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DEVELOPMENT & TRANSITION

7

JULY 2007

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Published by the United Nations Development Programme and the London School of Economics and Political Science

The Private Sector and Poverty Reduction

Scholarship, policy advising, and programming concerning private sector development in transition economies often reflects the view that 'If the horse gets enough oats, some will eventually pass through to the sparrows'. Ensuring that private entrepreneurship directly contributes to pro-poor economic growth has too rarely been at the centre of attention. This is regrettable, since–despite the many successes of privatization in the former Soviet Union, the new EU member states, and the Western Balkans–many questions about the linkages between private sector development and poverty reduction in these regions remain unresolved. In most of these countries, the numbers of operating private companies relative to the population remain quite small compared to OECD levels. Private sectors in much of the Western Balkans and the former Soviet Union are dominated by microenterprises, most of which operate on a subsistence basis in the informal sector. Strong middle-sized companies, or larger enterprises that have adopted good practices of corporate governance and corporate social responsibility, are few and far between.

These questions are particularly important for development agencies, for whom strengthening the pro-poor character of economic growth by helping market mechanisms to better serve the needs of the poor, are increasingly a priority. This issue of *Development and Transition* examines the current state of the region's private sector, and how development agencies can strengthen its pro-poor characteristics, in five broad areas: (1) microfinance; (2) countercyclical financial instruments; (3) corporate social responsibility (CSR); (4) informality; and (5) the evolving relationships between the private, state, and non-governmental sectors.

The issue begins with a debate between Milford Bateman and Grzegorz Galusek on the effectiveness of post-communist microfinance. This 'point/counterpoint' discussion is followed by Tom Thorogood's case study analysing guarantee funds in Serbia–a study that shows some strengths and weaknesses of microfinance in practice. These articles are followed by Julia Korosteleva's macrofinancial analysis of GDP-indexed bonds, which suggests that greater private trading of these instruments could reduce the threat of currency crises that can be particularly hard on the poor in emerging markets.

Some observers have suggested that the travails of transition are leading to a reassertion of state ownership and control in Russia and some other CIS countries. However, David Woodruff explains how in the Russian economy this trend is driven in large part by the commercial ambitions of parastatal companies, rather than by policies of re-nationalization. Alena Ledeneva's and Eugene Nivorozhkin's survey of 'informal' business practices in Russia, and Vyacheslav Toporov's analysis of 'one-stop shops' in Ukraine, show how heavy-handed state regulation, and associated rent-seeking opportunities, continue to burden private sector development. Geoffrey Prewitt's analysis of social enterprises in the region strikes a similar note, emphasising the barriers to social entrepreneurship posed by ill-advised regulatory frameworks. However, Jessica Allina-Pisano's study of postcommunist land privatization suggests that prospects for poverty reduction in rural areas are only loosely connected to land reform policies. The issue concludes with Peter Serenyi wondering whether CSR in the region will be able to move beyond its currently marginal role.

This issue suggests that 'blanket' reforms such as generic SME support, commercially oriented microfinance, and the liberalization of business environments, are too often pursued without paying proper attention to local and global conditions and post-communist legacies. But it also suggests that there are many areas in which, by giving the market a push, development actors can strengthen the private sector's ability to reduce poverty.

James Hughes and Ben Slay

The Microfinance Debate: An Opening Thought

In 2006 Muhammad Yunus and the financial institution he founded, Grameen Bank, won the Nobel Peace Prize for their pioneering work in extending microcredits to the poor. In his acceptance speech, Dr. Yunus made the following observation, which serves as a fitting way to open our point/counterpoint on microfinance:

"Poverty is created because we built our theoretical framework on assumptions which under-estimate human capacity, by designing concepts, which are too narrow (such as the concept of business, credit-worthiness, entrepreneurship, employment) or developing institutions, which remain half-done (such as financial institutions, where the poor are left out). Poverty is caused by the failure at the conceptual level, rather than any lack of capability on the part of people".

Muhammad Yunus, Oslo, 10 December 2006.

Undermining Sustainable Development with Commercial Microfinance in Southeast Europe

Milford Bateman

The October 2006 award of the Nobel Peace Prize jointly to Bangladesh's Grameen Bank and to Dr. Mohammad Yunus, Grameen's founder, is the latest turn in a decade of media hype surrounding microfinance. As is well known, the Grameen Bank model was discovered by the international community in the 1980s, and thereafter gradually deployed within developing countries to address issues of poverty and under-development. The ascendance of the neoliberal project from the early 1990s onwards then led to crucial commercializing modifications of the basic Grameen Bank approach, resulting in the now dominant 'new wave' commercial microfinance model, led by microfinance institutions designed to operate as independent, commercially oriented, financially self-sustaining entities. These 'new wave' commercial microfinance institutions, it is said, avoid the need for constant international and government financial support while still extending microcredits to many poor individuals and communities.

The commercial microfinance mirage

The 'new wave' commercial microfinance model arrived in Southeast Europe in the early 1990s, and is today widely seen as one of the most successful donor interventions in the region. Indeed, such is the presumed positive impact of Bosnia and Herzegovina's new microfinance sector that the country is now often described as the 'best practice' example that all developing and transition states should carefully follow, particularly other post-conflict countries.

However, many of the alleged developmental benefits of the commercial microfinance model in Southeast Europe, and by extension in many other countries, are a mirage. Very little solid evidence has emerged to confirm that commercial microfinance has facilitated sustainable economic and social development–as opposed to some largely temporary impacts involving a lucky few, well-publicized microenterprises. In fact, far more evidence is emerging to suggest that commercial microfinance may well have undermined, if not largely destroyed, prospects for sustainable socio-economic development trajectories in the region.

The informal sector serves as the final destination of almost all microenterprises supported by microfinance. It is fundamentally wrong to assume that the informal sector has unlimited abilities to elastically expand and absorb all new microenterprises. New informal microenterprises do not raise the total volume of business so much as redistribute or subdivide it between new and existing microenterprises. Globalization-driven conditions of an unlimited labour supply and dramatically reduced formal sector (especially public sector) employment opportunities have combined to 'saturate' economies with informal-sector microenterprises almost everywhere. As the UN's 2003 'Challenge of the Slums' report emphasized,[1] this 'saturation' trend has produced recognizable declines in incomes and wages in many developing countries, trapped within increasingly dominant urban slums. There is very little evidence to support Hernando de Soto's idea that an ever-expanding informal sector can serve as the decisive

'agency' factor to precipitate an eventual sustainable growth and development trajectory.

This 'saturation' phenomenon is increasingly becoming the norm in Southeast Europe. Many sectors are increasingly under pressure from an influx of new entrants, all desperate to survive in conditions of flat demand. Obvious examples include the retail sector, cross-border trade, simple services, cafes and local transport (e.g., taxis). One reflection of 'saturation' is the high rate of microenterprise exit emerging almost everywhere in the region. For example, the World Bank's 2005 evaluation of its Local Initiatives Project (LIP) microfinance programme in Bosnia and Herzegovina found that 30 percent of the microenterprises surveyed in 2002 had failed after just two years.[2] Using panel household survey data for 2001-2004, World Bank researchers estimated that around half of the individuals in Bosnia and Herzegovina starting a new microenterprise in 2002 and 2003 closed their new business within one year of its establishment.[3]

Commercial microfinance institutions in Southeast Europe have been more than willing to support microenterprises operating well below minimum efficient scale, and thus with little realistic chance of long-run survival. In a desperate attempt to survive, most of these microenterprises are forced into hyper self-exploitation – accepting ultra-low earnings, long hours, and so on – while others, as noted above, simply collapse. Many microfinance institutions are more than willing to do this because ultimately unsustainable microenterprises are nevertheless very often able to repay their microcredit in the time allowed. These microfinance institutions are more interested in their own survival even if this is achieved through constructing local microenterprise structures with very little real future – a 'house of cards'. Examples of this trend can be found in Croatia, where many patently unsustainable 'micro-farms' were established in the dairy sector thanks to microfinance support–many of which were only able to survive thanks to the Croatian government's subsidies available for 'three-cow-and-above' farms.

A patently unsustainable micro-farm?

Commercial microfinance has also 'crowded out' potentially sustainable microenterprises wanting to deploy relatively advanced technologies, skills, and product and process innovations. Southeast European countries in the early 1990s had significant endowments of technologies, skills and industrial expertise, which could have provided obvious 'entry points' for technology-intensive micro- and small enterprises. Many potential micro-entrepreneurs came forward from the most advanced sectors and companies with ideas for establishing sustainable microenterprises. However, many of these potential micro-entrepreneurs simply could not deal with the standard commercial microfinance business model–high interest rates and short repayment periods–and most quickly abandoned their ideas. Potential entrepreneurs were instead forced to establish simpler businesses, such as in retail trade. The 'deindustrialization' that characterized economic development in the region was therefore consolidated with the help of commercial microfinance. This represents a huge opportunity cost for a region that once boasted a high degree of technological sophistication.

Microfinance and local development need not go together

Inter-enterprise connections are now understood to be a crucial determinant of a local economy's ultimate sustainability and progress. When many enterprises are engaged in activities that make use of technology, innovation, skills, coordination and planning, managerial competences and so on, a local economy can gradually advance and prosper in a sustainable manner. But such beneficial grass-roots dynamics cannot arise if the local economy is dominated by microenterprises with little need, ability, or wish to cooperate. While commercial microfinance in Southeast Europe has clearly produced significant *numbers* of new microenterprises, the overwhelming majority of these companies is unable to forge the efficiency-enhancing horizontal ('proto-industrial districts') and vertical (sub-contracting) connections that are crucial to establishing a sustainable development trajectory.

Many of the early microenterprises in Southeast Europe were always going to prefer to enter into simple shuttle trading operations if they could, as these sectors are the mainstay of microfinance operations across the world. However, the subsequent entry of many microenterprises into such operations helped generate the surge in imports (many EU-subsidized) that arrived in Southeast Europe after 1990, and in Bosnia and Herzegovina after peace was concluded in late 1995. In Kosovo after 1999, the main microfinance institution – ProCredit Bank – was very heavily engaged in supporting trade-based microenterprises, quickly becoming the most profitable microfinance bank in Europe.[4] However, by first monopolizing and then channelling both international donor funds and local savings overwhelmingly back into simple trade-based microenterprises, commercial microfinance created a most unsuitable foundation for sustainable development and growth.

Finally, the rapid rise of commercial microfinance has contributed to the steep declines in social capital levels experienced since 1990. Recasting individual survival as a function of individual entrepreneurial success can undermine the bonds of solidarity, shared experience, and trust that often exist within poor communities. This is a truism. Recasting community development and support activities as commercial operations – a central operating principle of commercial microfinance – can also dissolve local solidarity, interpersonal communication, volunteerism, trust-based interactions, and goodwill. Operating in the informal sector is itself associated with a diminution of social capital, not least since most informal microenterprises do not need to develop the trust-based linkages with government and other enterprises that typically underpin legitimate business operations and ethics.

Commercial microfinance: An 'anti-development intervention'?

It has yet to be shown that commercial microfinance is associated with sustainable economic and social development, or sustainable poverty reduction, in Southeast Europe. Microfinance has instead undermined most local economic and social development triggers, such as cumulative and coordinated investments, capturing economics of scale and scope, technological innovation, inculcating social capital, or incorporating technical skills and knowledge. Commercial microfinance therefore amounts to what the former World Bank economist David Ellerman has called an 'anti-development intervention' – an intervention that, like bad medicine, produces some modest short-run pain relief (quick poverty reduction for a lucky few), but in the longer run undermines prospects for a sustainable recovery and eventually leads to 'death' (to the chances of sustainable economic and social development). In light of this, current efforts by the US-based MicroCredit Summit, growing numbers of commercial banks, and some high-profile charitable foundations, to effectively 'flood' developing and transition countries with microfinance can only be looked upon with real concern.

Milford Bateman is an independent consultant and Visiting Professor of Economics at the University of Pula, Croatia. He has been a regular consultant to UNDP on poverty reduction and local economic development issues in Southeast Europe and elsewhere. Dr Bateman's most recent published output on microfinance can be found in the edited book by Thomas Dichter and Malcolm Harper entitled *What's Wrong with Microfinance?*, to be published in July 2007 by Practical Action Publishers.

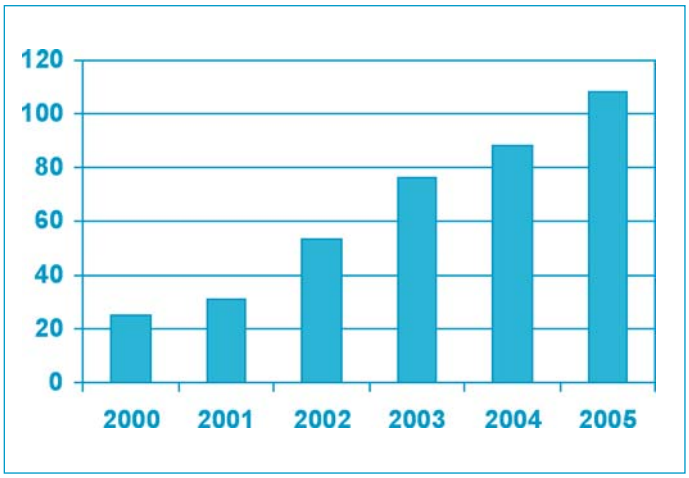
1 UN Human Settlements Programme (2003). *The Challenge of the Slums.* London and Sterling, VA: UN-Habitat and Earthscan.
2 Dunn, E. (2005) *Impact of Microcredit on Clients in Bosnia and Herzegovina.* Washington DC: Impact LLC.
3 Kunt, A. D, Leora Klapper and Georgios A. Panos (2007). *The Origins of Self-Employment,* Development Research Group. Washington DC: World Bank.
4 *See The Economist,* 14 September 2002.

'Commercial' Microfinance: Too Much, or Not Enough?

Grzegorz Galusek

During the 1990s, large numbers of microfinance institutions (MFIs) were set up across Eastern Europe, with a mandate to foster microenterprise development and address rapidly spreading poverty. These MFIs had by the end of 2005 served over 4 million active clients, predominantly low-income families and microenterprises that would not otherwise have had access to financial services. By now, most of these MFIs can be considered a success, for they have moved from reliance on donor funding towards sustainability, serving low-income clients and gradually integrating with the formal financial sector. As the data in Chart 1 below show, MFIs have grown particularly rapidly since 2000.

Chart 1: Numbers of sustainable[1] NGO MFIs in Eastern Europe and the CIS



Source: *Annual Mapping Study Survey of the Microfinance Centre for Central and Eastern Europe and the Newly Independent States.* Microfinance Centre, Warsaw.

Microfinance in Eastern Europe and the CIS

While transition has brought opportunities to many business-savvy people, for others it has meant a serious decline in living standards. In the 1990s, poverty levels increased dramatically in most of the region. Unemployment, resulting from enterprise restructuring and weak economic growth, was a key driver of rising poverty rates. Many of the 'new poor' had enjoyed secure jobs before the transition; they possessed important educational and skill levels, but had inadequate business skills. Self-employment or work in family or individually owned businesses became important survival strategies for those facing lay-offs from inefficient state factories, restructuring, or budget cuts.

In developed market economies, sound, deep financial sectors are a precondition for private sector development. But in the transition realities of the 1990s, financial sector instability and restructuring often precluded financing small- and medium-sized enterprise (SME) growth, while financing for microenterprises hardly existed at all. In addition to serving as a poverty reduction tool, microfinance emerged to fill these gaps in the demand for financial services.

How is microfinance organized in Eastern Europe and the CIS?

The organizational characteristics of microfinance in Eastern Europe and the CIS are quite diverse, embodying four different models:

- **Greenfield microfinance banks.** These were set up in the late 1990s as a way of leapfrogging traditional MFI development models, which emphasize building institutional capacity in a non-bank, credit-only MFI and then transforming it into a more complex legal structure (often a bank). Such transformations are often necessary to access non-subsidized financing to support the MFI's growth, or to diversify its product offering. As full-service banks (with banking licenses), they can offer a wide range of financial products. So far, 17 such banks are operating in Eastern Europe and the CIS, predominantly in the Balkans. These banks are enjoying rapid growth in their loan portfolios and client bases. As the data in Table 1 below show, the average microfinance bank at the end of 2005 was servicing more than 36,000 clients.

- **Down-scaling banks.** In this model, donors or governments offer mainstream commercial banks credit lines and technical assistance to provide financial services to microenterprises. This model was developed in Latin America by the Inter-American Development Bank and later adapted by the EBRD to the Eastern Europe and CIS region, particularly in Russia and Central Asia. But while this assistance has strengthened the banking system, providing greater transparency and improved lending practices, the banks have not yet reached large numbers of low-income clients.

- **Credit unions** are the most common MFI in Eastern Europe and the CIS, growing rapidly since the early 1990s. In most countries they offer credit and savings services (predominantly for consumption purposes) to their members; as the data in Table 1 below show, the average loan size is around $1,700. But while countries such as Poland, Ukraine, and Romania have developed robust financial cooperative sectors, in Central Asia these institutions tend to be much weaker.

- **NGO MFIs** have been important providers of microfinance since the early 1990s. The NGO label may be somewhat misleading: most of these MFIs function as specialized, sustainable financial intermediaries balancing social and commercial goals. Many have evolved from NGOs into more advanced commercial forms, to allow for faster growth. Most of these MFIs provide credit to low-income micro-entrepreneurs; target groups include women, Roma communities, and rural households. This model is a particularly important source of finance for micro-entrepreneurs: as the data in Table 1 show, the average NGO MFI loan in the region is around $1,100.

Most NGO MFIs offer financial services on market principles to the target group determined by their

Table 1: MFI lending in Eastern Europe and the CIS

Numbers of MFIs:	Numbers of MFIs:		Borrowers per MFI	Overall MFI loan portfolio	Average MFI loan:	
	Lenders	Borrowers			portfolio	size
Credit unions	5,499	2,684,800	488	$4,571,774,743	$831,383	$1,703
Microfinance banks	17	619,948	36,468	$2,038,139,329	$119,890,549	$3,288
Downscaling banks	47	187,064	3,980	$980,827,165	$20,868,663	$5,243
NGOs	164	650,915	3,969	$707,462,935	$4,313,798	$1,087
Regional totals	**5,727**	**4,142,727**	**723**	**$8,298,204,172**	**$1,448,962**	**$2,003**

Data as of 31 December 2005. Source: *2005 State of the Microfinance Industry in Eastern Europe and Central Asia,* Pytkowska J., Microfinance Centre for Central and Eastern Europe and the Newly Independent States (MFC), 2006.

mission, balancing commercial and social goals. In some cases they offer (or link with providers of) business development services,[2] in order to stimulate business growth through building microenterprise capacity for better marketing, information technology, and management. However, many MFIs work according to purely commercial principles irrespective of their legal status or original mandate; social and developmental outcomes are taken for granted. This often results from the market pressures to scale up or transform.

The donor community may be partly to blame for encouraging (in the past) MFI business models that focus solely on financial performance. However, in recent years there have been many calls for a stronger focus on the 'double bottom line'–providing information on social impact as well as financial performance. Many developmental organizations have sought to minimize the risk of mission drift. Social performance management has for example become one of the priority areas for the Microfinance Center (MFC) in Warsaw: the MFC's quality audit tool and strategic management toolkit provide a menu of practical methods that can help translate MFIs' social goals into their daily operations.

No single MFI institution can be regarded as universally superior. National legal and regulatory environments should therefore be flexible enough to accommodate a variety of different institutional arrangements, in order to ensure that different vulnerable groups are offered the financial services that most closely correspond to their needs. This is not always recognized by policy makers in some East European and CIS countries, where the provision of microfinance services through some of these MFIs is illegal.

Significant market gaps are still present

While access to SME finance (including for high-end microenterprises) has been improving, financial services for low-income households remain an urgent development issue. According to demand studies conducted by the MFC, only 1 percent of low-income households have a bank account in Georgia, 16 percent in Azerbaijan, 17 percent in Ukraine, 22 percent in Romania, and 67 percent in Poland.[3] In many East European and CIS countries, most low-income people have limited or no opportunities to protect themselves against financial risks or benefit from the formal financial sector.

The potential demand for microfinance services could be quite dramatic, however. A micro-credit demand study conducted in 2006 in Poland for the European Investment Fund showed that there were 2 million actual (14 percent) and potential (86 percent) low-income clients who would benefit from micro-loans in Poland alone. Only a tiny fraction of the existing microenter-

A $2,000 loan helped this shopkeeper expand her business in Bulgaria
Photo courtesy of the Microfinance Centre

prise market is currently served by formal financial institutions. The situation is probably even more dramatic in the region's poorer countries. The study highlighted inadequate financial products for low-income households, low financial literacy of potential clients, and their mistrust of formal financial institutions, as key barriers to transforming potential into effective demand for microfinance services.

Conclusions

While the data point to rapid growth of microfinance in Eastern Europe and the CIS, they also demonstrate the failure of MFIs in this region to reach low-income groups on a large scale. This underscores the importance of non-financial services (including basic financial education) in helping the poor to absorb and manage family and microenterprise finance, to properly use financial services, and to develop business skills. These market gaps create opportunities for designing microfinance strategies and products to respond to these unmet needs. This means combining existing microfinance knowledge and experience with new technologies and private capital to create the new business models needed to reach more poor people. It also requires policies to level the playing field for different institutional models, and strengthen incentives for private sector investment in microfinance.

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1 'Sustainable' refers to MFIs whose operating incomes equal or exceed their operating expenses.
2 Examples include such MFIs as Zene za Zene in Bosnia and Herzegovina, Microinvest in Moldova, Kamurj in Armenia, and Stedonica Opportunity Bank in Serbia.
3 Matul M., M. Rataj (2006). *Microcredit Market Development in Poland.* Warsaw: The Microfinance Centre.

Figure 3: Cumulative growth in active borrowers by institutional type

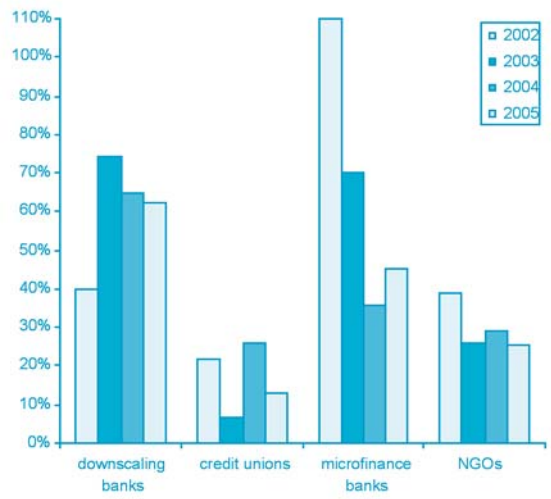
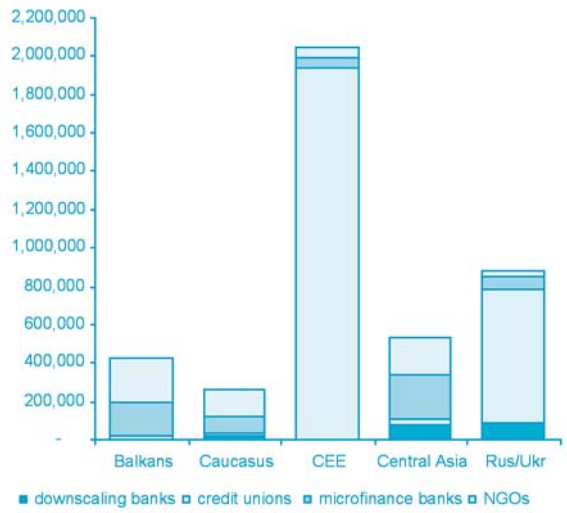


Figure 4: Total number of active borrowers by institutional type and sub-region



Source: *2005 State of the Microfinance Industry in Eastern Europe and Central Asia,* Pytkowska J. Microfinance Centre for Central and Eastern Europe and the Newly Independent States (MFC), 2006.

Guarantee Funds and Job Creation in Serbia

Tom Thorogood

Despite high GDP growth, which has averaged 6.5 percent annually since 2003, unemployment rates continue to be alarmingly high in Serbia: the national average remains over 20 percent, and some regional rates are much higher. Unemployment rates could increase further in the near future as the remaining socially owned companies are privatized or go into liquidation proceedings. Support for the creation and expansion of small- and medium-sized enterprises (SMEs) is widely recognized as one of the most effective forms of job creation. This article explains how guarantee funds can help address the liquidity constraints that often hamper SME development, via the example of a UNDP guarantee fund introduced as a pilot project in South Serbia.

The South Serbia Guarantee Fund

The high costs of, and inadequate access to, finance are frequently listed as important constraints on SME development–particularly in less-developed regions such as South Serbia. In mid-2004, as part of its support

for economic development in this region,[1] UNDP's South Serbia Municipal Improvement and Recovery Programme established a guarantee fund. While credits of up to €5,000 had been available for small businesses and in excess of €100,000 were available for large companies, many SMEs struggled to obtain loans in the €10,000 – €50,000 range, due to the absence of loan collateral. Not only do banks in Serbia often request 200 percent collateral for a loan of this size, but most property and land holdings–particularly those outside Belgrade–are not registered in the land cadastre, so that title of ownership cannot be used as a guarantee. Even when property is accepted as collateral, banks often put a low value on it.

The guarantee fund has sought to fill this gap by providing guarantees to creditworthy SMEs in South Serbia through a public sector institution established for this purpose. The fund itself was established by the region's largest municipality, Leskovac, which has provided $20,000 annually to cover the fund's running costs and another $40,000 to guarantee loans for activities in its jurisdiction. Most of the guarantee fund's lending capital (some $240,000) has been provided by the Norwegian Government via UNDP.

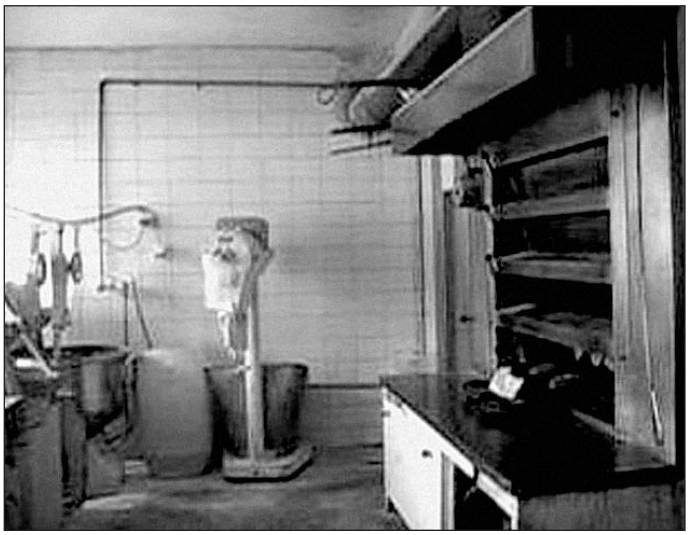
SMEs that have been offered loans can apply to the guarantee fund for up to 50 percent of the collateral needed. Loan guarantees are serviced via contracts with three of Serbia's largest banks: Komercijalna Banka, YU Banka, and Agrobanka. The value of the guarantee, which is initially deposited in the bank, is gradually returned to the fund as the loan is repaid, thus giving the fund a 'revolving' character. SMEs supported by the fund must be assessed as creditworthy both by the bank and the guarantee fund.

Some 27 loans, worth some $555,000 and creating 114 jobs, have to date been supported by guarantees from the fund worth some $278,000. The types of businesses supported include small-scale wood processors, bakeries, sweets producers, meat processors, dairies, and various service-sector enterprises. Credits for activities or businesses involved in trading, alcohol, or gambling are not supported by the fund, and start-up loans are avoided. As the associated risk levels fell, the banks engaged in this programme reduced their interest rates to 8.5-9 percent – well below the 12-16 percent rates Serbian banks typically charge for SME loans.

Lessons Learned

The results of an independent evaluation of the guarantee fund conducted in October 2006 pointed to a number of conclusions. On the positive side, the fund has improved SME access to credit and increased employment by supporting private banks in their core business areas. Not surprisingly, the demand for loan guarantees has far exceeded the supply: fund data indicate that only 27 guarantees were provided out of a total of 500 applicants during 2004-2006. While prospects for the take-up of these guarantees were initially constrained by the conservative lending posture of Serbia's banks, these attitudes underwent a profound change as the banks began to appreciate the benefits of this scheme. In this sense, the guarantee fund may have helped deepen Serbia's financial system.

The evaluation also noted some weaknesses in the guarantee fund. As a pilot programme, its initial geographical coverage was far too ambitious; it would have been better to initially focus on one or a cluster of municipalities. Likewise, more thought should have been given to the institution managing the fund. In transition economies, public sector institutions often have difficulties offering efficient, apolitical management of this type of financial activity. At the very least, more specialized expertise should have been employed in the design phase of the fund. As a result, the management of the guarantees issued has not always been as tight as it could be. Allegations concerning excessively long grace periods in the repayment of some loans, and uses of funds for purposes other than those specified in the loan contracts, have been raised. So have questions about whether some of the borrowers tapping the guarantee fund would have been able to provide the collateral needed without access to this scheme.



Bakery equipment purchased with support from the guarantee fund

In addition to collateral on bank loans, guarantees can be provided directly through suppliers of equipment and machinery. More broadly, other financial products could be developed to meet the needs of the SME sector. Such products that have been created in neighbouring countries (e.g., guarantee funds to support equipment purchases in Macedonia) could be adapted to Serbia. These problems suggest that the capital available under the guarantee fund has not always been used in the most efficient manner. Selecting a stronger institution to manage the fund, and putting in a more effective oversight framework, could have avoided some of these problems.

Conclusion

Despite these difficulties, it is clear that credits provided to SMEs in South Serbia have helped generate income and employment in this important region,[2] where unemployment is such a chronic problem and very few initiatives can show tangible results in addressing it. Still, further support should be conditional on changes in the management arrangements, in order to increase the efficiency with which the guarantees and their associated credits are deployed. Finally, for this initiative to make a real difference, considerably more funds should be available to guarantee loans, somewhere in the range of €2 to €3 million, thus affording many more applicants access to this service and making a significant impact upon employment in the region.

Tom Thorogood is Programme Manager for the Municipal Improvement and Revival Programme Phase II in South Serbia.

1 Reference is to the 13 municipalities in South Serbia where UNDP implements the Municipal Improvement and Revival Programme Phase II.
2 See 'The South Serbia Programme: Lessons in Conflict Prevention and Recovery'. *Development and Transition*. Issue 6. April 2007.

Countercyclical Financial Instruments: Prospects for Transition Economies

Julia Korosteleva

High levels of public debt and its risk profile–particularly the prevalence of short-term and foreign currency-denominated debt–are widely viewed as primary indicators of vulnerability to international financial crises. These factors helped trigger Russia's financial crisis in 1998, as well as a series of high-profile debt defaults across 'emerging market' economies, including Argentina and Turkey in 2001, and Uruguay in 2002. The high social costs of these crises underscore the importance of improving sovereign debt structures and introducing countercyclical market-based financial instruments which, along with sound macroeconomic policies, could help reduce the vulnerability of emerging economies to external shocks. GDP-indexed bonds (GIBs) and other contingency-linked debt instruments could help make public debt structures more sustainable, reduce the risks of currency crises, and yield substantial benefits in economic performance.

Why countercyclical financial instruments?

Debt instruments that are indexed to real economic variables such as GDP and exports, or their determinants (e.g. natural disasters, commodity prices, or changes in total imports purchased by key trading countries) can provide considerable insurance benefits. These instruments can be seen as comprising bond and insurance contract elements, with payments contingent on the performance of these real variables. The issuance of bonds whose nominal values or coupon payments are linked to commodity prices seems sensible for countries with a poorly diversified export structure where a few products dominate.

Commodity-linked bonds could benefit transition economies like Azerbaijan, Kazakhstan, and Russia, whose development prospects in general–and fiscal and external positions in particular–can be quite sensitive to terms-of-trade movements. Similarly, hedging against shocks to prices of key imports, notably gas and oil, could be very important for such small open economies as Belarus and Moldova. Disaster insurance contracts would be beneficial to small countries that are vulnerable to natural catastrophes like Georgia or Tajikistan, for whom the cumulative damage from various natural disasters reached 70 and 58 percent of GDP respectively in 1975-2002 (Borensztein et al. 2004). Larger and more diversified economies could benefit from greater use of hedging against macroeconomic fluctuations by linking the nominal values of their debt to GDP growth trends.

To the extent that they allow investors to share the returns and risks of economic upturns and downturns, GIBs resemble equity-like instruments. When bond returns are linked to GDP growth in the issuing country, its debt burden is reduced in the event of adverse

shocks and weak economic performance, and vice versa. For example, a country with an anticipated GDP growth rate of 4 percent that is paying interest on its standard ('plain vanilla') government bonds of 8 percent can consider issuing GIBs that would pay one percentage point extra for each 1 percent above the baseline growth rate, and 1 percent less for every percentage point by which real GDP growth falls short of 4 percent. In years of economic slowdown with growth, say, equal to 2 percent, the issuing country would pay 6 percent (instead of 8 percent on the non-indexed bond).[1]

Such indexation mechanisms work as automatic stabilizers, reducing the country's debt-servicing costs–and the possibility of default–during economic downturns (Borensztein and Mauro 2004). By increasing the 'space' for countercyclical fiscal policy, GIBs can help keep debt/GDP ratios relatively stable, thereby reducing the likelihood of debt and currency crises. They can also help restrain new spending during periods of high growth. Broader use of GIBs would reduce the need to pursue contractionary macroeconomic policies during periods of slow growth, in order to maintain access to international financial markets or to IMF and World Bank funding. This may improve the investment and business climates, enhancing prospects for economic growth and poverty reduction.

Obstacles to the expansion of countercyclical debt instruments

Despite these benefits, GIBs have been used only sparingly in the region. So far, only Bosnia and Herzegovina and Bulgaria have issued bonds containing an element of GIBs as part of their Brady restructurings that included clauses providing higher coupon payments when GDP growth reaches a certain threshold.[2]

A number of obstacles limit the spread of GIBs in the region. These include:

- **GDP measurement and moral hazard:** The accuracy of GDP data, which is essential in determining the value of GIB coupon payments, is not always above reproach in transition economies. Moreover, the authorities may be tempted to misreport or revise the official figures, in order to reduce coupon payments during economic upturns.

- **Data revisions and lags in publication:** Large revisions of GDP data for transition economies are not uncommon; significant over- or under-payment of coupon payments can result. Lags in data publication and revisions could reverse the GIBs' countercyclical effects.

- **Complex pricing:** Some investors may be reluctant to purchase GIBs because of difficulties in understanding their pricing. A well-established pricing model for GIBs should be developed–possibly by the international development community.

- **Illiquidity:** Markets for new debt instruments are usually illiquid, and the cost of their issuance is higher than for standard bonds, whose large turnover can minimize transactions costs. The ensuing liquidity risk could reduce GIBs' attractiveness for investors.

- **Callability:** Many bonds are 'callable': they contain clauses allowing the issuer to repurchase them when they reach a certain price. Making GIBs callable could allow governments to repurchase them during periods of high economic growth, preventing investors from obtaining the anticipated higher coupon payments. In general terms, then, GIBs would have to be non-callable if they were to be used extensively.

Many of these obstacles reflect the start-up costs associated with any market innovation, financial or otherwise. International development agencies like the World Bank, IMF, and the UN system–whose mandates include promoting economic growth and reducing poverty via better management of the global governance architecture–could accelerate the expansion of GIBs by underwriting some of the costs of their development.

Conclusions

Their past vulnerability to currency and debt crises suggests that transition economies could benefit from the issuance of GIBs. However, GIBs are a rather specialized financial product; many transition economies are focusing instead on deepening the market for their 'plain vanilla' bonds. Indeed, a number of the poorest CIS countries do not have sovereign credit ratings, effectively making their 'plain vanilla' bonds–for which domestic markets are quite under-developed–too risky for most international investors. Thus, many transition economies which might find GIBs potentially beneficial are unable to issue them on the international markets at a reasonable cost.

However, in transition economies with relatively well-developed financial systems, there is scope for GIBs to develop further. This is particularly important in light of the need for deeper domestic markets for long-term, local-currency instruments that could help make public debt structures less prone to crises. GIBs issued in local currency on domestic capital markets may appeal to institutional investors, such as emerging hedge funds, insur-

ance companies, and pension funds. The latter in particular are likely to have an interest in debt instruments that carry a relatively low default risk, and are either inflation-indexed or denominated in local currency. The mandatory-funded pension schemes that have emerged recently in many transition economies as the second pillar of pension systems could in particular increase the demand for GIBs. Prospects for the more rapid expansion of trading in these instruments would improve if international development agencies could help bear the risks of deepening these markets by underwriting some of their costs.

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1 This example assumes away additional costs often associated with GIBs, such as insurance premiums.

2 'Brady bonds' (named after former US Treasury Secretary Nicholas Brady) are a securitized form of restructured public debt. They are a common component of sovereign debt restructuring agreements in developing countries. In the cases of Bulgaria and Bosnia and Herzegovina, these bonds were 'callable', so that instead of making additional payments to their holders when GDP growth surpassed the threshold levels, the authorities repurchased the bonds (Segal 2004).

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The Expansion of State Ownership in Russia: Cause for Concern?

David M. Woodruff

In the last five years, the weight of state-owned firms in the Russian economy has expanded dramatically, leading some observers to speak of a reversal of market reforms. Such concerns are overstated. Neither the behaviour of Russian state-owned enterprises (SOEs), nor the environment in which they operate, recalls the pre-reform era. Indeed, much of the SOEs' expansion reflects the commercial, profit-driven ambitions of their leaders rather than a coherent policy rationale. The government's main challenge is not to ensure the microeconomic efficiency of SOEs, but to make sure that the SOEs' expansion drive does not threaten its other priorities.

SOEs on a buying spree

According to researchers at Alfa-bank, in the middle of 2003 the Russian state owned stock worth about 20 percent of the capitalization of Russia's stock market. By early 2007 the state's share had risen to 35 percent (Grozovskii 2007). Much of the growth represented a buying spree by SOEs, especially oil company Rosneft and the natural gas monopolist Gazprom (OECD 2006, 38). Among the largest acquisitions were major assets confiscated from the private oil company Yukos in lieu of tax debts, purchased by Rosneft, which thus became the country's largest producer of crude oil. Gazprom, for its part, purchased the private oil company Sibneft for $13 billion in 2005. In 2006 it agreed to spend over $7 billion buying a share of the Sakhalin II oil project from Royal Dutch Shell. In the banking sector Vneshtorgbank has acquired private rivals. Defence firms in aviation and shipbuilding are consolidating into large new conglomerates under state ownership. The state's arms-export firm Rosoboroneksport has taken control of assets in metallurgy and auto manufacturing.

Back to the USSR?

Because privatization is so closely identified with economic reform, some observers have seen growing state ownership as evidence of a reversal of reform. However, such judgments obscure the shifts underway by implicitly associating contemporary SOEs with the rickety enterprises of Soviet-era ministerial bureaucracies that Russia privatized in the 1990s. Russia's SOEs operate on international capital markets in ways that radically differ from the pre-privatization era. SOEs have borrowed huge sums on international markets to fund their acquisitions; Rosneft took on $22 billion of debt in early 2007 for the purchase of Yukos assets; Gazprom is seeking $12 billion in new financing for its entry into Sakahlin II and other purchases. Even though the majority of their shares are held by the state, all major SOEs view stock market capitalization as a crucial measure of their performance. Gazprom has liberalized circulation of its stock, unifying long-segregated foreign and domestic markets; with a capitalization of over $220 billion, it is now one of the world's most valuable firms. Rosneft, Vneshtorgbank, and Sberbank have held initial public offers for a portion of their shares. On taking over carmaker AvtoVAZ, Rosoboroneksport

prioritized repackaging ownership to capture stock market returns.

Their capital market activities force a certain level of transparency on the SOEs. They also invest a vocal constituency of profit-oriented lenders and minority shareholders with the power to hold hostage SOEs' ability to raise finance. The eagerness of investors to lend money to and buy shares in SOEs may in part represent rational herd behaviour aimed at cashing in on a booming market. But this eagerness also suggests that investors view the risks associated with state ownership as insignificant.

Beyond raising general concerns about the microeconomic efficiency of SOEs, some observers have suggested that the slowing growth in Russian oil production since 2004 reflects state expansion in the sector. However, rapid oil production gains in the prior years were largely a one-off, short-term opportunity to use new technology to improve yields from mature fields discovered in the Soviet era. Gazprom and Rosneft seem to be managing their newly acquired oilfields no worse than Sibneft and Yukos did before them (Woodruff 2006).

Borrowing Up a Storm

Ironically, SOE expansion is creating the greatest challenges in areas where one might expect state ownership to confer an advantage–fostering a coherent set of priorities and a long-term focus. SOEs' massive foreign borrowing is a primary example. When these loans are converted into roubles, the money supply expands, contributing to Russia's core macroeconomic dilemmas of inflation and real exchange-rate appreciation. Borrowing has been especially intense recently. In the final quarter of 2006, foreign indebtedness of state-owned banks and other firms grew by $13.9 billion, nearly 19 percent. Capital inflows for 2006 reached a record $40 billion, a figure that was nearly equalled in the first five months of 2007 alone.

Russia's Minister of Finance, Aleksei Kudrin, and other government officials have called for a slowdown in SOEs' foreign borrowing, and have pushed state firms embarking on IPOs to seek capital from the rouble-holding public instead of relying solely on new funds from abroad. Macroeconomic factors limit how much incoming investment Russia can effectively absorb. The state must thus regard international financing as a scarce resource, and take steps to ensure that it is directed in line with long-term development priorities. At the moment, however, SOEs are directing these scarce resources not to production projects, but to empire-building acquisitions, saddling themselves with large debt burdens that could be a barrier to their subsequent development (Hubbard 1998).

Gazprom is the most important example. As gas consumption rises with economic growth, and as deposits in developed fields dwindle, the company will need to make large investments in new fields. But Gazprom has not made these investments a priority. Instead, it has raised capital to bring more assets under its control. Gazprom is presently poised to significantly widen its presence in the power generation sector, where assets are now being sold off as part of efforts to promote competition and attract investment. Despite objections from the state's anti-monopoly organ, Gazprom is also likely to win approval for the purchase of coal producer SUEK, which would leave it controlling nearly 40 percent of the country's coal output. Thus, Gazprom's acquisitions threaten to undermine the competitive logic of the intricately crafted electricity sector reform.

In other sectors, however, SOEs do not threaten to reduce competition (to the extent that it exists to begin with). Banking has been dominated by state-owned entities since the 1998 financial crisis, and acquisitions by state banks do not significantly change the competitive balance in the sector. In automobile manufacturing, foreign companies are building significant new capacity. Private companies will likely continue to play a central role in the production and refining of oil. Nevertheless, in these sectors too, SOEs have concentrated on purchasing existing assets rather than on new productive investments.

Conclusion

In assessing the growth in state ownership of the Russian economy, the key issue is not the precise percentage of assets owned by the state. Indeed, this is likely to shrink in the medium term. Even though many energy-system assets will wind up under the control of Gazprom, others will pass to the private sector. Heavily leveraged SOEs are also likely to engage in additional share offerings to pay down their debts. This reversal, should it occur, would not resolve the major difficulties revealed in the SOE acquisition boom. Russia's macroeconomic situation limits the volume of foreign investment it can accept without severe inflationary consequences. It needs to take steps to insure these funds are directed not to reshuffling ownership, but to productive investments for the long term.

So far, expanded state ownership has failed to accomplish this urgent goal. This may cast a long shadow over prospects for converting Russia's current economic boom into sustainable development, the benefits of

which are broadly distributed across different regions and social groups.

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Informal Practices in the Russian Private Sector

Alena Ledeneva and Eugene Nivorozhkin

In the 1990s, Russia's development emphasized reforming formal institutions. Yet the outcome of these reforms often depended on informal practices that both opposed and contributed to formal structures. These informal practices moderated some of the exigencies of transition, helping companies to exploit legal loopholes and optimize tax schemes. However, they also allowed companies to engage in asset stripping, share dilution, and transfer pricing, not to mention the limitation of shareholder voting rights and the abuse of Russia's insolvency laws. While the Russian economy of today is much more stable and prosperous than it was 10 years ago, Russian businesses continue to require a high degree of informality to 'get things done'. Informal practices persist because interpersonal trust compensates for popular distrust of state and financial institutions.

Informality and Russia's economic transition

Informality is commonly associated with corruption and the absence of the rule of law; it is believed to subvert the foundations of good governance and investor confidence. Informality certainly allows competent players of informal rules to bend the system to their advantage. What is rarely noticed, however, is that these practices played a key role in transforming Soviet enterprises into private businesses able to compete in a market environment. For example, Adachi underscores the importance of informal corporate governance practices in three major Russian companies–the oil company Yukos, Russian Aluminium and Norilsk Nickel–in their struggle to survive, to deal with the disintegration of the Soviet economic system, and to compete and grow under post-Soviet constraints (Adachi 2005). In *How Russia Really Works* (Ledeneva 2006), informal practices associated with barter, financial schemes, and alternative contract enforcement mechanisms are shown to have both advanced business and strengthened the importance of non-market alliances, which are both competitive and anti-competitive.

While informal practices rapidly adapt to legal changes and make use of legal institutions, they also create obstacles to consolidating the rule of law. Although primarily benefiting certain groups, informality caters to a wider set of economic needs and is implicitly endorsed by the state. The state itself is sometimes accused of 'tax terrorism' against business. Hainsworth and Tompson (2002) refer to 'the informal fiscal system' that reflects official responses to short-term financial and political pressures. Part of the problem is the lack of clear, accessible, and consistent rules. Thus, contradictions in tax legislation virtually guarantee a degree of informality, since officials must decide which rules to enforce and when. The tax organs sustain non-transparency by devising enabling regulations that allow them to manipulate inconvenient legislation. Vested interests in state agencies lead to informal 'bargaining' between taxpayers and officials at all levels. The formal rules of the game–tax legislation, normative acts, ministerial instructions–are important factors in these negotiations, but they are not definitive.

Firms often resort to paying in cash to avoid taxation

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The relationship between taxpayer and tax collector is not normally based on negotiation, but in Russia, as Hainsworth and Tompson indicate, 'The bargained tax bill is no more a paradox than was the bargained plan'. Unlike the use of black cash or bribery, many tax schemes are grounded in legal loopholes and can be more properly described as tax avoidance than tax evasion. They exploit defects in the tax legislation which, according to some respondents, may have been left there on purpose. The centrality of law in such creative scheming, however, is a noticeable and positive development.

The key role of Russian banks

Russian banks tend to play a dual role vis-à-vis the tax organs–they are both taxpayers to, and agents of, the fiscal organs. Since a substantial share of tax revenues is collected via the payments system, tax authorities rely heavily on banks not only to provide information about clients' finances, but also to cooperate in tax collection. This practice creates an incentive for firms to conduct transactions in cash. However, the use of black-cash strategies by firms is limited, and typically requires the banks' help in obtaining large quantities of cash in violation of restrictions on the use of cash for inter-company transactions. Hence, banks play a critical role in so-called 'tax optimization' strategies.

The centrality of banks in managing financial flows and information, and in mediating between tax collectors and tax payers, allows them to create and exploit these profitable lines of business. Russia's Central Bank fell under intense scrutiny following the murder of Andrei Kozlov, its first Deputy Chairman, in September 2006. There are widespread concerns that Central Bank decisions concerning small- and medium-sized banks are overly subjective and often politically motivated.

Trust-based relationships are also the basis for insider trading, which (given the few legal restrictions on it) seems widespread on Russian financial markets. While the law 'On Securities Markets' prohibits trading based on 'office information', its definition is vague and penalties for its use are insufficient. The notion of 'insider information' is not used, and the Federal Service for Financial Markets (FSFM) has insufficient powers to deal with it. A draft of the law on 'insider information' was prepared by the FSFM in 2005; it remains under discussion. Whether its eventual enactment will reduce the scale of insider trading and price manipulation remains to be seen.

It is often assumed that informal practices in Russian business are a Soviet phenomenon and thus are less common today. Our research and recent events in the banking sector dispel this myth. Informal practices, in particular those associated with discrete banking services, are reported to be essential for business operations and indicative of the importance of interpersonal trust in Russian business (Ledeneva 2006). The prime break with the Soviet past has taken place in relation to the poor. Informal practices in today's Russia are much more exclusive and do not cater to their needs.

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'One-Stop-Shop' Reforms in Ukraine: Do They Work?

Vyacheslav Toporov

Massive job destruction and the spread of poverty have accompanied the transition from a socialist to a market economy in Ukraine. While the post-1999 economic recovery has increased wages and productivity, it has not yet brought substantial improvements in job creation to reduce poverty. The poor endure longer periods of unemployment, have more restricted access to the labour market, and are overrepresented in sectors with high rates of underemployment such as agriculture and construction. More rapid business formation could alleviate these tensions by creating more income- and employment-generation opportunities.

In their efforts to improve the business environment, many governments are seeking to ensure better start-up conditions for companies, both by simplifying initial registration procedures and by reforming subsequent regulatory processes. In Ukraine, the authorities (supported by the World Bank and other international donors) have focused mainly on simplifying business registration procedures, which take the form of a series of permissions and licensing decisions made by various general and sectoral regulatory agencies. Donors generally prefer to focus on such changes as they are relatively easy to measure and track for reporting purposes.

'One-stop shops' have a role to play . . .

As in other transition economies, the 'one-stop-shop' approach was chosen in Ukraine as a model for simplifying registration procedures. Following the Law 'On State Registration of Legal Entities and Individual Entrepreneurs' adopted in 2003, one-stop shops were set up in many Ukrainian municipalities. These measures put representatives of various state agencies in one location to better provide information about and accelerate business registration procedures, thereby reducing opportunities for corruption associated with multiple, non-transparent contacts between entrepreneurs and state agencies.

Nearly 200 one-stop shops have been established in Ukraine, often at the initiative of the local authorities. Statistical data indicate that their introduction cut the duration of standard registration procedures nearly in half, from 38 to 20 working days. However, survey data collected by the International Finance Corporation (IFC) show no significant changes in the costs or efficient provision of information to entrepreneurs.[1] Entrepreneurs in 2006 continued to identify regulatory pressures, corruption, and unstable legislation as key causes of Ukraine's unfavourable business climate. Other survey data[2] indicate that 72 percent of top managers believe that 'friendly relationships' with civil servants are necessary to be successful in business. Transparency International's Corruption Perceptions Index persistently places Ukraine among the countries where perceptions of corruption are greatest.[3] While unofficial payments to civil servants (as measured by Transparency International) in 2006 constituted 3.4 percent of companies' sales volumes, smaller businesses faced higher official and unofficial payments.

. . . but are not the whole story

These data underscore how business formation in Ukraine–as in other transition (and some developed) economies–is constrained by factors that are not linked to registration and licensing, and therefore can-

One-stop shops are supposed to help small businesses like this emblem maker

not be cured by one-stop-shop reforms. In addition, one-stop shops in Ukraine have weak legal powers and are generally advisory in nature. Because they often do not provide detailed information, one-stop shops are sometimes incapable of advising on the exact procedures of individual agencies. Frequent changes in the secondary legislation and enabling regulations needed to implement Ukraine's basic legal framework, particularly concerning licenses and permits, continue to offer significant rent-seeking opportunities to local officials.

Mutual distrust continues to pervade relations between business and regulatory agencies in Ukraine. Since registering a company requires obtaining significant numbers of permits and licences, both entrepreneurs and regulators know that frequent controls, verifications, and inspections can follow registration. Smaller companies in particular fear the 'costs of exposure' that come with registration. As a result, large numbers of businesses eschew legalization to avoid both formal registration costs and further pressures from regulatory bodies. Faced with the challenges of regulating entrepreneurs with at least one foot in the informal sector, state agencies seek to maintain extensive controls over businesses, without considering the overall burden imposed on entrepreneurs in this way. This is particularly the case in countries in which the communist nomenklatura has preserved key positions in the state administration.

In Ukraine, matters are further complicated by the partial decentralization of economic administration, which gives the local administration substantial de facto autonomy in setting the commercial 'rules of the game'. Regulatory authority is therefore dispersed across multiple national and sub-national laws in an inconsistent, often contradictory fashion. Moreover, the introduction of permit-issuing one-stop shops was partially compromised by the reluctance of certain government bodies to bring their regulations into compliance with the legal frameworks upon which these reforms are based. Statistics show that the volume of legislation adopted has been increasing each year (see figure 1), often at rates exceeding the monitoring and compliance capacities of entrepreneurs and civil servants.

Conclusion

To address these problems, UNDP's Crimea Integration and Development Programme supported the establishment of one-stop shops in all Crimean districts, and is now focusing on supplementary measures to help realize the promise of these reforms. These include developing a comprehensive review of current regulations pertaining to business licenses and permits, an audit of institutional capacities in key state and local government agencies, advocacy for the 'secondary legislation' needed to limit the discretion of line ministries and other regulatory agencies in these areas, improved adjudication of commercial disputes, and the creation of a web portal providing comprehensive information on business registration procedures in Crimea.

Since barriers to the creation and expansion of new businesses go well beyond registration issues, the significance of one-stop shops in Ukraine should not be exaggerated. Broader approaches to improving the business environment are needed at all stages, not only at registration. Improvements in administrative and regulatory transparency could improve inter-sectoral understanding of the big picture, and promote better top-down and grass-roots control over law making and implementation. Measures to strengthen the judiciary's ability to resolve commercial and regulatory disputes can significantly contribute to this transparency. Stronger technical and human capacities of both regulatory bodies and one-stop shops themselves could reduce incidences of misinterpretation of legal acts, and make their contribution to any business promotion system more valuable.

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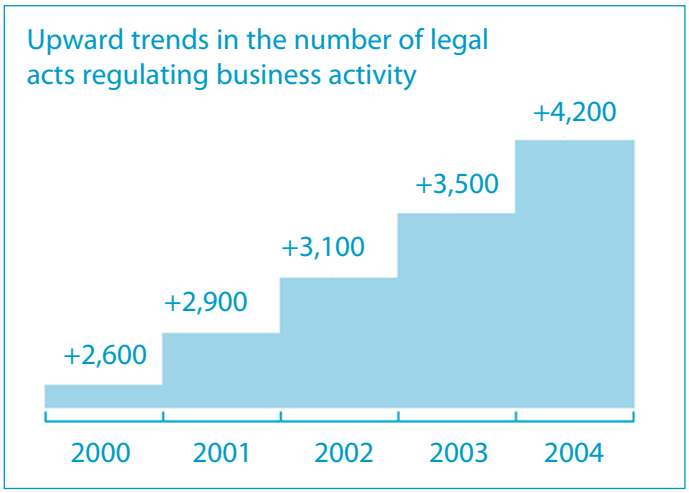
1 *Business Environment in Ukraine 2004*, December 2004. International Finance Corporation. (http://www.ifc.org/ifcext/uspp.nsf/Content/PMSurveysRU). See especially the section on company registration.
2 'Quarterly Enterprise Survey'. Institute for Economic Research and Policy Consulting, October 2006. http://www.ier.kiev.ua.
3 See, for example, Transparency International's 'Corruption Perceptions Index' (2004).

Figure 1



Source: Ukrainian electronic legal database *Liga*.

Towards a 'Fourth Sector'? Social Enterprises as a New Hybrid for Employment Generation

Geoffrey D. Prewitt

Social enterprises are receiving increased attention as institutions promoting employment and social inclusion. They entered the European development discourse in the early 1990s as an attempt to describe the organizations found in the porous boundaries of the voluntary sector (civil society) and the private sector (the market). Like civil society organizations (CSOs), social enterprises do not enjoy precise, universally accepted definitions, legal or otherwise. Social enterprises may be cooperatives, associations, foundations, mutual benefit and voluntary organizations, charities, and other not-for-profit or limited-profit distribution entities that tend to focus on general interest social services and work integration measures, often promoting local development in disadvantaged regions.

> ***What is a 'social enterprise'?***
>
> A common definition of social enterprise is, 'Any private activity conducted in the public interest, organized with an entrepreneurial strategy but whose main purpose is not the maximization of profit but the attainment of certain economic and social goals, and which has a capacity for bringing innovative solutions to the problems of social exclusion and unemployment' (OECD, 1999).

A new way forward?

Voluntary sector institutions during the last 30 years have acquired a central role in addressing poverty, unemployment, service delivery, and other social problems.[1] Social enterprises have become a relevant actor in new welfare systems and employment strategies in countries ranging from Mexico to New Zealand, but most notably in the EU-15 countries. Experience from these countries demonstrates that social enterprises can help reduce poverty by:

- Improving access to basic public services (social, educational, health, etc.) for local communities, including for those who are unable to pay;
- Supporting local economic development in depressed communities;
- Helping to integrate vulnerable groups (ethnic minorities, single women, people with disabilities) into the labour force; and
- Generating employment in the provision of these services.

While a number of countries have passed legislation to support the expansion of social enterprise activities,[2] the countries of Central and Eastern Europe and the Commonwealth of Independent States (CIS) have been slow to do so. CSOs in these countries often function as traditional development non-governmental organizations (NGOs), providing social welfare and humanitarian assistance, particularly in post-conflict areas. Few CSOs in these countries have an explicit mandate to address critical employment issues, particularly with respect to such vulnerable/marginalized groups as youth, ex-combatants, the displaced, or the long-term unemployed. In a region with significant unemployment rates, it is surprising that more CSOs are not engaged in this area, focusing instead on short-term 'bandage' interventions. In many cases, this leaves CSOs at the mercy of donor trends and the imperatives of mobilizing external resources. In contrast, by engaging in economic activities through social enterprises, CSOs could generate their own revenue.

Impediments to social entrepreneurship in transition economies

Social enterprises have yet to emerge in large numbers in the countries of Central and Eastern Europe and the CIS. Although the new EU member states–particularly the Czech Republic, Hungary, Poland, and Slovakia–have embraced them, further East there is much less recognition of the potential benefits of social enterprises. Reasons for this include:

- Difficulties in obtaining data on the numbers of these organizations, or their sectoral and employment profiles;
- Unfavourable legal frameworks (in Macedonia, not-for-profit organizations are not permitted to engage in economic activities);

- Non-transparent and unstable public support (including subsidization policies) for social enterprises, particularly in light of the non-trivial resource requirements associated with starting up social enterprise activities;

- Inadequate appreciation of the actual and potential benefits of social enterprise activities (particularly in terms of employment creation) by national and local authorities, as well as by the private sector; and

- Weak interest in or lack of understanding of 'social entrepreneurship' in many CSOs.

Removing barriers to social entrepreneurship

The expansion of social entrepreneurship can be seen as a structural dynamic common to countries with differing social welfare regimes, legal frameworks, and levels of economic development. This evolution reflects a need for solutions that combine entrepreneurship with the pursuit of social aims, and which benefit from multiple funding sources (public funding, commercial income, volunteer labour, donations, etc.). Unfortunately, legal frameworks in CIS countries often seek to introduce firewalls between economic and social activities. Not-for-profits must therefore create subsidiary companies whose activities (if conducted lawfully) are liable to commercial taxation. This discrimination against social entrepreneurship acts as a major brake on the expansion of not-for-profit activities. On the other hand, there is always a risk that commercial companies may seek to 'redefine' themselves as social enterprises in order to reduce or avoid taxes. Therefore, the blurring of economic and social activities can be abused and requires careful regulation.

Addressing these constraints requires new approaches to entrepreneurship, in order to create more legal and fiscal space for commercial activities conducted by the not-for-profit sector. Clarifying the legal definition of the 'public interest' served by social enterprises–with a particular emphasis on service provision for local economic development–may also be necessary. Regular assessments of social enterprise activities and mandates are important to ensure accountability and reduce the likelihood that commercial interests are not pursued under the cloak of not-for-profit status. The legal relationships between social enterprises and the public sphere should likewise be redefined, in order to facilitate the outsourcing of social service delivery to social enterprises. As concerns relationships with the private sector, move-

Workers team up to rebuild houses in the Skenderaj/Srbica municipality of Kosovo *© Hazir Reka*

ment from charitable donations towards more collaborative approaches should be promoted, particularly in countries with welfare-to-work schemes or quota systems for disadvantaged workers. International actors could facilitate the dissemination of good practices, both in terms of helping to reform legal frameworks and describing the social enterprises that have thrived in those legal contexts.

What next for social enterprises in the region?

Since social enterprises are only now consolidating their position in OECD countries, their maturation in transition economies may still be some years away. More robust efforts to ensure an appropriate environment for social enterprises–in terms of enhancing cooperative ownership, supporting the development of entrepreneurial skills in the voluntary sector, and increasing awareness of different actors (including international ones) about the significance of social enterprises–are particularly important. For social enterprises to realize their full potential, attention must be given both to the larger policy arena and to the organizational structures themselves. This will require addressing negative, historical associations with 'collective' action, as well as broadening the scope, legal parameters, and definitions of voluntary activities. In order for social enterprises to realize their full potential, attention must be given both to the larger policy arena and to the organizational structures themselves.

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1 As noted, for example, in *Social Enterprises*, OECD, 1999; and *The Emergence of Social Enterprise*, Carlo Borzaga and Jacques Defourny (eds.), 2001.
2 For example, Italy's *Law on Social Cooperatives* (1991) and Belgium's *Social Purpose Company* legislation (1995).

Agricultural Privatization in Central and Eastern Europe and the CIS

Jessica Allina-Pisano

Governments in Central and Eastern Europe and the Commonwealth of Independent States (CIS) have pursued a variety of agricultural privatization policies during the post-socialist period. The central stated aims of privatization were relatively uniform across the region: greater efficiency through improved labour incentives linked to private ownership, and the creation of a rural middle class with a stake in democratic governance and political stability. Socialist-era collective farms were restructured or dismantled, and farm assets parceled out to members of former collectives. Some countries, such as Romania and then Czechoslovakia, applied one policy in privatizing collective farms and another for state farms while others, like Bulgaria and Ukraine, did not.

In most countries in the region, rural populations and their representatives responded to agricultural privatization policies with opposition and, in some cases, overt resistance. This led, in almost all cases, to substantial fluctuations in both policy design and implementation during the 1990s. That reform should have encountered some societal resistance is not surprising: both major approaches to privatization (restitution and distribution) threatened entrenched power structures in the countryside by moving land and farm assets into private ownership.

Countries in Central and Eastern Europe pursued land privatization through restitution programmes that granted land directly to its former owners or, as in the case of Hungary, indirectly through compensation vouchers to be used at auction. The latter approach, as Verdery (2003) has observed, privileged rural development over the restoration of previous land tenure arrangements. Restitution was to reshape not only the countryside, but also the nation: in many cases, reallocation of property reinforced post-World War II decisions aimed at ethnic homogenization and nation-building.

In contrast, the CIS countries privatized land by distributing shares to those who had worked on collective and state farms during the last decades of socialism, without regard to pre-socialist patterns of land tenure and ownership. This apparently less contentious approach nevertheless generated or heightened social conflicts, as rural populations contested the boundaries of the community to be included in distribution and, on many farms, members refused to allow the allotment of land and labour assets.

The implementation of both land restitution and distribution policies has generally moved more slowly than anticipated, as farm directors resisted decollectivization and as contentious cases passed through the courts. Furthermore, rural people across the region faced common disincentives to acquiring land: the absence of affordable credit and machinery, and low prices on agri-

cultural commodities made leaving collectives an unattractive prospect. The social services–health care, education, other services–provided by collective and state farms under socialism were also powerful incentives for rural people to remain on large-scale farms.

The valuation and distribution of non-land assets proved difficult for farms across the region, and in most CIS countries, non-land assets were never allocated to members of collectives. Typically, assets of former collectives were to be divided among their members according to a formula that reflected some combination of wage levels under socialism and the number of years that people had worked for the collective. However, the economic instability of the early 1990s, with attendant inflation and currency crises, required the repeated revaluation of farm assets. On most agricultural enterprises, this was a task that directors had neither the inclination nor resources to undertake.

Ultimately, the 'privatization' of non-land farm assets did take place, but not under the rubric of reform policy. Across the region, members of collective farms spontaneously dismantled agricultural infrastructure for resale and informally appropriated machinery and other farm assets. This practice, observed in a variety of national contexts, was the product not only of socialist-era attitudes towards collective property ('everything around me is the collective farm's, everything around me is mine'), but also of more recent transformations: changing attitudes towards property amidst political and economic transition, receding state control and surveillance of rural areas, and short-term incentives to appropriate common property before one's neighbours did. Many rural people believed that their labour under socialism entitled them to a share of farm assets: if farm directors and politicians would not ensure that they had it, some decided they would take it for themselves–just as elites had done under industrial privatization.

Land tenure outcomes

Many factors complicate the task of accurately assessing privatization outcomes in the post-socialist countryside. In most cases, states' resources for data gathering in rural areas are inadequate. Those involved in designing and overseeing privatization policies have good reason to emphasize or exaggerate reform successes, while producers continue to face tax incentives that encourage the underreporting of harvests, profits, and machinery acquisition. Across the region, variation in reported outcomes sometimes reflects differences in how

A ruined state farm and flour factory near Barbele, Latvia *© Jan Banning / PANOS PICTURES*

researchers collect information, rather than actual differences on the ground.

Still, there is general agreement that agricultural privatization has produced a bifurcated set of land tenure outcomes across Central and Eastern Europe and the CIS: land consolidation in some areas, and excessive fragmentation in others. This bifurcation is not due to differing policy approaches, as consolidation and retention of large-scale agriculture occurred under both restitution and distribution programmes. Rather, the different outcomes reflect variation in the size of land plots, crop types, and the response of local elites to reform policy.

In much of the region, agricultural privatization resulted in the preservation of large-scale farms, as rural people stayed in collectives or formed cooperatives as a hedge against risk (Meurs 2001), and as local business and state elites worked together to maintain large-scale agriculture (Allina-Pisano 2004). These enterprises operate on the basis of leasing relationships, and former collectives are often able to collect monopoly rents. In many cases, these large-scale farms are less modernized and rely more on human and animal labour than did their socialist predecessors.

Where the size of land allotments under privatization was relatively small (a hectare or less) and therefore manageable for household production, and where recent traditions of cultivation favoured fruits and vegetables over industrial crops and grain, rural people had more incentive to claim land, and there was more de facto distribution. In such cases, including the Baltic states and countries in the Caucasus, as well as Moldova and Kyrgyzstan, the first 10 years of reform resulted in the allocation of small land share plots and fragmented land tenure systems.

In either case, however, the paper record of agricultural privatization reflects only ownership patterns and may obscure patterns of land use (Allina-Pisano 2007). For example, apparent land fragmentation has often been accompanied by informal leasing arrangements that have in recent years led to land consolidation. Conversely, large-scale farms frequently subcontract work to smaller organizational units within the enterprise.

Prospects for sustainable development

There is thus no clear association between privatization approaches and resulting land use patterns. Instead, the greatest variation in both responses to and outcomes of land privatization appears to exist at the local level, differing from farm to farm and from village to village (Allina-Pisano 2007, Verdery 2003). This type of variation, in which the skills, connections, and other resources of individual farm directors and other local elites are more likely to determine the health of a farm than the details of reform policy, is explained in part by the nearly uniformly disadvantageous economic environment.

Agricultural subsidy regimes and protectionism in the European Union and North America, as well as lower labour costs in China and Africa, make it difficult for farmers in Central and Eastern Europe and the CIS to make a profit from sustainable agriculture. Large-scale farms are under increasing pressure to engage in unsustainable practices: to lease land for serial cultivation of nitrogen-leaching cash crops, to withhold lease payments or salaries from rural people, etc. New EU member states in the region will not have full access to the EU's CAP benefits for some time; in the meantime, commercial agriculture will continue to be fraught with risk.

Meanwhile, small-scale agriculture is likely to continue to be viable only where off-farm income sources (e.g., remittances) can sustain rural households. If the socialist past was marked by inefficient large-scale agricultural enterprises that informally supported household production, the post-socialist present is characterized by more fragmented land tenure systems, in which rural communities have greater freedom to pursue small-scale production, but take on greater labour burdens, and greater risk, in doing so. Without reform of subsidy regimes in the West, post-socialist countries are likely to see a growing role for large-scale leasing enterprises, with narrow profit margins and fewer and fewer benefits for rural people.

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Corporate Social Responsibility and Post-Communist Business: From State Paternalism to Enlightened Self-Interest?

Peter Serenyi

The voluntary integration of social and environmental concerns into commercial operations–'corporate social responsibility' or 'CSR'–is not a new trend in the West. Often encouraged by the watchdog efforts of consumer groups, companies in many western countries have been spending money on responsible business practices for years, often because they see it as important for their reputation and image. What is new, however, is that firms are starting to recognize–and some studies are beginning to show–that CSR can boost a company's profits. By reducing the usage of energy and other inputs, firms can promote environmental sustainability as well as reduce costs. Firms are increasingly aware that better working conditions for employees can help reduce turnover and absenteeism.[1] Financial institutions are increasingly integrating CSR criteria into investment decisions, creating new financial opportunities for companies that embrace CSR principles.

In post-communist countries, the notion that companies have a social role to play is not new. Under socialism state-owned companies built and maintained social, cultural, sporting, housing, and recreational facilities, and provided hot water at subsidized rates for local communities, without commercial cost-benefit analysis. These activities were part of the communist ideology of guaranteed welfare and social protection; they were not driven by factors of economic efficiency.

When privatization began in the 1990s, many firms divested themselves of these social obligations in order to stay afloat in the market economy. This focus on core business activities often created feelings of nostalgia and resentment among people whose access to social services was being scaled back. When combined with popular views equating privatization with corruption and insider deals, these divestitures further reduced popular trust in post-communist companies and their managers. Recent UNDP surveys for Croatia and Hungary reported that many people don't trust the new capitalists. According to data published in 2004, more than half of Poles believe that private businesspeople don't obey the law.[2]

The (slow) rise of CSR in transition countries

In contrast to state paternalism, CSR is about the development of the communities, markets, and human resources on which a company's long-term prospects depend. It reflects a forward-looking 'enlightened self-interest' approach by companies looking for partnerships with other stakeholders to find solutions to common problems. In contrast to the West (where civil society groups spurred companies to adopt CSR principles), in the post-socialist world, the first big CSR push came from foreign investors seeking to align their business practices in Eastern Europe with CSR principles at home. EU accession processes also helped catalyze post-communist CSR, by encouraging local companies to distinguish themselves as progressive and able to compete on the more brand-conscious, consumer-driven–and often more socially aware–single market. Some local NGOs are starting to push companies to go beyond what is required by law to promote social and environmental goals. And some business leaders see the pursuit of CSR as a way of strengthening popular trust in post-communist companies.

CSR is supported by the United Nations, both regionally and globally. The Global Compact was founded in 2000 by former Secretary-General Kofi Annan as a voluntary alliance of businesses that agree to follow 10 core CSR principles in such areas as human rights, environmental protection, labour standards and anti-corruption. With over 3,200 member companies, the Global Compact has become the world's largest CSR initiative. In the Europe and CIS region, national networks exist in Armenia, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Georgia, Hungary, Lithuania, Northern Cyprus, Macedonia, Moldova, Poland, Russian Federation, Turkey, and Ukraine. These networks help companies to exchange ideas on how best to implement CSR principles, and to better support development programming.

Coca-Cola's 'Every Drop Matters' regional water partnership with UNDP highlights recent developments in this area. Since for Coca-Cola clean water is a key input for virtually all its products, sustainable water resource management is a key business objective. One joint project in Croatia has mobilized local communities to regularly clean local rivers by 'adopting' them.[3] Microsoft, which is providing software and curricula to telecentres around the region, is working with UNDP in Bulgaria to provide computing and Internet facilities to tens of thousands of beneficiaries. It is also working to strengthen IT skills of disadvantaged Roma communities in Hungary, the disabled in Poland and the Czech Republic, and youth in Slovenia, to bolster their employment prospects.

Multinationals are also introducing CSR principles to the region via supply chain management. For example, the British retail chain Tesco has offered its suppliers the chance to sell on the UK market if they can follow stringent social and environmental principles. Danisco Sugar in Lithuania employs supply chain management techniques to ensure that social, environmental, ethical and quality standards are being met by its suppliers.

Human resource development is another focus area for CSR in the region. SVIK, a Slovak textile company, has invested in a local trade school in order to increase the number of skilled Roma workers on which the company can draw. Today, Roma employees–most of whom were trained in this trade school–comprise one third of SVIK's workforce. Kurt Zrt, a medium-sized data recovery company in Hungary, has sponsored technical education programmes for disadvantaged youth, as part of efforts to ensure adequate supplies of skilled workers.

Large Russian companies–including those in which the state retains important ownership stakes–are also showing strong interest in CSR. The aluminum maker Rusal is spending $10 million a year to run grant programmes that support the environment, worker health and safety, and the communities in which the company operates. Other Russian companies such as gas giant Gazprom and electricity provider UES are demonstrating their interest in CSR, in part so they can access Western capital. Going beyond what is required by law is important for western markets, which have shown more skepticism towards Russian business practices. Pursuing CSR has served to lower financing costs and risk premiums for Russian companies.[4]

Microsoft is helping people with disabilities gain high-tech job skills in the Czech Republic

Photo courtesy of Microsoft

Firms in Russia are not the only ones who need to improve public perceptions of their business practices. Charges of corporate social irresponsibility have been levied against prominent western multinationals, including Coca-Cola and Tesco. In 2006, six states in India announced partial or complete bans on Coca-Cola products after claims that the drinks contained harmful pesticides. Tesco has been criticized for building on highly contested greenfield sites, and for undermining the livelihood of small traders. For these (and other) reasons, critics perceive CSR initiatives as being merely window dressing to distract attention from harmful corporate behaviour.

More questions than answers

The fundamental question for development practitioners is whether CSR helps to reduce poverty. Unfortunately, its newness in the post-communist region precludes definitive answers to this question. It is clear that long-term thinking–a cornerstone of corporate social responsibility–gets short shrift in many local companies, which are fighting for survival, struggling to pay salaries, and fending off the tax office. UNDP research on CSR in Poland strongly suggests that large numbers of companies will not become interested in CSR until their customers start to value it. However, UNDP CSR studies conducted in Croatia, Hungary, Lithuania, Poland, and Slovakia do suggest that CSR initiatives can have a significant impact on poverty and social exclusion.

Prodded by foreign investment, multilateral organizations, and local leaders, CSR has a fighting chance among larger companies in the region. As distinct from the West, where the chief drivers of CSR have been consumers and civil-society groups, the chief proponents of CSR in Central and Eastern Europe and the CIS remain foreign investors and large indigenous companies. The real question now is how to spur consumers and civil society groups to replicate the role they play in the West, in pushing companies to pursue more responsible business practices.

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1 *Competitive Social Responsibility: Uncovering the Economic Rationale for Corporate Social Responsibility among Danish Small- and Medium-Sized Enterprises.* Working paper prepared by Mark Kramer, Marc Pfitzer, and Paul Lee. FSG Social Impact Advisors and the Center for Business and Government, John F. Kennedy School of Government, Harvard University, July 2005.

2 Beata Roguska, 'The Owner, Employer, and Citizen: Reconstructing the Image of Entrepreneurs', in *The Economic Awareness of Polish Society and the Image of Business,* ed. L. Kolarska-Bobinska. Warsaw: The Institute of Public Affairs, 2004, p. 103-131.

3 See http://www.undp.hr/show.jsp?shownewsrepcat=71660&page=51980&showsingle=68444.

4 Stephen Schmida, 'A Russian Twist on Responsibility.' *The Moscow Times.* 31 January 2005.

FORTHCOMING CONFERENCES

The International Media Forum on Corporate Social Responsibility will be held in Kyiv, Ukraine on 12-13 July. The Forum, organized by the UN's Global Compact in partnership with *Expert* magazine and Mobile Telecommunications System, will focus on the role of the media in promoting, challenging, and implementing corporate social responsibility (CSR). To register for the event please send an email to gc@un.org.ua.

The MDG Forum on North and Central Asia will be held in Bishkek, Kyrgyzstan on 19-20 July. This event will focus on progress made towards achieving the Millennium Development Goals (MDGs) in Central Asia and the Caucasus. Participants will also discuss water and land management, pro-poor growth through regional cooperation, and MDG data and monitoring. The event is being organized by the United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP), the United Nations Development Programme (UNDP), and the Asian Development Bank (ADB). For more information please contact Jacek Cukrowski (jacek.cukrowski@undp.org).

JOB OPENING

UNDP's Bratislava Regional Centre is currently looking to fill the position of Regional Practice Leader (Democratic Governance Practice). For more information please visit http://europeandcis.undp.org/?menu=p_jobs.

World Water Week will take place in Stockholm, Sweden on 12-17 August. This is a key annual event for experts and organizations working in the field of water governance. This year's focus is 'Striving for Sustainability in a Changing World'. For more information please contact Juerg Staudenmann (Juerg.staudenmann@undp.org).

Building Capacity to Measure and Foster the Progress of Societies: The role of Evidence-based Policy-Making. This event, to be held on 26 September 2007 in Moscow, will bring together representatives of multilaterals, non-governmental organizations, and the media to discuss how to bring statistics, policy makers, and societies closer together. The organizers are: the International Programming Evaluation Network (IPEN), the State University – Higher School of Economics, the Organization for Economic Cooperation and Development (OECD), the United Nations Children's Fund (UNICEF), the United Nations Economic Commission for Europe (UNECE), and the United Nations Development Programme (UNDP). For more information please contact Jaroslav Kling (jaroslav.kling@undp.org).

The forum entitled, **Business Reputation: Responsibility, Transparency, Sustainability,** will be held at the President Hotel in Moscow on 5 October 2007. The Russian Union of Industrialists and Entrepreneurs is organizing the event together with UNDP-Russia and the Global Compact Office. Participants will include Russian companies and international organizations that are working on issues of sustainable development and socially responsible enterprise. For more information please contact Asel Abdurahmanova (asel.abdurahmanova@undp.org) or Larissa Zelenina (larissa.zelenina@undp.org).

The sixth ministerial meeting **Environment for Europe** will take place in Belgrade, Serbia on 10-12 October 2007. The meeting will follow up on the last ministerial held in Kyiv, Ukraine in 2003. In attendance will be ministers of the Environment, Foreign Affairs, Finance and other sectors to discuss the progress of the official environmental strategy for the countries of Eastern Europe, the Caucasus, Central Asia, as well as the Balkan region. For more information please contact Viktoria Zimm (viktoria.zimm@undp.org).

The 39th National Convention of the **American Association for the Advancement of Slavic Studies** (AAASS) will be held at the Marriott Hotel in New Orleans, Louisiana on 15-18 November. This national forum makes possible a broad exchange of information and ideas, stimulating further work and sustaining the intellectual vitality of Slavic Studies. For all issues relating to the AAASS National Convention, please contact: Wendy Walker, AAASS Convention Coordinator (walker@fas.harvard.edu).

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