



Russia: Bank Assistance for Private Sector Development

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Abbreviations and Acronyms

ARCO	Banking Sector Restructuring Agency
CAE	Country Assistance Evaluation
CAS	Country Assistance Strategy
CBR	Central Bank of Russia
CCMD	Center for Capital Markets Development
CMDP	Capital Markets Development Project
EBRD	European Bank for Reconstruction and Development
EC TACIS	European Union's Technical Assistance for the Commonwealth of Independent States
ESW	Economic Sector Work
FDI	Foreign Direct Investment
FIDP	Financial Institutions Development Project
FSD	Financial Sector Development
FY	Fiscal Year
GKI	Russian State Property Committee
GoR	Government of Russia
HIID	Harvard Institute of International Development
IBRD	International Bank for Reconstruction and Development
ICR	Implementation Completion Report
IFC	International Finance Corporation
IFIs	International Financial Institutions
IMF	International Monetary Fund
IPP	Investor Protection Program
KHF	Know-How-Fund
MPP	Mass Privatization Program
OECD	Organization for Economic Cooperation and Development
OED	Operations Evaluation Department
PAR	Performance Assessment Report
PIAL	Privatization Implementation Assistance Loan
PIU	Project Implementation Unit
PPP	Purchasing Power Parity
PSD	Private Sector Development
QAG	Quality Assurance Group
RF	Russian Federation
RL	Rehabilitation Loan
RPC	Russian Privatization Center
SAL	Structural Adjustment Loan
SME	Small and Medium Enterprise
SOEs	State-Owned Enterprises
STF	Systemic Transition Facility
TA	Technical Assistance
TCA	Technical Cooperation Agreement
TEs	Transition Economies

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Preface

This paper is one of the background papers prepared by outside experts as an input to the Russia Country Assistance Evaluation (CAE Task Manager, Gianni Zanini) by the Operations Evaluation Department (OED) of the World Bank. Findings are based on a review of project appraisal and completion reports, sector reports, and a number of other documents produced by the borrower, the Bank, and research papers in the academic literature. Bank staffs were interviewed at both headquarters and in the field office. Their valuable feedback is gratefully acknowledged.

The authors (Dr. Saul Estrin, a professor of economics and deputy dean, and Dr. Alan Bevan, a research fellow, at the Center for New and Emerging Markets/Economics, London Business School) are grateful for the comments received on previous drafts by the OED peer reviewer (Alice Galenson), the CAE task manager, other contributors to the CAE background work (Mr. Ivan Szegvari of EBRD), ECA staff (Mr. Paul Siegelbaum) and Mr. Russell Cheetham (former ECA director of the department including Russia), which have been taken into account in the July 2001 version. However, the views expressed in this paper remain entirely those of the authors. They do not necessarily represent the views of the World Bank.

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Executive Summary

1. The Government of Russia (GoR) embarked upon an ambitious reform program in 1992. Given its heritage Russia was always likely to present a particularly intractable case of transition, and in contrast to Poland, for example, the Russian Federation (RF) lacked a unified, governing, political group committed to reform. In common with many other transition economies, the early period of RF reform witnessed rapidly increasing inflation and a substantial output decline. Russia returned to positive gross domestic product (GDP) growth by the end of 1997, but limited microeconomic reform progress hampered macroeconomic development and culminated in the August 1998 crisis. Despite improvements in macroeconomic performance since 1998, substantial and fundamental reforms are still required to redress serious impediments to private sector development.

2. In this paper we critically assess the Bank's sector assistance strategy in private sector development and financial sector development, which can be broadly considered in four distinct phases. Phase 1, the premembership assistance phase (fiscal year (FY) 90 and FY91), largely took the form of technical cooperation agreements, and technical assistance (TA) projects, centered around privatization and private sector development (PSD), banking reform, and specific sector reforms, particular in the housing sector.

3. In Phase 2 (FY92 to FY95) the Bank enacted Rehabilitation Loans (RLs) I and II, which were both designed as single-tranche rapid-disbursing loans, aimed at cementing the RF reform agenda. We concur with OED's Performance Assessment Report (PAR) that the RLI outcome was marginally satisfactory; the relatively limited objectives were only partially achieved, with some precluded by implementation delays. RLI did, however, establish the groundwork for RLII, which was implemented without specific conditionality. This loan contributed towards cementing the reform agenda at a time when the threat of political instability was tangible. However, as OED noted, project success was limited by poor borrower performance. We feel that the conclusion that the sustainability of both RLs is unlikely is somewhat harsh however.

4. The other major initiative at this time, the Privatization Implementation Assistance Loan (PIAL), succeeded in rapidly transferring ownership from state control via the Mass Privatization Program (MPP). This was undoubtedly a crucial factor in changing the economic environment of the RF. Given the political and economic milieu of the time, we find that the Bank correctly supported the MPP. The PIAL suffered, however, from a lack of continuity of responsible Bank staff, which was a mistake given the complexity and significance of the project, and the lack of GoR familiarity with Bank procedure. More fundamentally while the MPP was a logistic success, it did not lead to improved enterprise restructuring as noted by OED. This was because the GoR and PIAL did not sufficiently address the fact that the MPP was only the first stage of a process of successful transformation of ownership to outside agents. While the deficiencies can mainly be attributed to an insufficient will on the part of GoR, we argue that the Bank should have expended more effort in encouraging governmental support for microeconomic reform.

5. It is in Phase 3 (FY96 to FY98) that some real alternatives for Bank strategy emerged. We believe that the Bank was overly optimistic in its assessment of RF reform progress at this point. In significantly increasing its funding to the RF, the Bank paid insufficient regard to the fact that while some macroeconomic triggers were being met, sectoral and structural triggers were not. A variety of problems were apparent in the RF at this time, including a lack of political support for reform, nonpayments, barter, and continued soft budget constraints, while problems of capital flight, corruption, and the weakness of the institutional framework were becoming clearer. Bank policy appears to have suffered from an insufficient assimilation of evidence from other sources. While one could argue that the Bank was afraid to “lose” a voice in the RF, especially given potential co-ordination problems between the various donor agencies, it was probably clear at the time that the conditions were not right to increase lending volumes. Although Structural Adjustment Loans (SALs) I and II, did involve GoR in an ongoing dialogue, and much of the SAL III agenda is included in the recent Gref program, these achievements are modest relative to the sums of money involved. The unsatisfactory outcomes of the SALs stemmed from a combination of poor borrower performance (political splits and the lack of political will within GoR and the Duma), poor Bank performance (insufficient economic sector work (ESW) in preparation for SAL I), and limited conditionality that pertained only to procedural actions and not outcomes.

6. Since the August 1998 crisis, the Bank has attempted to refocus its strategy. We suggest that several lessons from its experiences in the RF should be incorporated in future strategy:

- Competition. The lack of consideration for market structures inhibited privatization from inducing sufficient competitive pressure to prevent entrenchment of vested interests, and hence failed to encourage real restructuring. The Bank should have expended more effort in exhorting GoR towards pro-competitive policy and in ensuring enactment of legislation to aid entry, infrastructure development, preventing regional controls and tax barriers, enforcing effective competition policy and relaxing non-tariff barriers to trade.
- Privatization Efforts to develop outsider ownership, and improve corporate governance and capital markets should have been more closely tied to the MPP.
- Conditionality must be carefully tied to real policy implementation rather than intermediate steps, for example, the passing rather than merely drafting of legislation, and must not be waived *ex post*.
- ESW is essential to direct Bank activity correctly, especially in such a volatile political and economic situation. Insufficient ESW may have detracted from the performance of SALs I and II.
- Continuity of Project Teams. Continual changes in the responsible Bank staff slowed program development and may have disenfranchised the borrower, potentially reducing loan performance, particularly when careful monitoring and supervision was required;
- “Ownership” of Projects and Targeted Lending. The Borrower must be afforded a sense of ownership of, and therefore responsibility to, a program. With such a fragmented political structure, this is more likely to occur when programs are carefully targeted to, for example, specific sectors or issues, rather than in general lending programs.

7. The RF is now faced with an unfinished reform agenda in the private sector development-financial sector development (PSD-FSD) area. We recommend that the Bank target its future activities in the RF in several priority areas:

- Tax Reform and Utilities Pricing. Tax collection has improved in the RF since the August 1998 crisis. However, evidence of poor tax discipline remains, and this softens budget constraints, discourages restructuring, and increases the public sector deficit. The Bank should also continue to encourage rational utility pricing and enforcement of charging in order to harden budget constraints and improve enterprise performance.
- Residual Government Ownership of Privatized Enterprises. GoR continues to retain considerable ownership within privatized companies, and the Bank should encourage GoR to withdraw voting rights from its shareholding.
- Secondary Ownership Transfer and Capital Market Development The reversal of entrenched insider control requires secondary transfer of ownership, which in turn requires a well-functioning, liquid, capital market. This should be supplemented with effective legislation to ensure protection of minority shareholders' rights. The Bank should thus supplement its Capital Markets Development Project with measures to support the development of effective property rights and corporate governance, which will also serve to encourage Foreign Direct Investment (FDI). In the current financial climate company investment must rely disproportionately on external funds which will not be made available in sufficient quantities until property rights issues are resolved.
- Banking Sector Development Undercapitalized, nonviable banks, which fail to operate on truly commercial grounds continue to operate in the RF. Some enterprises have consequently been able to subvert the hardening of budget constraints, while those wishing to restructure have been unable to obtain sufficient suitable financing. The Bank should thus enact its proposed financial sector TA program as a priority.
- Competition Policy We urge the Bank to place high priority on reassessing its strategy towards ensuring enforcement of competition policy to counter incumbent dominance, and to establish an environment that is conducive to, and supportive of, enterprise entry and small and medium enterprise (SME) sector development.
- Development of the Social Safety Net Although the GoR reform program is currently on-track, we would urge the Bank to monitor the situation carefully, as the development of a sound, well-targeted, but not excessively generous, social safety net is essential for maintaining the popular support for the reform process towards which the Bank has expended such effort.

1. Introduction

1.1 Russia has been in the process of momentous economic and political change for well over a decade. Early reforms within the centrally planned structure (the *Perestroika* movement) were undertaken under the leadership of then-President Gorbachev from 1987 to 1989, in response to long-term slow growth and inefficiency. This preceded the dissolution of the Soviet Union at the end of 1991 and the subsequent collapse of communist rule in the Russian successor state. In common with much of the region, the transition from central planning has required Russia to instigate efforts aimed at liberalization, privatization and macroeconomic stabilization. Unlike the rest of the region, however, the Russian reform process has been carried out on an unprecedented scale and consequent level of complexity. This paper provides an assessment of the relative successes and failures of the momentous Russian reform program and World Bank assistance programs in the area of private sector development.

2. Preconditions to Russian Reform

2.1 The process of “transition” from plan to market is different from that of development, and the transition process in the former Soviet Union has also been very different from that of Central Europe, for example, Poland, Hungary, or the Czech Republic. The first point was clear from the time of the joint IBRD-IMF-EBRD-OECD study of the Soviet Union in 1990 (“reference needed”), and the second had emerged by the time of studies comparing privatization and corporate governance in Central Europe and in Russia from 1994 to 1996. Since these points have been relevant to World Bank policy towards private sector development in Russia, it is worth expanding briefly on the core processes of transition and on the particular institutional problems of the former Soviet Union.

2.2 There are similarities between developing economies and the transition economies, for example, weak institutional and legal frameworks, shortage of capital, deficient capital markets, and poor policy environments. However, there are also differences. The capital stock, while suitable for industrial activity under central planning, was often inappropriate for production in a market economy (see Brada et al (1995) for evidence of this in Central and Eastern Europe). Apart from shortcomings in management, transitional economies are rarely constrained by labor or skills shortages and often provide excessive rather than insufficient social protection and infrastructure. The transition countries were over-industrialized rather than underdeveloped (the industrial share in GDP in several Central European economies in 1989 exceeded 50 percent) and faced the task of fundamental restructuring from planning to markets, from state to private ownership, from autarchy to trade, and from industry to services, rather than economic development *per se*.

2.3 The transition economies were almost all at a middle-income level in purchasing power parity (PPP) terms in 1989, and most were emerging from a system of central planning. There were some other important inheritances that needed to be addressed in the transitional path. Saving rates, though high (20-35 percent of GDP), were extracted compulsorily through high enterprise profits taxes and forced savings, and used for inefficient investments through a planned allocation mechanism. There were virtually no non-liquid assets in private hands, and

the tradition was for the state to provide education, healthcare, and pensions, often through the workplace.

2.4 The planners provided the mechanism whereby demand and supply was intermediated. The allocation of resources occurred primarily through a quantity-based planning system. There were no markets in the supply of goods, either for final products or through supply chains. Firms rarely had direct contact, either with suppliers or purchasers or final consumers. These relationships, which form the glue for a market economy, did not exist and when planning disappeared, it took a considerable time for them to be formed, exacerbating a major contraction on the supply side through “disorganization.” This was not well understood in the early years of transition; explanations for the output decline instead concentrated initially on the demand side and on liquidity constraints.

2.5 Moreover, the planning system also meant that there was no market for labor or capital, and the trade system was autarchic within the COMECON structure.

2.6 To ease the informational demands of planning, firms were gigantic and often highly vertically integrated in forms that would not have emerged in a market economy. These organizations were orientated to production rather than sales, and did not have financial independence from the state. Incentives to innovate and to improve efficiency were weak, with firms underwritten financially (soft-budget constraints). This underlies deficiencies in managerial skills.

2.7 The Soviet type of planning was not of the Lange-Heal sort, which sought to replicate market outcomes through a centralized allocation mechanism. The structure of output followed planners’ preferences, and was focused to industrial production, notably machine tools, heavy industry and defense, while economic geography was determined by the planners in ways that would not have emerged through competitive forces (giving rise to, for example, the Soviet monotonowns). Massive restructuring was therefore required post-reform to ensure the pattern of supply was brought to consistency with demand, implying major shifts from industry to services, from heavy to light industry and from machinery and weapons to consumer goods. Experiences from other economies suggests that such restructuring might need to rely disproportionately on the emergence of new firms, rather than reorientation of existing companies.

2.8 Given the size of existing firms, market structure was highly imperfect. Planned economies contained virtually no small firms, and did not have the institutional and legal infrastructure to induce and aid their creation (supply of funds, clear legal frameworks, level playing fields with incumbents etc.). Competition from trade had also been largely excluded. The political system favoured incumbents, and at the local level was built on relationships between managers and politicians.

2.9 Once growth in the communist economies started to slow, macro-imbalances began to emerge as the authorities sought to maintain the appearance of wage increases without underlying productivity growth. The resulting structural budget deficits surfaced in the fixed-price planned environment as shortages and queues. The consequence was the widespread emergence of a black economy, and large-scale corruption. The accumulated monetary balances

that were the manifestation of excess demand stored up an inflationary threat for when prices were liberalized.

2.10 There was an agreement that the transition path required stabilization and the eradication of budgetary deficits (eliminating enterprise subsidies), price liberalization in the context of an effective legal framework facilitating voluntary contracts, free entry and exit; competition in private markets to be speedily enhanced through trade opening (exchange rate convertibility, reduced tariffs), competition policy, and the privatization of existing enterprises. Foreign direct investment was also seen as crucial in supplying private capital, scarce managerial skills and technology.

2.11 The above summarises the main features of the reform process common to all transition economies. It led to the enactment of a range of policies in Central Europe between 1990 and 1994, focused on price and trade liberalization, privatization, legal and infrastructure development and stabilization. Though all the transition economies suffered a decline in output, growth was restored in most of Central Europe by 1993, and foreign direct investment flows were significant by 1994. There were, however, a number of reasons, already visible by the early 1990s, which suggested why Russia was likely to present a particularly intractable case of transition. Policies needed to be adjusted to take account of these problems.

2.12 Russia was a very large country, with many economically distinct regions which were widely dispersed, which had been using a highly centralized planning system since 1927. The “disorganization” implied by the collapse of planning in Russia was therefore likely to be marked, especially when combined with the collapse of the Soviet Union (and therefore relationships with enterprises now outside the new Russian Federation but formerly within the Soviet Union), and the associated collapse in the payments system. In retrospect, it is unsurprising that the output drop in the former Soviet Union was both deeper and lasted longer than in Central Europe.

2.13 The size, economic geography, and the population dispersion of Russia, combined with the poor transport infrastructure to make it much harder for trade to play a pivotal role in introducing competition outside a few large conurbations. This highlighted the need to address the competition issue prior to privatization, by breaking enterprises up vertically and horizontally; otherwise privatization would merely lead to the entrenchment of local-regional monopolies. A legislative basis for effective competition policy was, therefore, also particularly urgent in the Russian environment.

2.14 Russia had no tradition of capitalism upon which to fall back. The economies of Central Europe had been capitalist, at least in the interwar period and in some cases during the nineteenth century. Commercial legislation and traditions existed; outdated but available for revision. The Russian experience with capitalism had been shorter, and was far more distant, perhaps three generations previously. Three of the most fascinating papers produced by the Bank in the early 1990s indicate the implications of this (Webster, 1992 a,b; Swanson and Webster, 1992); many Czech, Polish and Hungarian entrepreneurs at the start of transition had either been entrepreneurs themselves (including abroad) or were the children of entrepreneurs. Russia did not have this tradition upon which to rely. This implied that particular institutional effort in the form of

training, exhorting, rewarding, and facilitating was needed in Russia to encourage entrepreneurship to develop.

2.15 The Russian economy was more complex, closed and inflexible (for example, internal passports restricting labor mobility), which raised transaction costs above those of Central Europe. This increased the opportunities and rewards for arbitrage and corruption, which were already well embedded before the decline in law enforcement associated with the collapse of the central Soviet apparatus in 1991.

2.16 Russia had a far more complex public expenditure system than other transition economies, being composed of a web of republics, oblasts, and regions with different legal expenditure and revenue raising powers. In addition to the structural deficits associated with transition, this ensured that Russia was likely to have a large budgetary problem arising from its fiscal federalism and the weakness of central control.

2.17 Unlike in Poland or the Czech Republic, Russia was not governed by a unified political group committed to reform. The reformers were a small group with limited appeal to voters who relied for their position on the support of the president, while facing determined opposition from the Duma and many regional governors.

2.18 It is in the light of these features, some, but not all, of which were known at the start of Russian reforms, that the Bank's policies need to be evaluated.

3. Russian Economic Performance and Political Environment

3.1 Following the dissolution of the Soviet Union, the Government of Russia (GoR) embarked upon an ambitious reform program from the start of 1992, led by then-President Boris Yeltsin. In the spirit of the Washington Consensus, GoR introduced initiatives to liberalize prices, wages, and trade, and promote macroeconomic stabilization in response to substantial reductions in GDP and industrial output of 14.5 and 18 percent respectively between 1991 and 1992 (EBRD, 2000). The third strand of reforms aimed at the development of a private sector were instigated in 1992. GoR embarked on a national privatization program centered around the mass privatization of medium and large state-owned enterprises (SOEs). Further reforms in this period were aimed at creating an enabling environment for private enterprise through the commercialization of the banking sector and the introduction of equity and securities markets, together with a variety of legal and institution reforms.

3.2 As expected, the liberalization of wages and prices led to a rapid increase in the rate of inflation, which was exacerbated by loose monetary policy of the CBR. Annual average consumer prices increased by over 1,500 percent in 1992 and by a further 875 percent in 1993, only falling below three digits in 1996 (EBRD, 2000). The rate of decline of GDP reduced in 1993 (falling by 8.7 percent), increased in 1994 (a decline of 12.7 percent) and reduced thereafter. Industrial output followed a similar trend, although with a larger initial contraction, falling by 14.1 and 20.9 percent in 1993 and 1994 respectively. Bolstered by high world oil prices, positive GDP and industrial output growth returned in 1997, and inflation maintained a

downwards trend with annual average consumer prices increasing by only 14.7 percent (EBRD, 2000).

3.3 Although Russia appeared to be making significant progress by this time, the country had experienced one of the deepest and longest periods of economic contraction of any of the transition economies—the Central European countries made rapid progress in economic reform and had all returned to positive GDP growth by 1994. This was partially a reflection of the scale and complexity of the reform task facing Russia and the fact that Russia did not benefit from the favorable geographic conditions enjoyed by the Western transition economies (TEs). However, Russia had also made insufficient reform progress at the microeconomic level, which was hampering macroeconomic development.

3.4 Lack of microeconomic and institutional reform began to manifest itself in several forms. The evidence suggested that neither privatization nor competitive pressures were leading incumbent firms to restructure. Labor productivity was declining. Barriers to entry for new firms were very high and consequently there was little entry. Foreign direct investment outside the natural resource sector was limited.

3.5 The microeconomic problems had macroeconomic consequences: the demonetization of the economy; ultimately reflected in the emergence of barter; a burgeoning shadow economy; the weakness of the banking sector; and poor tax collection¹. In turn, poor tax discipline contributed further to the low level of enterprise reform through the continued softness of enterprise budget constraints. Budget constraints were further softened through indirect subsidization via the privatized monopolist utilities and the banking sector via the Central Bank of Russia (CBR), and the lack of a credible bankruptcy law. The resulting inability of Russia to service its public and external debt led to a default in August 1998. This crisis was exacerbated by the fragile nature of the banking sector, with the result that the large outflow of finance instigated a systemic failure similar to that experienced by Latvia some years previously—although on a considerably larger scale. The Rouble plummeted on the currency markets ending 1998 at 30 percent of its end-year 1997 value. Widespread dollarization of the economy ensued, with analysts reporting that the volume of dollars in circulation exceeded that of Rouble M2 in 1999. Consequently the upwards trend in GDP and industrial output was reversed in 1998, falling by 4.6 and 5.2 percent respectively, and end-year consumer price inflation rose to over 80 percent (EBRD, 2000). In response to the crisis, GoR introduced temporary controls, which rescinded some of the reform progress made to this point.

3.6 More recently Russian macroeconomic performance has again rebounded—output expanded by 3.2 and 6.5 percent in 1999 and 2000 respectively (EBRD, 2000,)—and the temporary controls introduced in the immediate aftermath of the August 1998 crisis have been removed. The large Rouble devaluation encouraged import substitution, which in turn stimulated domestic output, and this, coupled with high oil prices, contributed to macroeconomic growth and a large current account surplus in 1999 and 2000. Hence macroeconomic data suggests that Russia recovered well towards the end of the millennium, though without fundamental enterprise restructuring and microeconomic reform, sustainability of the renewed growth is questionable.

¹ Poor tax collection was undoubtedly exacerbated by the fiscal-federal structure of the RF, which gave considerable tax powers to the regional administrations to collect local taxes that were to be remitted to the federal budget.

While Russia has undoubtedly made significant progress, the private sector picture is less encouraging and substantial reforms are required in many areas to redress serious impediments in private sector development.

3.7 From a political perspective, one must appreciate the contradictory agenda of various Ministries within GoR, which made it considerably more difficult for the Bank to align itself with a body in favour of reform. There was also a considerable degree of “capture” of the state by industrial interests, especially from the energy sector, from an early date in transition. Discussions with Bank staff from the time indicate that the reform group was not in a position to insist that powerful line ministries fall into line on policy positions advocated by them and supported by the Bank. Moreover, the collapse of a nuclear superpower naturally led to significant external pressure being placed upon the Bank from, among others, the G7 to preclude the possibility of chaos in a state in which there was weak control of the nuclear arsenal. Unfortunately, while the Bank, together with the International Monetary Fund (IMF), was expected to lead and coordinate this effort, it would appear that the Bank did not have anything close to the required number of qualified staff to fulfill this role until 1993.

4. Development and Performance of the Private Sector

4.1 Under the provisions of the 1989 legislation, enterprise collectives—workers and managers—could exercise an option to buy out the firm on a case-by-case basis. This ignited a process of spontaneous privatization. These firms were even more heavily dominated by insiders than those privatized in subsequent countrywide programs.

4.2 The first national privatization program introduced by GoR in 1992 sought to privatize small-scale enterprises, mainly in the services sector, by direct sale or buyout, and medium and large enterprises via a voucher-based mass privatization program (MPP). Vouchers were distributed to all Russian citizens, which could be converted into equity stakes in two ways: vouchers could be exchanged for shares in voucher investment funds, as in Poland for example; alternatively vouchers could be directly converted into equity stakes in corporatized enterprises. GoR recognized that the vouchers could be regarded as monetary surrogates, and secondary trading was permitted. Unfortunately this period also witnessed the development of non-licensed private investment funds, many of which transpired to be pyramid schemes which defrauded investors of their cash investments. This undoubtedly damaged the credibility and popular support for the privatization process. Nonetheless, in terms of sheer numbers, the MPP was successful with 16,000 enterprises being privatized by the completion of the scheme in July 1994. Following completion of the MPP, GoR instigated the “loans-for shares” scheme in late 1995, which sought to auction large stakes in enterprises to banks that would in turn extend loan finance to the acquired enterprise. Aside from legislative problems—which are discussed in more detail below—his process was rather opaque, unlike the transparent MPP. Consequently this development seem likely to have damaged the credibility of the privatization process and contributed directly to the establishment of financial-industrial groups.

4.3 Although the privatization program led to the divestiture of a large number of enterprises, ownership and control of the privatized enterprises fell largely into the hands of managers and workers. Under *perestroika*, insiders had been afforded effective control over their enterprise, and this was formalized under the MPP. This entrenchment discouraged the required enterprise

restructuring, so that the bulk of restructuring undertaken was defensive rather than proactive. Enterprises were able to act in this way owing to continued softness of budget constraints through tax holidays or exemptions (many of which were afforded at the regional rather than federal level) and through soft credits from CBR via pocket banks, compounded with weak bankruptcy legislation. Moreover, the process enabled the development of complex cross-holding equity positions between enterprises and banks—the so-called financial-industrial groups that were often controlled by oligarch owners of the privatized natural monopolies. If, in the reformers' minds, the concept behind privatization was to ensure demand-led development of the institutional and legal framework that would bring market discipline to bear to ensure enterprise restructuring, cost reductions, and enhanced productivity and profitability, such forces could not operate in these insider-owned firms. Ownership of these firms was dispersed, they were protected from capital market discipline, and they were excluded from external sources of funding.

4.4 The commercialization of banking activity emerged after the demise of the monobank structure, and the number of commercial banks in operation increased rapidly. Poor regulation by the CBR led to more than 2,000 banks being in operation by the end of 1993, increasing to more than 2,500 in 1996. Many of these were established with limited capitalization and low capital adequacy ratios (as in the Czech Republic and Latvia), and were initially pocket banks, to provide finance to a group of enterprises whose directors were frequently also board members of the bank. Other newly established banks were faced with an environment that was not conducive to prudent lending policies and screening of loans. The slow pace of legal and institutional development in Russia meant that property rights were very poorly defined (and in many cases remain so), financial reporting was opaque, and the legal system was ineffective. In large part this explains the slow rate of entry of foreign banks to the Russian system. A combination of these problems together with the unstable macroeconomic environment has constrained the availability of credit to the portion of the private sector, which could be viable in the long term given sufficient restructuring. Hence enterprises have been forced to rely on internally generated funds for investment, and, consequently, most have failed to restructure even when willing to do so.

4.5 These constraints have been magnified by the underdevelopment of the domestic equity market, on which total market capitalization remains extremely small. With the exception of the very largest firms—generally, the natural monopolies and utilities—enterprises have also been unable to obtain financing by issuing stock, further constraining their ability to restructure.

4.6 Overall, therefore, although Russia has made significant progress in terms of divesting SOEs, establishing private enterprise, and creating a financial sector, much remains to be done to redress the shortcomings of the program to date. In particular, the development of the private sector has been constrained by (a) the concentration of ownership and control in the hands of insiders who have entrenched their position and failed to encourage restructuring; (b) the development of a poorly regulated, undercapitalized financial sector, which has been used as a vehicle for transference of GoR subsidies and has failed to provide private credit; (c) the weak enforcement of tax liabilities, which has softened budget constraints and weakened the GoR's fiscal position; (d) a weak legal system—largely because of weak enforcement rather than actual legislation—which has often been introduced at the behest of the international financial

institutions (IFIs); and (e) the poorly defined property rights and corruption, which have discouraged foreign entrants.

4.7 Liberalization and privatization were not associated with systematic attempts to enhance product market competition. Unlike, for example, in Hungary and the Czech Republic, Russian firms were usually privatized without being broken up and without oversight from a Competition Office. Competition issues were not significant in the privatization process. The legal and institutional basis for competition policy, to the extent that it existed, was anyway outdated and weak. Little was done to enhance the position of potential entrants vis-à-vis incumbents or to facilitate large-scale, foreign, direct investment. As a consequence, Russian firms enjoyed a significant degree of monopoly power, particularly on regional markets, and this was not eroded as the reform process proceeded.

5. Evolution of the Bank's Sector Assistance Strategy

5.1 The Bank's sector assistance strategy in PSD and FSD was based on privatization (particularly the MPP) and the development of an enabling environment for private sector activity, including banking sector, land, and housing reform. Bank strategy can be broadly considered as comprising four distinct phases. Phase 1 (FY90 and FY91), the pre-membership assistance phase, which largely took the form of technical cooperation agreements; Phase 2 (FY92 to FY95) in which the Bank began, and rapidly increased, lending to Russia; Phase 3 (FY96 to FY98), during which the Bank built on what it regarded as open commitment to structural reform and addressed a loss of momentum in privatization; and, finally, Phase 4 (FY98 to the present day), following the August 1998 crisis, when the Bank adjusted its strategy towards aiding recovery from the crisis and alleviating poverty. This phase was undertaken in much closer cooperation with the IMF. This section details the major policy initiatives in each of these phases.

5.2 The Bank signed a Technical Cooperation Agreement (TCA) with the USSR on November 5, 1991. Moreover, prior to the RF's becoming a formal Bank member, a Technical Assistance Trust Fund was established to finance TA activities. The TCA identified priority areas that the program was to address in Russia, and 34 TA projects, all with fairly low-level funding, were identified in the TCP. The three major components of this initiative were privatization and PSD, banking reform, and specific sector reforms, in particular the housing sector. The privatization and PSD component comprised three individual projects: (a) Privatization (Project TF028512, US\$1.7 million) to provide TA to the Russian Privatization Agency to aid the launch of the MPP; (b) PSD (TF028515, US\$0.5 million) to support GoR's institutional capacity development initiative in regulatory reform and enterprise assistance; and (c) FDI (TF028514, US\$0.5 million) to assist regulation of, and the development of incentives for, foreign investment. The banking reform initiative was aimed at supporting the development of commercial banking activity, in order to create an enabling environment for PSD, under three projects: (a) Financial Sector Project (TF028508, US\$0.1 million) to encourage international banking standards and support a deposit assurance scheme; (b) Bank Legislation (TF028510, US\$0.2 million); and (c) Accounting Project (TF028524, US\$0.2 million) to enable Russian banks to adopt international accounting standards. Finally, a housing sector project (TF028503,

US\$0.3 million) was established to aid privatization of the housing stock and increase competition in new building activity, hence supporting labor mobility.

5.3 The Bank approved its first Country Assistance Strategy (CAS) for the Russian Federation (RF) on July 22, 1992. This marked a distinct change in the Bank's strategy in Russia from TA to loan activity aimed at supporting the development of an enabling environment for PSD. Consequently, Bank priorities were established towards privatization and enterprise reform, financial sector reform and infrastructure development and expansion. The 1992 and 1993 CASs emphasized a need to achieve these objectives by channeling resources for PSD and development of market-based institutions through viable financial institutions operating according to sound commercial principles. This view was reaffirmed in the 1994 CAS, which also recognized the growing need for legal and institutional development to support PSD. By 1995 the Bank regarded Russia as having made "impressive progress" in the institutional and legal development required of a functioning market economy, but recognized a need to prioritize reforms towards more rapid enterprise restructuring and agricultural-land reform. The Bank, therefore, took a leading role in the development of a post-privatization restructuring program (given the completion of the MPP in July 1994) that included (a) lending to enterprises through the commercial banks, (b) developing regionally based equity venture funds, and (c) providing TA to enterprises through local Privatization Centers.

5.4 During this period the Bank's lending instrument mix consisted of two quick-disbursing operations (Rehabilitation Loans I and II, totaling US\$1.2 billion) together with separate TA loans and several sector investment operations. The first Rehabilitation Loan (RLI, US\$600 million, approved August 6, 1992) was designed as a rapid-disbursing loan to support the RF reform program in the areas of enterprise reform (including privatization), antimonopoly policies, support for FDI and FSD, and development of the social safety net. RLI supported reforms in these areas by providing budget support and foreign exchange to imports by the emerging private sector. By virtue of the emphasis on rapid disbursement, the loan was provided in a single tranche without conditionality. Together with this general reform-supporting loan, the Bank portfolio in this period included (a) a Privatization Implementation Assistance Loan (US\$90 million, approved December 17, 1992) to support the MPP and policies aimed at supporting competition; (b) an Enterprise Support Project (US\$200 million, approved June 21, 1994) to provide investment and working capital finance for *de novo* and privatized enterprises; and (c) a Financial Institutions Development Project (US\$200 million, approved May 19, 1994), which was mainly focused on strengthening the commercial banking sector and modernizing systems, together with the development of CBR supervision capabilities, and modernizing accounting standards and practices.

5.5 Following the 1995 CAS, a second Rehabilitation Loan (RLII, US\$600 million) was approved on June 6, 1995, with the aim of supporting macroeconomic stabilization and structural reforms, particularly the speed of trade liberalization. Although negotiations for the loan began in August 1993, implementation was suspended as a result of the deteriorating political situation in RF and poor macroeconomic progress. Processing of the loan began again in April 1994, but was again suspended following a further deterioration of the macroeconomic conditions in Autumn 1994. This led to a failure to meet the conditionality requirements on the second tranche of the IMF's Systemic Transition Facility (STF) program. Board approval was finally obtained following presentation in mid-1995 after the IMF reached a Stand-By Arrangement with the RF

in the second quarter of 1995. Following approval by the Bank's Board, disbursement of RLII, as in RLI, occurred in a single tranche.

5.6 By FY96-97 the Bank was becoming increasingly optimistic over RF reform progress. The RF's macroeconomic situation appeared to show signs of improvement, though for reasons discussed above this improvement was probably not sustainable. It was, however, clear that privatization momentum had waned, and that GoR had to take action to regain this momentum. Moreover, GoR also had to take measures to improve the quality of privatization, to deal with a rapid expansion of the banking sector and to correct lagging agricultural reforms—especially land ownership legislation. The FY97 CAS was extremely optimistic about developments in the RF, regarding this period as a “window of opportunity” in which the Bank should significantly increase its assistance once GoR demonstrated commitment to increase the pace of reform initiatives. In order to restore growth, the CAS recommended a broad set of PSD reforms that reiterated previous recommendations, including the acceleration of capital market and banking sector development; establishment of property rights and improvement of legal enforcement (including bankruptcy legislation); competition and reform of the natural monopolies; and agricultural developments through accelerating the pace of farm restructuring and development of land markets. This CAS, however, also recognized the need to stop nontransparent privatization and emphasized case-by-case privatization and the removal of impediments to entry and exit in order to successfully promote competition.

5.7 In accordance with the Bank's desire to accelerate the pace of the RF reform process, lending assistance to RF also increased in scale and speed of disbursement. Three major initiatives were explicitly designed to increase the speed of structural adjustment in the RF in this period: Structural Adjustment Loans (SALs) I, II, and III. SAL I (US\$600 million, approved June 5, 1997) was rapidly followed by SAL II (US\$800 million, approved December 18, 1997). The approval of SAL III on August 8, 1998 (US\$1.5 billion) was rushed in an attempt to stem the incipient macroeconomic crisis. It was intended to extend and deepen developments in SALs I and II, and was a clear indication of the Bank's movement towards large-scale financial support and a desire to increase the speed of RF reform. Four other initiatives are notable in this period in addition to the SALs:

- (a) an Enterprise Housing Divestiture Project (US\$300 million, approved May 7, 1996) was intended to encourage enterprise restructuring through divestiture of social assets and reform of housing subsidies;
- (b) a Capital Markets Development Project (US\$89 million, approved May 30, 1996) to aid development of a regulatory infrastructure, an efficient and secure trading, clearance, settlement and registration system, and tracking systems for government securities;
- (c) an Enterprise Restructuring Services Project (US\$85 million, approved June 5, 1997) to provide restructuring services to more than 200 eligible enterprises (with a direct credit line from the Ministry of Finance) to increase efficiency and aid access to commercial credit lines; and

- (d) a Legal Reform Project (US\$58 million, approved June 13, 1996) to provide TA on legal drafting, classification and dissemination of legal information, legal education, and public information provision and judicial reform.

5.8 The package of assistance, of which SAL III was part, could not prevent the financial crisis in RF of August 1998. As a consequence, SAL III implementation was suspended after disbursing the first US\$300 million tranche of its three tranche back-loaded structure, and an additional US\$100 million in FY99. SAL III was eventually cancelled in FY00. Understandably, the crisis induced a dramatic change in the Bank's operational priorities from those in the 1997 CAS. It was clear that new priorities were required to deal with the fallout from the crisis, in particular to restructure the banking sector. The Financial Institutions Development project (FIDP) was restructured accordingly to improve banking legislation and audit the major banks to ensure that they were applying due diligence. Similarly the Bank implemented a joint program with the IMF to develop and implement bank restructuring strategies.

5.9 The FY99 CAS refocused the Bank's activities in RF. Responsibility for commercial lending operations were passed to the International Finance Corporation (IFC), and the Bank shifted from project-based lending towards poverty reduction and systemic institutional development. Consequently, the Bank continued to emphasize large adjustment loans focused on policy reforms and institutional development and the creation of an enabling environment, rather than the more specific investment lending of earlier years. The Bank intended to provide assistance to enable the GoR to develop programs in PSD (especially to strengthen corporate governance) and FSD (in particular, to reform the banking sector). Lending to RF during the most recent period has been at a slower pace and lower level, and seems likely to remain so for some time. During FY00 the Bank proposed development of SAL IV to replace the cancelled SAL III, to support reforms aimed at hardening enterprise budget constraints and reducing administrative interference in private business activities. The FY00 CAS also contained plans for a financial sector assistance program to assist GoR and the CBR in developing a financial sector reform strategy, improving bank supervision, and to support the banking sector restructuring agency (ARCO).

5.10 According to the FY99 CAS, commercial lending initiatives will fall solely under the remit of the IFC, which will focus its activities on agents in the private sector in an effort to increase investment in the real sector, encourage FSD, and provide TA. The IFC intends to do so through setting example to commercial financiers, attracting FDI, transferring technology and good business practices, and institutional development. In order to do so, the IFC will work with small local banks, help establish local leasing companies and provide TA to the SME sector through the Private Enterprise Partnership. It is hoped that by dividing responsibilities in this manner, IFC activities will successfully support and enhance Bank policy in RF.

6. Bank Products and Services Assessment

6.1 Throughout this program of assistance to Russia, the Bank has evaluated and revised its assessment of the constraints and risks associated with its lending program and the RF reform program more generally. The FY92 CAS, while being generally positive with regard to the reform program, noted three key risks or constraints to the program, which could contribute to

ongoing macroeconomic fragility in the RF: the possibility of a weakening political commitment to reform; inadequate implementation capacity in Russia that would prohibit efficient use of loan funds; and the deterioration of foreign exchange reserves following trade disruption, which was unlikely to be ameliorated by additional external financing. The Bank stated that: “Shortcomings in any of these [the latter three] areas could produce substantially higher inflation, stagnant or declining living standards, or rising unemployment. The political backlash resulting from this situation could derail the reform process.” [1992 CAS para. 48]

Viewed in this light, it seems clear that RLI was designed to be a single-tranche, rapid-disbursing loan to provide foreign exchange financing to the RF, so preventing the third outcome and hopefully cementing the reform agenda. The RLI documentation explains that the loan would aid imports to support, for example, enterprise reform, agriculture, the transport sector, the health sector, and the coal industry.

6.2 Implementation of the loan occurred through existing agencies in the RF. However, as the ICR of February 1997 notes, these agencies were reliant on TA provision by the U.K. Know-How-Fund (KHF) rather than directly through the Bank group, as typically occurred in similar Bank operations in other former Soviet republics. Although there was an eight-month delay in establishing a project implementation unit (PIU) for the loan, the ICR concludes that implementation was satisfactory, as it succeeded in familiarizing GoR with Bank operations. Moreover the TA provided by the KHF demonstrated valuable public-procurement lessons to GoR. The PIU-related delay no doubt contributed to the loan’s being closed on September 30, 1994, rather than the original date of December 31, 1993, with full disbursement occurring on February 1, 1995. Analytical ESW to support Bank activities in the RF was confined to synthesizing work undertaken under the previous TCP, while TA work in various areas was regarded as completing the ESW program.

6.3 Both the ICR and an OED Evaluation Memorandum (of June 1997) regard the overall project outcome as satisfactory, sustainability as likely, bank performance as satisfactory, and the institutional development impact as substantial. Nonetheless, the OED evaluation notes that the GoR macroeconomic reform program was not fully implemented in the early phase of the loan, with the aforementioned macroeconomic deterioration in FY92-93; hence such conditionality as existed was not entirely met.

6.4 An OED review in 1999 of RL I and II noted that a Rehabilitation Loan framework was chosen over a more traditional policy adjustment operation, as it was felt that the unstable evolving political situation in the RF precluded the possibility of meeting adjustment lending preconditions. OED rightly concluded that the outcome of RL I was marginally satisfactory, with its objectives being partially achieved. This conclusion is appropriate, given the relatively limited objectives of this project and that one of the main objectives of the loan, the rapid alleviation of foreign exchange reserve shortages, was not achieved owing to the implementation delays.

6.5 Nonetheless, RL I succeeded in establishing the groundwork for the implementation of RL II, which was given Board approval in June 1995. As noted previously, RL II was prepared in close collaboration with the IMF. Once again, the loan was established as a single-tranche operation and implemented without specific conditionality. The completion report for RL II

explains that the majority of the objectives of RLII were carried out prior to Board approval of the loan. The review concluded that the overall project was satisfactory, and that the outcomes were sustainable.

6.6 OED did not concur with this finding, and rates the RL II outcome as unsatisfactory and questions the original rationale for, and design, of RL II. In so doing, it claims that the Bank was aware of the difficult policy environment in RF at the time of design, and policy objectives insufficiently addressed the required fiscal and structural issues in the RF. While this position has some merit, one could view RL II as the second tranche of a larger Rehabilitation Loan program. Hence while many of the objectives of RL II were extensions or replications of those of RL I, in reality the loan was intended to provide support for GoR in order to limit political instability and prevent retrenchment of the GoR reform program. While one could take the OED view that RL II should have furthered the reform agenda to induce progress on fiscal and structural issues, one should acknowledge the significant danger of political instability at the time. Although additional reform progress would have been ideal, cementing the agenda at a time when the threat of political instability was tangible must be regarded as a valuable objective in this light.

6.7 Nonetheless, OED noted that the RLs were not entirely successful in cementing reform; the report reaches the conclusion that borrower performance was marginally unsatisfactory in the case of RL I and unsatisfactory under RL II, as GoR made limited reform progress and indeed reversed some trade and price liberalization measures. Nonetheless, the resulting conclusion that the sustainability of both RLs is unlikely seems a somewhat harsh corollary, although this may be explained by the fact that the review took place after the 1998 crisis. Despite this, OED correctly identifies several important lessons from the RL experience; in particular, it is clear that such programs require more detailed supervision than standard projects, and that ring-fencing portions of funding for specific activities serves to complicate implementation and delay it beyond the point when the funding was required—as in the Pre-Identified Import and PIU component of RL II.

6.8 The other main project in this second phase of activity for which Bank evaluation materials are available is the Privatization Implementation Assistance Loan (PIAL). As noted in the project ICR, preparation of this project was financed through support to the Russian State Property Committee (GKI) with a grant from the Bank's Trust Fund for Russia, a Project Preparation Facility, and two grants from the European Union's Technical Assistance for the Commonwealth of Independent States (EC TACIS) program. The primary focus of the PIAL was to provide support for the RF privatization program, to establish and develop supporting institutional capacity with the RF in the form of the Russian Privatization Center (the PIU for the loan), and to implement the MPP. In addition, the project was intended to assist GoR in policy design and to assist in aiding business entry through new business and infrastructure service provision. Consequently, the program consisted of four interrelated components:

- (a) a Policy Design Component, providing TA to support complementary policy analysis to the privatization process;

- (b) a Privatization Implementation Component, to provide TA and equipment to support the privatization process together with the establishment of the Russian Privatization Center as the PIU for the project;
- (c) a Business Development and Promotion Component, to provide TA to the public and private sector, improving understanding of, and policy towards, the emerging private sector in RF; and
- (d) the Refinancing of the Project Preparation Facility.

Funding for the program was divided between the Bank, EBRD, and GoR, with Board approval occurring on December 17, 1992, and becoming effective from December 7, 1993. The loan was restructured on several occasions, most notably in 1996 with the inclusion of an Investor Protection Program (IPP) component, which was intended to assist GoR with investor compensation and development of a mutual fund industry, including the liquidation of illegal investment fund operations in RF at the time. Additionally, the loan was subject to several delays owing to the problem with the availability of additional grant funding, and due to the investigation into the activities of Harvard Institute of International Development (HIID), which was assisting the Institute for Law Based Economy, the implementation body for the IPP. As the ICR notes, utilization of the loan was further delayed as GoR appeared to prefer utilizing bilateral grant finance between 1993 and 1996 rather than the PIAL (this led to the Bank's rating Borrower Implementation Performance as deficient). The loan was closed on June 30, 1999, three years after the originally intended closure date.

6.9 Specific analysis of the choice of the MPP as a privatization vehicle and the likely factors that contributed to this choice are presented in section 7 below. Suffice it to say that the PIAL contributed significantly to the design and implementation of the MPP, which was completed at the end of June 1994. While this was a logistic success, we concur with the most recent OED ICR evaluation in that the program did not lead to improved enterprise restructuring. This is because GoR and the PIAL did not sufficiently address the fact that the MPP was only the first stage of a process of successful transformation of ownership to outside agents. Furthermore, the PIAL contributed financing to the process towards case-by-case privatization, although GoR rejected this strategy in favour of the loans-for-shares program.

6.10 However one might regard the MPP, it undoubtedly succeeded in rapidly transferring ownership from State control. The ICR correctly notes that the MPP was viewed as a major reform achievement at the time, and, as we note below, it is not clear that the political and economic milieu of the time permitted any alternatives. Moreover, the PIAL contributed to TA provision to GoR policy and implementation in a variety of Russian agencies. Following the MPP, PIAL funds were directed towards enabling restructuring activity among privatized enterprises. This led to the development of the Enterprise Restructuring Services Project, following a request from GoR, using some of the funds for the PIAL. This project was later cancelled following the August 1998 crisis.

6.11 The Business Development Promotion component of the loan was conducted with assistance from the Working Center for Economic Reform and its Institute for Private Sector Development and Strategic Analysis. This collaboration gave rise to a significant volume of

research, publications, and conferences, and appears to have been a valuable contribution. Moreover, the problems with the IPP component of the loan led the Bank to transfer responsibility for implementation to the Center for Capital Markets Development (CCMD). The ICR notes that this transfer of responsibility led to improved implementation in the final nine months of the project.

6.12 Given such a broad program, project outcome is of varying quality throughout the variety of activities. Nonetheless, within such a broad program the Bank was able to restructure the loan on several occasions in response to GoR requests, given the emerging conditions in the RF. As the ICR notes, the project was initially hampered by the lack of knowledge of Bank procedure, given that the loan was the first TA project in the RF. Hence, this loan, together with RLI, certainly served to lay groundwork for future Bank operations in the RF. Although the ICR does not provide an explicit rating of sustainability, it seems reasonable to regard it as satisfactory, given the successful divestment of SOE ownership and capacity building within local agencies. However, the Russian Privatization Center (RPC) proved unsustainable owing to the departure of its chief executive officer in late 1996 and the removal of foreign TA as donor fund lines were closed. The satisfactory overall outcome rating of the ICR is valid, given the significant impact that the project had on the RF reform process.

6.13 However, there are two significant deficiencies in the project. The first concerns the lack of continuity of Bank task managers and the staff within the Resident Mission. Both the ICR and Quality Assurance Group (QAG) reports note that Bank supervision lacked continuity (staff continuity received an unsatisfactory grading in the QAG). While this situation appears to have been rectified from FY98, there seems little doubt that the a project of such complexity and significance for the RF reform effort required greater continuity and close supervision in the early stages, particularly given that RF loan partners were not familiar with Bank procedure. This is noted in the ICR as one of the key lessons learned from the project, and it is to be hoped that the Bank heeds this generic lesson in future operations, particularly when there are frequent changes within the government and bureaucracy of countries of operation.

6.14 More fundamentally, while the MPP enabled the initial divestment of ownership, primarily to insiders, the project failed to enable the successful transformation of ownership to outside agents. In part this is understandable, given the vested interest referred to below. However, it seems clear that the Bank should have expended more effort on the development of capital markets and the banking sector in the RF. Although the FIDP and Capital Markets Development projects (CMDPs) were geared towards development of the financial sector in the RF, efforts should have been much more closely tied to the MPP and the PIAL more generally. Hence, while performance of the PIAL can be rated satisfactory, the lack of complementary financial sector and capital development work is a failure of design.

6.15 In the third phase of activity the Bank displayed increasing optimism over reform progress in the RF. Consequently the scale and speed of Bank activity in this phase increased significantly with the introduction of SAL I and II. The SALs were intended to assist GoR in structural and institutional reform towards sustainable macroeconomic growth and alleviation of potential fiscal difficulties. SAL I focused on reform in four key areas: (a) fiscal reform, (b) reform of infrastructure monopolies, (c) private sector development, and (d) financial sector reform. SAL II continued the reform package of SAL I with the addition of a trade reform

support component. Approval of SAL III followed a mere eight months after approval of SAL II. Hence, as noted in the OED review of SALs I and II, the SALs are perhaps best regarded as three tranches of the same operation, rather than as free-standing operations.

6.16 Unfortunately this ambitious, and costly, program did not result in significant reform progress in the RF. In particular, progress in banking sector and tax reform has been limited. However there was limited progress in terms of fiscal reform and, reform of natural monopolies prior to the 1999 crisis. More positively, PSD components of the SALs induced efforts to improve the enabling environment for the emerging private sector in the form of developing the legal framework for bankruptcy (in draft form), for land transactions, and for the adoption of International Accounting Standards. However, given that the combined disbursed funds for SALs I to III amounted to almost US\$1.6 billion, this is modest relative to the sums of money involved. Against this, one should note the possibility that the SALs did succeed in involving GoR in an ongoing dialogue, which is likely to prove beneficial in the longer term. Consequently, while it is difficult to support the conclusions of the ICRs for SALs I and II, which assess overall performance of both loans as marginally satisfactory, the OED conclusion of unsatisfactory performance is reasonable.

6.17 Essentially the reason that the SALs did not produce significant concrete progress in the RF can be attributed to unsatisfactory performance of both the Bank and the Borrower. Evaluation of Borrower performance is complicated by the difficulty of evaluating which body constitutes the Borrower on such a far-reaching project. Nonetheless, given the political splits and the lack of political will within GoR and the Duma, Borrower performance must be deemed unsatisfactory. From the Bank's perspective, it is clear that there was insufficient ESW in preparation for SAL I, as OED notes. Under these circumstances, the Bank should ideally have delayed the implementation of SAL I until suitable ESW was undertaken to identify priority areas and potential actions. Moreover, such ESW would have led to a deeper understanding of the scale of the reform effort required in the RF and hence led to a more realistic assessment of the rate at which reform progress could reasonably be expected. OED notes that the design of SAL I was flawed by the assumption that reforms could be introduced quickly, and the timing of SAL II was rushed, given the implementation problems in SAL I. [OED draft PAR p.18]

6.18 While OED suggests that the single-tranche structure of SAL I was appropriate, it questions the wisdom of implementing SAL II as a single-tranche operation. This seems a reasonable criticism if the incentives from such action would garner political will and ultimately aid implementation and reform. The more fundamental issue, however, concerns that of the nature of conditionality on SALs I and II. OED notes that one of the lessons from this experience stems from the fact that the limited conditionality that was attached to these operations pertained to correct procedural action and not to outcomes. In a volatile political and economic situation such as that in the RF, attaching conditionality to actions must be fundamental if loan programs are to achieve the desired results.

6.19 Fortunately, the Bank appears to have learned this lesson and applied more substantial conditionality to SAL III, both in its original form and in proposed revisions. Following the August 1998 crisis, the Bank and GoR engaged in a detailed dialogue regarding the restructuring of SAL III. A memorandum from the Operations Committee of April 2, 1999, clearly states that the revised program requires legislation not merely to be drafted but to have been passed by

parliament. Moreover, this memorandum included a clear prescription that tranches should be heavily back-loaded under the revised structure, in order to ensure the conditionality's being met at each stage prior to further Bank commitment. As noted above, this dialogue led to the Bank's releasing a further US\$100 million on August 3, 1999, as the first restructured tranche. However, it seems likely that these amendments contributed to GoR's requesting the cancellation of the restructured SAL III in August 2000, with cancellation effective from September 6, 2000. Nonetheless, as the January 11, 2001, Country Assistance Strategy Progress Report notes, the majority of the significant policies with SAL III have since been incorporated in GoR's new economic program.

6.20 Analysis of individual projects in the Bank's portfolio in the RF thus provides some valuable lessons for future Bank activities. However, in order to fully appreciate the factors that contributed to their evolution, design, and implementation, the following section considers the wider Bank strategy in the RF during the period under consideration.

7. Development Effectiveness Impact Assessment

7.1 Given that the above discussion has considered Bank strategy in the context of four distinct phases, it seems sensible to consider counterfactuals in the same framework. In Phase 1 (FY90-FY91) Bank strategy was largely aimed at studying the economy and understanding how the Bank could best assist the building of absorptive institutional capacity in the RF, and this was clearly a necessary precondition that could not be faulted. However, discussions with Bank staff suggest that by this time, the RF may have already lost control of much of the rents from its natural resource base. The repercussions of this loss of control were most significant from FY95 onwards. If one accepts this hypothesis, one possible corollary is that the Bank was wrong to assume that free-market-oriented institutional development would be demand-led—presumably, there were too many individuals with vested interests to prevent the development of institutional checks and balances. Hence one could argue that the Bank should have made more effort to force institutional development on the agenda, perhaps through attaching developments such as these as conditionality to the lending portfolio; although we acknowledge the potential for “virtual” compliance with conditionality. On balance however, given that state of knowledge about Russia at that time, it is hard to be critical of the Bank's policies.

7.2 Counterfactual assessment of the second phase of Bank activity (FY92-FY95) must revolve around the privatization process. Documentary evidence and discussions with Bank staff from this time all lead to the conclusion that Bank operations reflected strong external pressure on Bank activity (for example, from, amongst others, the G7). The Bank was charged with the task of affording large, rapid-disbursing loans with limited conditionality in order to support the RF's reformist group. Indeed the 1992 CAS notes that IMF officials provided a great deal of assistance in the preparation of RLI. There was genuine concern that without support for the reform program in the RF, the reform faction, who were by far the minority in the Duma, would have power taken from them and the opportunity would be lost. In this light it seems clear that the choice of following an MPP was driven by political economy considerations, as there was a genuine belief that the window of opportunity for reform was small, as there was a palpable threat of a return to Communist power. Whether the MPP prevented this from occurring is of

course impossible to verify, but the desire to instigate a rapid divestiture on the basis that it would be difficult to retract from a reform path is convincing.

7.3 There are of course several alternative privatization strategies that have been followed in a variety of TEs. The Hungarian and Polish privatization schemes relied heavily on initial public offerings and direct sales of SOEs to outside investors, including foreigners, managed by a state agency. Discussions with Bank staff from the time make clear that such a strategy was not acceptable to the RF authorities, as they regarded such a program as likely to be slow and too large to control centrally in a country the size of the RF. The Hungarian strategy also included several demonstration privatizations, mainly in the natural resources and telecommunications sectors, which were transparent and encouraged FDI. Nonetheless, the RF case does not seem to easily lend itself to this strategy as there were many vested interests, especially in sectors that would have been attractive to foreign investors. Moreover, given the political economy environment of this time, it is possible that such a strategy would have led to an even earlier loans-for-shares scenario and entrenchment of the oligarchs. Similarly, while several commentators have suggested that Russia should simply have continued with a policy of lease buyouts, which emerged during *perestroika*, it seems clear that this would not have been successful in Russia at the time. Russia did not have a sufficiently well-developed national or regional institutional environment, as in Poland or China respectively, for example, to prevent large-scale managerial expropriation of assets under such a scheme. Finally we consider whether the RF authorities could have broken-up SOEs prior to privatization, in order to prevent such powerful entrenchment and open the path to increased competition post-privatization. Our discussions with Bank staff indicate that this idea was considered internally by the Bank at the time. It appears, however, that the borrower regarded such a scheme as unacceptably slow and difficult.

7.4 While the MPP was a rapid and transparent mechanism for divestment, it was clear at the time that such a strategy was not free of economic and political risks. The Stiglitz-Ellerman perspective suggests that the issue is essentially one of the concentration of ownership and control (“reference needed”). By definition, the MPP had to lead to dispersed ownership, and hence managers without sufficient control to afford themselves legitimate rewards for good performance were always likely to engage in asset stripping. A similar outcome would probably have emerged if privatization had been delayed, as incumbent managers would still have been able to control the asset base of state owned firms (SOEs) but not the reward structure. The solution to this problem in the RF rested in a mixed strategy with MPP accompanied by the creation of concentrated ownership through case-by-case privatization, preferably in such a way as to induce FDI. While we acknowledge that this case-by-case privatization was politically unacceptable, it was probably clear from the outset that the MPP was unlikely to result in demand-led institutional and legal development. The most obvious manifestation of this in the RF is in the development of the banking sector with large numbers of pocket banks being operating effectively as treasury departments to associated enterprises. In this regard the Bank was correct to include institutional development projects in the RF program, but this could have been more focussed, particularly with regard to the development of legal capacity and enforcement. The gulf that has emerged between legal legislation and that enforced in the courts has been found to be one of the key constraints on FDI inflows to the RF (Bevan, Estrin and Meyer [2001]). However, in the second phase the Bank’s involvement in RF was quite modest. The decision to support the MPP was probably correct in the circumstances. The weaknesses of

Bank assistance were mainly in providing insufficient encouragement for governmental support for the microeconomic reform process and to ensure effective implementation of reforms.

7.5 This discussion suggests that the Bank was simply constrained by the political economy of the time: the window of opportunity was small and rapid action was required. This does, however, lead one to question whether the Bank expended sufficient effort in attempting to produce serious counter-arguments or whether it was simply too client focused. One can understand why the borrower wished to pursue the MPP strategy, and it appears that they were able to appeal to the work of chosen respected academics and practitioners to support the case for the MPP. The Bank, by contrast, appears to have not undertaken sufficient ESW to permit it to produce credible alternative strategies tailored to the RF case. Many people actively engaged at the time also take the view that the reformers would not have considered alternatives. Moreover, it is also unclear whether more ESW work on microeconomic reform would have altered in any significant way the subsequent domination of the business sector in RF by a relatively small group of vested interests

7.6 The concern over potential political instability is a recurring theme throughout the Bank's strategy in FY92-97. The FY93 CAS outlined the main areas requiring consideration as (a) macroeconomic stabilization, especially regarding pricing in the agriculture and energy sectors; (b) enterprise reform, a supporting financial sector and social safety net; and (c) limited institutional capacity and political factions, manifesting itself through the slow approval of loans by GoR and potential political instability. Bank strategy thus focused upon enabling rapid privatization, on the assumption that required institutional reform would be demand-led, and back-tracking would be made more difficult if state-ownership of enterprises was rapidly divested. Nonetheless, the Bank did note that there was a need to address the supply-side institutions, e.g. given that the commercial banking sector at the time seemed unlikely to provide adequate support for enterprise restructuring and was therefore likely to act as a constraint on further reform. Similarly the Bank repeatedly reaffirmed the need to advance development of a social safety net, in order to prevent any negative fallout from restructuring leading to political instability.

7.7 This seems to explain the emphasis of Bank strategy towards fast-disbursing loans with limited conditionality. Nonetheless, the Bank did suggest that the volume and speed of its assistance program should be considered in light of three scenarios (High, Intermediate and Low). Each scenario was associated with macroeconomic, structural, and sectoral reform triggers. The FY94 CAS suggested that the Intermediate case lending program was most appropriate at the time, and that loan activity should be linked much more closely to GoR sectoral reform progress. The Bank did note, however, that while financial volumes should be a reflection of reform progress, the Bank should have a critical number of projects in the RF if it was to be seen as having a credible voice in the reform process. There was an emphasis on flexibility in the Bank's strategy, which was only to be set in the short term and should be sufficiently flexible in the medium term to respond to the evolving conditions in the RF. Despite the IMF STF second-tranche agreement signaling that the trigger conditions identified as *necessary* to support Bank lending in a high case scenario have been largely met (FY95 CAS para.57) the Bank maintained an Intermediate case perspective through this period. This seems to have been a sensible decision, given that the Bank was becoming increasingly concerned

about fiscal relations between central and regional government, institutional capacity to deliver microeconomic reform, and political instability.

7.8 It is in the third phase of Bank activity—FY96-FY98—that some real alternatives for World Bank strategy emerged. While the Bank accepted that lending should remain at the Intermediate level through FY96, FY97 witnessed a remarkably optimistic assessment of RF reform progress. The FY97 CAS recommended moving to a High case scenario, with total lending increasing to US\$2-3 billion annually. While some of the macroeconomic triggers associated with such a move were being met in RF at this point, it is clear that the sectoral and structural triggers were not. The Bank seemed to pay insufficient attention to the fact that these triggers were not being met if the GoR would commit to an accelerated reform program. Although the Bank seems to have been aware that this strategy had risks—with regard to the usual areas of political instability, macroeconomic fragility, limited institutional capacity, and so forth—it claimed that these risks could be mitigated if triggers were closely tied to the loan activity. Unfortunately these were the same triggers that the Bank was ignoring in deciding to expand its loan strategy. Bank evaluation of its activities was typically highly reliant on macroeconomic fundamentals rather than microeconomic sustainability throughout this period; it is therefore difficult to establish reliable counterfactuals at such an aggregate level. Moreover, given that ESW was extremely limited in this period, it was in any case unclear how credibly the Bank could assess sectoral and structural developments and their relation to triggers in this period.

7.9 Hence, it is at this point that the interests of the Bank and the RF authorities seem to diverge. The loans-for-shares scheme inflicted significant damage on the RF reform program through further entrenching interested parties and encouraging the development of the Financial-Industrial Groups. Given this divergence, it seems surprising that the Bank chose this period to significantly increase funding to the RF and to move to an upper level Intermediate-High case scenario. By this time there was clear evidence of a variety of problems in the RF regarding nonpayments, barter, and continued soft budget constraints, which were discouraging serious enterprise restructuring. Moreover, issues of capital flight, corruption, and the weakness of the institutional framework were becoming clearer. It seems likely that the Bank did not engage in sufficient ESW, which it was in a uniquely strong position to undertake at this time. Moreover, although evidence had been emerging from other sources such as academic debate, the Bank does not appear to have sufficiently assimilated this outside work and used it in the policy debate. One could of course argue that the Bank simply wished to retain a presence in the RF, and that it was afraid to “lose” a voice in the RF, which could have found alternative sources of financing, but it was probably clear at the time that the conditions were not right to increase lending volumes in the face of such poor performance in the policy and institutional frameworks.

7.10 Given this strong sense of optimism and the lack of underlying ESW, the Bank appears to have been taken somewhat by surprise by the August 1998 crisis. This seems somewhat disingenuous given the emerging evidence in academic debate, the Russian media, and indeed views expressed internally by Bank staff at the time. The Bank was clearly aware that the RF was in danger of fiscal crisis, but appears to have thought that they could rectify the situation through increasing available loan funding to RF. The crisis induced a downgrading of project performance review: while 78 percent of projects received a “satisfactory” rating at the end of July 1998, this fell to 54 percent by early November and further to 33 percent by the time of the

July 1999 Country Performance Portfolio Review (CPPR). Initial attention was focused towards staving off the inevitable, but following the August 1998 crisis, the shift in Bank strategy towards emergency crisis resolution is entirely understandable. Moreover, the refocusing of Bank strategy towards poverty alleviation is welcome, as is the discussion of much more clearly focussed conditionality on the proposed SAL IV. Although, as noted above, it remains to be seen whether such conditionality will discourage the RF from borrowing from the Bank.

7.11 Viewed in this light, the post-crisis revision to Bank strategy in the RF is overdue and seems likely to reflect reduced external pressure on Bank activities. The most recent documents from the Bank indicate a much more focused strategy towards poverty alleviation in the RF—as indeed do many other donors, including the U.K. government—and appreciate the shortcomings of the reform program to date. In refocusing its strategy the Bank seems prepared to undertake much more ESW than previously, in order to target lending more effectively and attach more focused and readily verifiable conditionality through effectively implementing loan triggers. Whether the RF is willing to borrow from the Bank if such conditionality is applied is, however, unclear. It has been suggested that rather than engage in additional borrowing from the Bank, the RF would appear to currently prefer to rely on oil revenues, in order to avoid conditionality.

7.12 It is, however, clear that the RF is now faced with an unfinished reform agenda in the PSD-FSD area. The RF privatization program remains incomplete in the sense that the state retains a significant share holding in many privatized enterprises. The results of a recent survey of 400 privatized enterprises throughout the RF (Bevan *et al.* [2001]) found that the average state shareholding was 12.2 percent at the time of their privatization (predominantly between 1992 and 1994), declining to 5.7 percent by January 1, 2000. Moreover, 7.1 percent of the privatized enterprises continued to be subject to more than 50 percent state-ownership (both federal and regional government) immediately following privatization. Although this figure had diminished to 3.6 percent by January 1, 2000, it remains significant—particularly as it seems likely that the state is a relatively powerful shareholder in terms of voting rights. If the Bank believes that PSD is a vehicle for poverty alleviation, this situation should be addressed; we suggest two possible methods for this in our concluding section below. In these circumstances, there seem to be two possibilities: GoR could cancel its shares, which is unlikely to be politically acceptable, or GoR should voluntarily withdraw voting rights from its shareholding. It is also clear that the institutional development agenda is unfinished in the RF, and this remains a serious impediment to PSD-FSD. As noted above, one manifestation of this is the gulf between corporate law on the books—which has often been written at the behest of the IFIs—and enforcement of the legislation, and this has acted as a serious impediment to FDI inflows to the RF. We would suggest therefore that these issues should be considered carefully by the Bank in its future strategy in the RF. We consider this development and suggest future priority areas for Bank activity in the RF in our closing section.

8. Lessons and Agenda for Future Bank Activities

8.1 The Bank's experience in the RF reform process has provided a variety of lessons for future Bank activities, both in the RF and more generally. Policy revisions—for example, the restructured form of SAL III—and internal program evaluations illustrate that the Bank has

assimilated many of these lessons. The evidence of others has been apparent in discussions with Bank staff during this review process, and we urge that the following points be considered.

8.2 Competition. The Bank appears to have chosen to pay limited attention to policies to foster competition in the RF. While the MPP served to divest ownership from the state, competition issues rarely, if ever, entered the debate concerning market structure post-privatization. Our discussions with associated Bank staff suggested that the question of market structure was considered at the time of the MPP, but was rejected by GoR for reasons of ease and speed. Failing to address this issue reduced the potential for privatization to induce sufficient competitive pressure to prevent entrenchment of those with vested interests, and hence failed to encourage real restructuring. The crucial corollary was that competition-enhancing institutional development would not be demand-led. Consequently the Bank should have expended more effort on ensuring enactment of legislative measures to aid entry and an enabling environment for SME development, through infrastructure development, preventing regional controls, reducing tax burden and barriers, enforcing effective competition policy, and relaxing non-tariff barriers to trade.

8.3 Privatization. Although the Bank made a valuable contribution to the development of the MPP, neither GoR nor the PIAL sufficiently addressed the fact that the MPP was only the first step in a longer process of ownership transfer and the development of effective corporate governance. Effort under the FIDP and CMDP should have consequently been more closely tied to the MPP, as there appears to have been insufficient supporting analysis on the development of a supporting legal framework—including the introduction of, for example, legislation to ensure minority shareholders' rights—and capital market to ensure successful secondary trading to enable ownership concentration. Moreover, these weaknesses—together with the potential macroeconomic instability due to insufficient microeconomic development—have undoubtedly served to discourage FDI inflows to the RF at a time when they would have been invaluable. The Bank recognized that case-by-case privatization would have been an appropriate vehicle to encourage foreign investment, but in practice the scale might have been extremely limited.

8.4 Conditionality. Evidence from the Bank's involvement in the RF illustrate the generic point that conditionality must be very carefully tied to physical policy implementation rather than intermediate steps, for example, the passing rather than merely drafting of legislation. It is to the Bank's credit that this was clearly appreciated during the restructuring of SAL III; however, this requirement should have been implemented in earlier program dialogues with the RF. Moreover, in some cases a failure to enforce even "soft" conditionality such as drafting legislation was waived *ex post*. Doing so is always likely to create inappropriate borrower expectations, with likely resultant, poor, policy reform performance. This criticism may be less appropriate in the case of RL type of activities, but is extremely pertinent in the case of the SALs.

8.5 ESW. The difficulties encountered with the SALs illustrate the danger of rushing through the implementation of adjustment lending without sufficient supporting ESW. This is especially true given the complexities of the Russian environment and the lack of experience with transition on this scale. This problem has been acknowledged by the Bank in its internal review processes (particularly in the OED review of for SALs I and II). The Bank is in an extremely strong position to conduct high quality ESW and assimilate additional high quality work from external

bodies and individuals. The success of the early Bank involvement in the RF was undoubtedly assisted by the quality and volume of ESW, and future operations should harness the unique position of the bank and use the insights that can be derived to guide policy carefully.

8.6 Continuity of Project Teams. Reviews of RLI illustrate the need for continuity of task managers and Resident Mission staff. Irrespective of staffing quality, continual changes in the responsible staff will inevitably slow program development, as individuals engage in learning behaviour. Perhaps more importantly, high staff turnover has the potential to disenfranchise the borrower, potentially reducing loan performance. These points apply particularly in the case of wide-ranging, RL type of operations in countries of operation in which the Bank may have limited prior experience, and where monitoring and supervision must thus be conducted extremely carefully.

8.7 “Ownership” of Projects and Targeted Lending. Experience in the RF illustrates the fundamental need for borrower and lender priorities to closely coincide, and hence for the borrower to be afforded a sense of ownership of, and therefore responsibility to, a program. At the most simple level this is more likely in programs that are very carefully targeted to, for example, specific sectors or issues, rather than in general lending programs. The Bank may therefore wish to consider whether future objectives could be better met through targeted programs rather than general activities such as the proposed SAL IV. This will identify the borrower agent more carefully, and ease accountability for specific verifiable outcomes, so aligning incentives more carefully.

8.8 In this light, we recommend that the Bank target its future activities in the RF most carefully in the several priority areas: tax reform and utilities pricing; residual government ownership of privatized enterprises; secondary ownership transfer and capital market development; banking sector development; competition policy; and the social safety net.

8.9 Tax Reform and Utilities Pricing. Evidence suggests that tax collection has improved in the RF since the August 1998 crisis. Despite this improvement, evidence of poor tax discipline continues to emerge. In the corporate sector failure to repay or rescheduling of tax debts remain one of the main routes by which budget constraints are softened, and hence restructuring is discouraged. While the Bank acknowledges the need to reduce subsidies in its proposed for a possible SAL IV in its Country Assistance Strategy Performance Review of January 2001, weak tax enforcement, rather than direct state subsidies, seems likely to be the primary factor in softening enterprise budget constraints in the RF at present. Obviously this strategy will also have positive repercussions for the public budget, which are to be welcomed, and hence should contribute to macroeconomic stability, which must be maintained if microeconomic reforms are to be delivered. Similarly, the Bank should continue its efforts to ensure rational utility pricing and enforcement of charging in order to harden budget constraints and improve enterprise performance (aside from the positive environmental repercussions).

8.10 Residual Government Ownership of Privatized Enterprises. As we note above, anecdotal and empirical evidence suggests that GoR continues to retain significant—in volume and power—ownership within privatized companies. In these circumstances there seems to be two possibilities to further strengthen insider versus outsider control and prevent blockages against restructuring: GoR could cancel its shares or voluntarily withdraw voting rights from its shareholding. As the former of these possibilities is unlikely to be regarded as politically acceptable, the latter may be more expedient.

8.11 Secondary Ownership Transfer and Capital Market Development. One of the clear lessons from the Bank's experience is that PSD in the RF is unlikely to prove sustainable without the possibility of secondary transfer of ownership. The continued absence of a well-functioning, liquid, capital market entails that there is no transparent mechanism to facilitate ownership transfer. In this event, the entrenchment of insider control that occurred in many cases as a result of the MPP will not be reversed. Moreover, corporate governance is unlikely to significantly improve without enterprises being subjected to capital market disciplines, together with effective legislation to ensure protection of minority shareholders' rights. In this light the continuation of the CMDP following its restructuring, as noted in the 2001 CAS Progress Report, is to be welcomed and IFC should be provided sufficient support to ensure the success of this program. The Bank should supplement this activity with measures to support the development of effective property rights and corporate governance. This will also serve to encourage the increased levels of FDI, which should be attainable in the RF.

8.12 Banking Sector Development. The RF banking sector remains plagued by undercapitalized nonviable banks, which fail to operate on truly commercial grounds. As a result some enterprises have been able to subvert the hardening of budget constraints, while those enterprises wishing to restructure have frequently been unable to obtain sufficient financing to enable their restructuring. The results from the 400 enterprise survey referred to earlier indicate that financial constraint is the overriding problem facing enterprises in the RF at present, and is associated with poor restructuring, barter, and weak private sector performance (Bevan *et al*, 2001). It is thus essential that the Bank enact the financial sector TA program proposed in the 2001 CASPR, and we urge this to be a priority area of activity. We also concur with the Bank's opinion that the remit of the proposed Russian Development Bank should exclude the possibility for it to engage in commercial lending activities to the emerging private sector unless there is clear evidence of market failure, and not simply a lack of commercial viability.

8.13 Competition Policy. While effective ownership transfer, together with the development of the banking sector and capital market will promote competitive forces, these are not sufficient in themselves to ensure an effective competitive environment. The development and enforcement of pro-competitive legislation has been weak thus far in the RF, and this is an area that the Bank should regard as high priority. We urge the Bank to reassess its strategy towards ensuring enforcement of competition policy to prevent incumbent dominance. Moreover, while some policy developments—for example, the development of the financial sector—will serve to eliminate barriers to new firm entry, Bank activity should be focused towards establishing an environment that is conducive to, and supportive of, entry and SME development.

8.14 Development of the Social Safety Net. Although the GoR reform program is currently on-track and there appears to be a degree of political and popular consensus, we urge the Bank to monitor the situation carefully. In particular, we feel that the development of a sound, but not excessively generous, social safety net is essential to this process. The GoR development program, outlined in the 2001 CAS Progress Report, correctly highlights such needs as the protection of the socially vulnerable, improvements in access, and quality of health and education. Perhaps most importantly, however, GoR is correct to address the issue of accurately targeting state assistance to those in need, in order to foster long-run sustainable development in the RF.

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