially good for growth — remains small. Why is that? Survey evidence consistently points to a difficult business environment for both domestic and foreign investors.

Our simulations of a cross-country growth model suggest areas where economic reforms could increase Croatia's potential growth. A reduced state role in

the economy — through lower fiscal deficits and faster progress in privatization — would help ensure macroeconomic stability, enhance market competition, and support private sector activity. Indeed, with general government spending as a share of GDP exceeding the regional average by several percentage points, there is considerable scope to lower the fiscal deficit. Structural reforms to improve the business environment — notably, facilitating the start-up of new businesses, streamlining the bureaucracy, increasing labor market flexibility, and reforming the judiciary — would also be needed for sustaining faster growth.

## Microeconomic Problems Hinder Growth

Having conducted a "growth diagnostic" to identify binding constraints on growth, we find that growth is not held back, as is often the case, by financing problems or a lack of ideas for investment. Rather, Croatia is not yet as good a place in which to do business as it could be, even allowing for recent improvements. The diagnostic highlights the microeconomic problems stemming from the public sector: an inefficient bureaucracy and a high regulatory burden, problems with property rights, and corruption.

• The administrative and regulatory burden is particularly heavy at the local

level, with investors often facing numerous non-transparent fees and delays in obtaining necessary permits. Lingering land ownership uncertainties have also hindered investment in some regions.

• Employment protection legislation is strict by regional and OECD standards, especially for temporary workers. While this legislation has helped protect jobs for existing employees it has also acted as a severe disincentive to new job creation.

• Contract enforcement is slow. The European Commission has warned that creditor and property rights are undermined by "slow and inefficient court proceedings, poor case management and low administrative and professional capacity." Transparency International's corruption perceptions index indicates that Croatia suffers from "serious" levels of corruption, a finding corroborated by other survey evidence.

In sum, the analysis highlights how improvements to the business environment are critical to increasing Croatia's potential growth. In addition, potential growth would benefit from a reduction in the still-significant role of the state in the economy, in particular by reducing the ratio of public expenditure to GDP to levels more in line with regional standards, and by eliminating the drain on public resources from state-owned enterprises that have yet to be restructured.

Thus, if Croatia is to keep up with the more successful new EU members, the pace of reform needs to accelerate. Encouragingly, the government is aware of these problem areas — and the EU accession process is providing additional impetus for new measures in some of the more difficult areas that the authorities have already targeted for reform.

*David Moore and Athanasios Vamvakidis are Senior Economists in the IMF's European Department. Full text of their paper is available at: <http://www.imf.org/external/pubs/ft/wp/2007/wp07198.pdf> (IMF Working Paper No. 07/198).*

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## Good Governance Helps Fiscal Policy Spur Economic Growth

Well-run governments get better results out of their budget resources, according to *Fiscal Policy and Economic Growth: Lessons for Eastern Europe and Central Asia*, released July 2 by the World Bank. The study draws on quantitative analysis and case studies to confirm that more productive public spending, lower fiscal deficits, and greater reliance on non-distorting taxes can spur economic growth. The report reviews trends in public spending and taxation in Eastern Europe, Turkey, and Central Asia (ECA) since the 1990s and how they compare to trends in high-growth countries elsewhere in the world. Middle-income countries in Eastern Europe typically have bigger governments than comparator countries in Asia or Latin America because of large social transfers. Primary public spending in Croatia is more than double the size of that in Thailand, and the eight Eastern European countries that joined the EU in 2004 spend on average three times as much on social transfers as Korea. The lower-income countries in ECA have smaller governments, closer in size to the high-growth comparators. Once public spending exceeds about one-third of GDP, higher spending is associated with lower growth in countries with weak governance, but no such relationship exists in well-governed countries. The biggest challenge in most countries in ECA is to increase the efficiency of public spending, particularly to enhance growth prospects and ensure that populations benefit from expenditures in health, education, pensions, and infrastructure. The full report can be found at <http://www.worldbank.org/ecal/fiscal>

## Balkan Poverty Reduction Strategies Forum Focuses on Poverty and Energy Issues

The Fourth Poverty Reduction Strategy Forum, held in Athens on June 26-27, facilitated an exchange of experiences among the countries of the Western Balkans on how best to implement and execute national development strategies focused on poverty reduction and higher living standards. The Forum focused on the objectives of strengthening integration with Europe as a driver of economic growth, promoting greater social inclusion and poverty reduction, and designing and implementing power sector reforms to promote growth. The Forum was organized and co-sponsored by the Greek Government, the World Bank, the International Monetary Fund, and the U.K.'s Department for International Development. It brought together over 150 participants from Albania, Bosnia and Herzegovina, the Former Yugoslav Republic of Macedonia, Montenegro, Serbia, and UNMIK/Kosovo, as well as representatives from donor countries and civil society. The Forum recognized the importance of energy sector efficiency investments and growth. The most important trends in the energy markets of Western Europe and their impact in Southeast Europe were discussed. Participants noted that energy market potential is best maximized through a sub-regional approach based upon the development of a common energy market and the attraction of the private sector. This requires a comprehensive and coherent approach with careful sequencing of reforms and investment, supported with

an adequate and targeted social assistance program, and an effective communication strategy.

## DecadeWatch Monitoring Report Notes Significant Progress on Roma Inclusion Policies

Nine Central and Southeast European countries have made progress in advancing Roma inclusion since the launch of the Decade of Roma Inclusion in 2005, according to the DecadeWatch monitoring report prepared by teams of Roma civil society leaders and released June 11. However, countries must move from sporadic measures based on pilot projects to integrated policies and programs. DecadeWatch assesses governments' actions on introducing measures on the four Decade priority areas of education, employment, health, and housing, as well as institutional arrangements and anti-discrimination legislation. Country reports were prepared by Roma civil society alliances, and then countries were ranked on indicators on a scale from 0 to 4, with 0 capturing no action and 4 best practice. The report looks at government inputs, not outcomes, as the Decade was only launched in 2005. The country rankings not only track progress but also identify areas where countries can benefit from one another's experience. Hungary is the most advanced country in terms of institutional arrangements and policies, but each country excels in a particular area, for instance Romania with its health mediators program and Macedonia's employment data collection. The World Bank and the Open Society Institute supported DecadeWatch through assistance with training and methodology. The full report can be found at <http://www.romadecade.org/>

## Inflationary Pressures and Growth Slowdown Predicted in Most New EU Member States

Output growth gained further pace across the 10 new European Union member states in 2006, but is likely to slow down in 2007, according to the latest World Bank EU8+2 Regular Economic Report, released May 31. Growth accelerated in Estonia, Latvia, Poland, Slovakia, Slovenia, and Romania, while it remained largely unchanged in the Czech Republic, Lithuania, and Bulgaria. Only Hungary experienced a slowdown on the back of its fiscal austerity program. The region's overall strong performance reflected the favorable external environment of robust global growth, low interest rates, and positive emerging market sentiment. In some countries, however, booming domestic demand is leading to an overheating of the economy, and current growth rates are unlikely to be sustainable. Growth is expected to slow across the region in 2007, with the exception of Poland, Slovakia, and Bulgaria. The report's Special Topic reviews the impact of EU integration and the Common Agricultural Policy, which have led to substantial increases in agricultural income. The variation in income growth is as pronounced as the diversity in agricultural structures across the region. With the relative dominance of (semi) subsistence farming in many new member states, labor productivity lags far behind the EU15 average. The full report can be found at <http://www.worldbank.org/ecal/eu10rer>

## International Youth Conference Focuses on Employment and Citizenship

The World Bank, in cooperation with the Development Cooperation Office of the Italian Ministry of Foreign Affairs and the ILO, hosted the conference "Young People in Eastern Europe and Central Asia: From Policy to Action," from May 21-24. Participants included representatives at the governmental and non-governmental levels from 29 countries from the ECA region, as well as international organizations and civil society. The Rome meeting marked an important stage of the "Development and the Next Generation" program, initiated by the World Bank to alert political leaders around the globe to the need to invest in young people so that they play an active role in their countries' development. The conference aims to elaborate upon suitable policy strategies that favor the transition of the younger generations to the world of work and active citizenship. Despite the improving economic situation, poverty, unemployment, and social exclusion among young people in these countries is increasingly widespread. Without employment and social inclusion, young people are facing rising marginalization, threatened by crime and drug abuse, and are under pressure to emigrate. Migration is already a major policy issue for the region and for Europe, which may face difficulties managing the migratory pressures along its borders.

## Parliamentarians from Across Europe Share Lessons for Transition

A group of 30 parliamentarians from across Southeast, Central, and Eastern Europe met in Slovenia on May 17 and agreed to expand the Southeast Europe Chapter of the Parliamentary Network on the World Bank (PNoWB) to include the countries of Central and Eastern Europe. The gathering followed the founding of the Southeast Europe PNoWB Chapter in Greece in September 2006. Meeting in Bled, the PNoWB held its annual conference of parliamentarians from the ECA region. Organized under the theme of "Sharing Lessons for Transition," this year's regional meeting discussed four common themes — migration, social and spatial inequality and the role of regional policy, judicial reform, and public-private partnerships for infrastructure. The parliamentarians shared their lessons and experiences of transition and European Union integration.

*This part has been provided courtesy of Merrell Tuck and Christina Lakatos, Europe and Central Asia External Affairs*

## Tajikistan Development Forum Outlines the Roadmap for Future

Representatives of the Tajik government, international development agencies, bilateral donors, civil society and private sector came together in Dushanbe on June, 2 for the Tajikistan Development Forum that took stock of the country's development efforts to date, defined further priorities and the way forward. The Forum was organized by Tajik government with the support of the World Bank and other development partners. The discussions focused on the challenges for future

development and determining the role each partner can play in contributing to the government's development vision. The forum provided an opportunity to assess the implementation of the Tajikistan first Poverty Reduction Strategy, discuss the implementation of the country's National Development Strategy and the second Poverty Reduction Strategy recently adopted by the government, as well as energy sector development strategy, development of the country's human potential, rural programs and resolution of cotton farm debt, investment climate improvement and public administration reforms. For more information about the Forum and World Bank in Tajikistan, please visit: <http://www.worldbank.org/tj>

## Basic Health Care Expanded to 98% of Kyrgyz Republic Population

The 1998 regional financial crisis resulted in a 43% depreciation of the real exchange rate in the Kyrgyz Republic. As unemployment became more rampant and social systems collapsed, poverty grew and health indicators deteriorated. Today, thanks to the intervention of the World Bank's International Development Association (IDA), fully 98% of the population is registered for a package that entitles them to basic primary care services. The introduction of the "Outpatient Drug Benefit" package has reduced out-of-pocket payments for outpatient drugs. The share of the health budget allocated to primary health care increased from 10.2% in 2000/2001 to 25.1% in 2004/2005. Improvements in health that are probably connected to these reforms included a 60% decline in infant mortality from respiratory infections between 1996 and 2004, falling from 123 per 10,000 live births to 48. In addition, critical institutional changes have been accomplished: the Ministry of Health was reorganized at all levels, from being a service provider to a more modern institution, engaged in policy making, priority setting, resource mobilization, and budget formulation, monitoring and evaluation. IDA resources were critical to the scaling up of this very successful health reform program which began under the First Health Reform Project.

## Socioeconomic Impact of HIV/AIDS in Ukraine

The HIV/AIDS epidemic in Ukraine started in 1987 and has accelerated dramatically since then. At present, the epidemic in the country is among the fastest growing in Europe, with officially registered new HIV cases having doubled over 2000-2004. Data suggest Ukraine may be on the brink of the generalized epidemic phase. The epidemic is shifting from high-risk groups to the general population. The data indicate that in 2006 every fifth HIV-infected person was in the 18-24 age group. The share of women among the new cases reached 42%. The study "Socioeconomic Impact of HIV/AIDS in Ukraine" forecasts that in the medium term HIV/AIDS will have a significant impact on economic growth, investment and social welfare, life expectancy, and population growth. The longer-term impact could be even more devastating. Prevention and treatment programs must target as a priority young people, women, and the worst-infected regions of Ukraine. The full text can be found at: <http://go.worldbank.org/JW4JCA2EE0BT>

## World Bank Publications

Information and orders: the World Bank, P.O. Box 960, Herndon, VA 20172, U.S.; tel.: +1-703-661-1580, fax: 703-661-1501, <http://www.worldbank.org/publications>, email: [books@worldbank.org](mailto:books@worldbank.org), or visit the World Bank InfoShop at 701 18th Street, N.W., Washington, D.C., tel.: +1-202-458-5454

### World Development Indicators 2007

April 2007, ISBN: 0-8213-6959-8, SKU: 16959

World Development Indicators is the World Bank's premier annual compilation of data about development. This statistical reference combines over 900 indicators for some 150 economies and 14 country groups in more than 80 tables. It provides a current overview of the most recent data available, as well as important regional data and income group analysis in six thematic sections: World View, People, Environment, Economy, States and Markets, and Global Links. The CD-ROM editions contain 45 years of time series data, covering 1960 to 2005, and offer mapping, charting, and data export formats.

### Global Monitoring Report 2007: Confronting the Challenges of Gender Equality and Fragile States

April 2007, ISBN: 0-8213-6975-X, SKU: 16975

The 2007 Global Monitoring Report on the Millennium Development Goals, jointly issued by the World Bank and the International Monetary Fund, assesses the contributions of developing countries, developed countries, and international financial institutions toward meeting universally agreed development commitments. Fourth in a series of annual reports leading up to 2015, this year's report reviews key developments of the past year, emerging priorities, and provides a detailed region-by-region picture of performance in the developing regions of the world, drawing on indicators for poverty, education, gender equality, health, and other goals. Subtitled "Confronting the Challenges of Gender Equality and Fragile States", the report highlights two key thematic areas — gender equality and empowerment of women and the special problems of fragile states, where extreme poverty is increasingly concentrated.

J. Edgardo Campos, Sanjay Pradhan (eds.)

### The Many Faces of Corruption: Tracking Vulnerabilities at the Sector Level

April 2007, ISBN: 0-8213-6725-0, SKU: 16725

How can policymakers and practitioners better comprehend the many forms and shapes that corruption takes? From the delivery of essential drugs, the reduction in teacher absenteeism, the construction of roads, the provision of water and electricity, the international trade in oil and gas, the conduct of public budgeting and procurement, and the management of public revenues, corruption shows its many faces. *The Many Faces of Corruption* explores the use of prototype road maps to identify corruption vulnerabilities, suggests corresponding "warning signals," and proposes remedial measures in each of several selected sectors and for a selected sample of cross cutting public sector functions that are particularly prone to corruption and that are critical to sector performance. Numerous technical

experts have come together in this effort to develop an operationally useful approach to diagnosing and tackling corruption, which serves as a reference for policymakers, practitioners, and researchers engaged in the business of development.

## World Bank Working Papers

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

Erwin Tiongson, Jean Fares

### Youth Unemployment, Labor Market Transitions, and Scarring: Evidence from Bosnia and Herzegovina, 2001-04

WPS4183, April 2007

The authors examine early unemployment spells and their longer-term effects among the youth in Bosnia and Herzegovina, where the labor market transition is made more difficult by the challenges of a post-conflict environment. They use panel data covering up to 4,800 working-age individuals over the 2001 to 2004 period. There are three main findings from their analysis. First, youth unemployment is high — about twice the national average. Younger workers are more likely to go into inactivity or unemployment and are also less likely to make the transition from inactivity to work. Second, initial spells of unemployment or joblessness appear to have lasting adverse effects on earnings and employment ("scarring"). But there is no evidence that the youth are at a greater risk of scarring, or suffer disproportionately worse outcomes from initial joblessness, compared with other age groups. Third, higher educational attainment is generally associated with more favorable labor market outcomes. Skilled workers are less likely to be jobless and are less likely to make the transition from employment into joblessness.

Anna Lukyanova, Rostislav Kapelyushnikov, Vladimir Gimpelson, Yevgenia Savchenko

### Skills Shortages and Training in Russian Enterprises

WPS4222, May 2007

In the transition to a market economy, the Russian workforce underwent a wrenching period of change, with excess supply of some industrial skills coexisting with reports of skills shortages by many enterprises. The paper uses data from the *Russia Competitiveness and Investment Climate Survey* and related local research to gain insight into the changing supply and demand for skills over time, and the potential reasons for reported staffing problems and skills shortages, including labor turnover, compensation policies, and the inhibiting effects of labor regulations. It discusses in-service training as an enterprise strategy for meeting staffing and skills needs, and presents evidence on the distribution, intensity, and determinants of in-service training in Russia. It investigates the productivity and wage outcomes of in-service training, and the supportive role of training in firms' research and development and innovative activities, concluding with some policy implications.

Aristomene Varoudakis, Erwin R. Tiongson, Taras Pushak

### Public Finance, Governance, and Growth in Transition Economies: Empirical Evidence from 1992-2004

WPS4255, June 2007

Revisiting literature on economic growth in transition economies, with particular focus on fiscal balance and the size of government, the paper expands the data used in previous analyses by up to 10 years and finds unambiguous evidence that fiscal balance matters for growth. A key finding is that determinants of growth may vary in relative importance, depending on the underlying institutional quality. There could be higher growth payoffs from macroeconomic stability and public expenditure in countries characterized by relatively better public sector governance. In addition, the size of government matters for growth in a nonlinear manner: beyond indicative thresholds of expenditure levels, public spending has a negative impact, while at levels below the threshold there is no measurable impact on economic growth.

David Dollar

**Poverty, inequality, and social disparities during China's economic reform**

*WPS4253, June 2007*

The rapid growth in China over the past 25 years has fueled a remarkable increase in per capita income and a decline in the poverty rate from 64% at the beginning of reform to 10% in 2004. At the same time, however, different kinds of disparities have increased. Income inequality has risen, propelled by the rural-urban income gap and by the growing disparity between highly educated urban professionals and the urban working class. There have also been increases in inequality of health and education outcomes. Some rise in inequality was inevitable as China introduced a market system, but inequality may have been exacerbated rather than mitigated by a number of policy features. Restrictions on rural-urban migration have limited opportunities for the relatively poor rural population. The inability to sell or mortgage rural land has further reduced opportunities. China has a uniquely decentralized fiscal system that has relied on local government to fund basic health and education. The result has been that poor villages could not afford to provide good services, and poor households could not afford the high private costs of basic public services. Ironically, the large trade surplus that China has built up in recent years is a further problem, in that it stimulates an urban industrial sector that no longer creates many jobs, while restricting the government's ability to increase spending to improve services and address disparities. The government's recent policy shift to encourage migration, fund education and health for poor areas and poor households, and rebalance the economy away from investment and exports toward domestic consumption and public services should help reduce social disparities.

## Other Publications

Libor Dusek

**Political Risk of Social Security: The Case of the Indexation of Benefits in the Czech Republic**

*March 2007, CERGE-EI Working Paper 318*

[http://www.cerge-ei.cz/publications/working\\_papers/](http://www.cerge-ei.cz/publications/working_papers/)

The trade-off between a risk-free but low-return pay-as-you-go social security system and a high-risk and high-return fully

funded system has long attracted considerable interest in the economics profession and in policy debates. Yet, the pay-as-you-go social security system is not really risk-free. The paper quantifies one element of the political risk of social security in the Czech Republic, namely the risk that those people who already retired face about the future evolution of their benefits, which are being devalued by inflation and revalued by indexations. The author measures how the political risk over the indexations of benefits has affected the people who retired during 1988-1995. The author finds that retirees faced fairly large volatility in the changes of real benefits, which reduced the expected utility of retirees by 0.8-1.3% of equivalent consumption.

Balazs Egert, Carol S. Leonard

**Dutch Disease Scare in Kazakhstan: Is It Real?**

*March 2007, William Davidson Institute Working Paper No. 866*

<http://www.wdi.umich.edu/files/Publications/WorkingPaper/slwp866.pdf>

The authors explore the evidence that would establish that Dutch disease is at work in, or poses a threat to, the Kazakh economy. Assessing the mechanism by which fluctuations in the price of oil can damage non-oil manufacturing — and thus long-term growth prospects in an economy that relies heavily on oil production — they find that non-oil manufacturing has so far been spared the perverse effects of oil price increases from 1996 to 2005. The real exchange rate in the open sector has appreciated over the last couple of years, largely due to the appreciation of the nominal exchange rate. The authors analyze to what extent this appreciation is linked to movements in oil prices and oil revenues. The results of real exchange rate models show that the rise in the price of oil and in oil revenues might be linked to an appreciation of the U.S. dollar exchange rate of the oil and non-oil sectors. But appreciation is mainly limited to the real effective exchange rate for the oil sector and is statistically insignificant for non-oil manufacturing.

Ville Kaitila

**Free Trade between the EU and Russia — Sectoral Effects and Impacts on Northwest Russia**

*April 2007*

<http://d.repec.org/n?u=RePEc:rif:dpaper:1087&r=tra>

The authors analyze the implications of free trade between the EU-25 and Russia using a computable general equilibrium model. They review the sectoral effects by countries and make an assessment of the impact on the regions in Northwest Russia. Free trade on its own would have a negative terms-of-trade effect in Russia and cause a small decline in welfare. If coupled with an increase in productivity, welfare would increase. This emphasizes the importance of reforms in the Russian economy. The quantity of production in Russia in ferrous and non-ferrous metallurgy, machine building and metal working, and wood and paper are the principal declining sectors with free trade. Production in capital goods, the fuel industry, and services increases. Thus there are some symptoms of Dutch disease. Due to its production structure the Northwest would seem to benefit slightly less than Russia on average in terms of the volume of gross regional product.

Roland Beck, Annette Kamps, Elitza Mileva  
**Long-Term Growth Prospects for the Russian Economy**  
*March 2007*  
<http://www.ecb.eu/pub/pdf/scpops/ecbocp58.pdf>

The paper provides an assessment of Russia's long-term growth prospects, in particular, the medium and long-term sustainability of the country's currently high growth rates. Starting from the notion that Russia's fast economic expansion in recent years has benefited from the unprecedented rise in oil prices, the paper presents new evidence on Russia's oil price dependency. The findings indicate that the positive impact of rising oil prices on Russia's GDP growth has increased in recent years, but tends to be buffered by an appreciation of the real effective exchange rate which is stimulating imports. Additionally, growth in the service sector — a symptom usually associated with the Dutch disease phenomenon — is mainly a result of the transition process. Finally, the paper provides an overview of the relevant factors that are likely to affect Russia's growth performance in the future.

Hideki Hiraizumi  
**Changes in the Foreign Trade Structure of the Russian Far East under the Process of Transition toward a Market Economy**  
*March 2007*  
<http://www.ide.go.jp/English/Publish/Dp/Abstract/094.html>

During transition toward a market economy, the economic connections of the Russian Far East (RFE) with external economies changed from a division of labor among the regions of Russia to an international division of labor. This happened due to trade liberalization, the presence of rich natural resources and developed processing industries, the advantageous location in proximity to Asia-Pacific countries, and the political and economic division of the once unified national economic space. The changes included: an increase in the value and importance of foreign trade for the RFE economy; the development of different territories of RFE along different trajectories due to differences in industrial structure and geographical location; a growth of exports and imports with China; a sharp increase of the exports of fuel, mineral resources and metal since the end of the 1990s, and the imports of machine, facilities and transportation means since 2002.

Slavo Radosevic  
**Research and Development and Competitiveness in South Eastern Europe: Asset or Liability for EU Integration?**  
*April 2007, UCL-SEES Economics Working Paper No. 75*  
<http://www.ssees.ac.uk/wp75sum.htm>

The paper explores the relationship between research and development (R&D) and competitiveness of the SEE economies from the perspective of the EU integration and the EU as a knowledge based economy. Specifically, the paper addresses the question of whether SEE is a potential asset or a liability in this process. SEE countries are quite diverse in terms of levels of competitiveness, with visible effects on the role of R&D which is confirmed by analysis of the demand and supply factors of R&D. The results show that innovation policy that takes account of the supply and demand side factors of R&D is essential to knowledge based growth in the SEE economies.

Christopher Gerry, Tomasz Mickiewicz  
**Inequality, Democracy and Taxation: Lessons from the Post-Communist Transition**  
*March 2007, UCL-SEES Economics Working Paper No. 74*  
<http://www.ssees.ac.uk/wp75sum.htm>

Using data for post-communist economies (1989-2002), the authors examine the determinants of income inequality. They find a strong positive association between equality and tax collection but note that this relationship is significantly stronger under authoritarian regimes than under democracies. They also discover that early macroeconomic stabilization resulted in lower inequality; confirm that education fosters equality; and find that larger countries are prone to higher levels of inequality.

Daniel Münich and Jan Svejnar  
**Unemployment in East and West Europe**  
*May 2007, IZA Discussion Paper No. 2798*  
<http://ftp.iza.org/dp2798.pdf>

The authors use 1991-2005 panel data on the unemployed, vacancies, inflow into unemployment, and outflow from unemployment in the Czech Republic, Hungary, Poland, and Slovakia and in the western part of Germany (a benchmark western economy) to examine the evolution of unemployment. The results suggest that despite diverse initial conditions and subsequent paths, the patterns observed in all the countries are surprisingly similar. The authors confirm that firms in Central and East European countries have been rapidly increasing labor productivity, often without a major net creation of jobs.

## Book Review

Erick Berglof, Gerard Roland (eds.)  
**The Economics of Transition: The Fifth Nobel Symposium in Economics**  
*Palgrave Macmillan 2007*  
 ISBN-10: 1-4039-9639-3

The volume contains the papers presented at the Fifth Nobel Symposium in Economics devoted to the Economics of Transition where 50 leading economists met in Stockholm in September 1999 to take stock of the knowledge accumulated in the research on transition and institutional change. The book chapters cover the following topics: soft budget constraints; the effects of changes in ownership following privatization policies in Central Europe; the output fall and the strong increase in barter and inter-firm arrears in many transition economies in the late 1990s; the large reduction in labor supply at the beginning of transition; the effects of reforms and initial conditions on economic performance in the different transition countries; insecurity of property rights as a first order effect explaining the lack of investment by firms in Poland, Slovakia, Romania, Russia and Ukraine; the informal sector and the link to government corruption as well as the causes of corruption; the organization of government, including decentralization; barriers to trade set up by provincial authorities in China in the mid-1980s as well as some positive aspects of the provincial organization of Chinese administration.

BT

**Developing Potentials for Learning**

August 28-September 1, 2007, Budapest, Hungary

The 12th Biennial Conference is organized by the University of Szeged, Eotvos Lorand University, and Hungarian Academy of Sciences. The theme of the conference can be looked at from different perspectives:

- Learning and cognitive science
- Social and economic dimensions of education
- Knowledge acquisition and expertise in specific domains
- Higher education, lifelong learning and professional development
- Teaching and teacher education
- Learning, special education, and social interaction.

*More information:*

[http://www.earli.org/resources/EARLI2007\\_Second\\_Call.pdf](http://www.earli.org/resources/EARLI2007_Second_Call.pdf)

**CEPR/ESI 11th Annual Conference "Global Imbalances, Competitiveness and Emerging Markets"**

September 28, 2007, Pretoria, South Africa

The Conference is hosted by the South African Reserve Bank. The conference will cover the following sub-areas:

- Implications of global imbalances for banking, financial markets and financial stability in mature and emerging markets;
- Impact of global imbalances on monetary policy in emerging markets;
- Modelling competitiveness and balance of payments issues associated with mature and emerging markets.

The conference will include three policy lectures by senior central bankers; three survey papers by reputed academics on global imbalances, competitiveness and emerging markets; a panel session of academics, commercial bank analysts and representatives of international institutions. One part of the conference will be reserved for central bank researchers of member countries of the European Union, the EU candidate countries and the Southern African Development Community.

*More information:* [http://www.cepr.org/researchers/notice-board/Call\\_for\\_Papers\\_Pretoria\\_September\\_2007.pdf](http://www.cepr.org/researchers/notice-board/Call_for_Papers_Pretoria_September_2007.pdf)

**Change, Rules and Institutions: Assessing Law and Economics in the Context of Development**

September 29-30, 2007, London, UK

The conference is organized by School of Oriental and African Studies, University of London. The relationship of law to economics is commonly explored in the context of specific enquiries, e.g., competition policy or contract theory. The conference aims at reassessing the relationship of law to economics in the context of development, embracing wider concepts, such as institutions, rule of law, and legal prerequisites of a market economy.

*To register, please email [i.glinavos@soas.ac.uk](mailto:i.glinavos@soas.ac.uk) stating institutional affiliation and using the following subject line: Registration Request L&E2007*

**World Bank Global Symposium "Education: A Critical Path to Gender Equality and Women's Empowerment"**

October 2-3, 2007, Washington DC

Persuasive evidence demonstrates that gender equality in education is central to economic development. Despite more than two decades of accumulated knowledge and evidence of what works in improving gender equality, progress on the ground remains slow and uneven across countries. What is missing? What is holding progress back?

The symposium will bring together a cross-section of senior policy makers, government representatives, global experts and leaders from the international community and the private sector for re-energizing the discourse on gender, education and development.

*More information:* <http://go.worldbank.org/D06LJDA771>

**Second International Symposium on Public Finance: Recent Fiscal Problems in Transitional Economies**

October 24-27, 2007, Bishkek, Kyrgyz Republic

The conference is organized by the Public Finance Department of Kyrgyzstan, Turkish Manas University and Center for Market Economics and Entrepreneurship of Hacettepe University. The topics to be addressed include:

- The new role of the state in transition economies
- Reform of the public finance system and tax reform
- Financing for development
- Free trade policy in transition economies
- Labor market trends and the socioeconomic structure of transition economies
- The effects of the 2004 and 2007 enlargements of the European Union on Central Asian transition economies.

*More Information:* <http://symposium2007.manas.kg>

**GDN's Ninth Annual Global Development Conference "Security for Development: Confronting Threats to Survival and Safety"**

January 29-31, 2008, Brisbane, Australia

The Global Development Network's conference will bring together researchers, policymakers and development practitioners from across the world to discuss the role of physical security as a precondition of human development. The conference will focus on pervasive threats, whose potential to cause physical or material damage shortens the planning horizons of individuals, communities and enterprises and challenges their survival. Threats to be addressed include violence (domestic abuse, violent crime, and civil conflict), and major calamities including pandemics and natural disasters (such as earthquakes, drought and floods). The conference will go beyond the identification of threats by highlighting responses in various parts of the world. The two and a half day conference will be supplemented by research workshops on a variety of topics.

*More information:* <http://www.gdnet.org/middle.php?oid=1220>

BT

**“Finance and Opportunity” by Ross Levine and Asli Demirgüç-Kunt**

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