

Economies in transformation: limitations and potentials of the transition process

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THE NINETIES might be one day characterized as the period when, immediately following the end of the Cold War, *one world* bearing the features of a market economy was being formed. One way or another, all economies are always in transition aimed at achieving the most flexible and efficient system.

However, the challenge posed by the economies of Central and Eastern Europe is unprecedented: the transformation from one system, predominantly based on central planning and state ownership, into another, based mainly on market principles, private ownership and encouragement of initiative and enterprise.

In previous history, radical transformations of this type took decades, if not centuries. Today they must be accomplished more rapidly. Economic change of such gravity demands a tremendous cultural transformation in the minds of the changing populations. To overcome psychological barriers, mentalities and values will have to be adjusted. This will take time, most probably a generation, before the changeover will be consolidated.

While concentrating on Central and Eastern Europe, the group drew also on the Latin American, Asian and

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A High-Level Expert Group discusses the process of transforming centrally planned economies into market ones. The key element in such a process has been defined so far as the transition from state ownership of enterprises and most services into private ownership. At the same time, the existing market economies are facing many challenges, including the redefinition of necessary regulatory and distribution mechanisms, both on the national and global level. The combination of these two processes, and the scale on which they are occurring, poses a number of political and practical problems which have never been addressed or successfully managed by any country in the world.

Southern European experiences. The countries of Central and Eastern Europe –while not a homogeneous group– must not only cope with changes in the economic, but also in the political system.

While a market economy is a condition, although not a sufficient one, for democracy, democracy in general is not a condition for a market economy. However, in present circumstances democratization is vital for any transformation to succeed. In order to gain acceptance of the new values and to create the civil society inherent in a democratic system, a series of political as well as economic reforms will eventually have to be put in place, safeguarding individual freedom and human rights, ensuring free elections and a parliamentary system based on political pluralism, popular participation and political accountability.

The political and economic disintegration accompanying the current reform processes in Eastern Europe weakens these countries and their economies, and places extraordinary demands on the skills and vision of the political leadership and the understanding, cooperation and tolerance of the population.

“Economic change demands a cultural transformation in the minds of the people”

With the acceptance of the market mechanisms, *one world* is emerging where all countries benefit from the division of labor and economies of scale through competition, freer trade and payments. During the transition process toward a market economy, three key tasks must be accomplished:

1. The adoption and implementation of appropriate macroeconomic stabilization policies removing disequilibria with a view to facilitating economic growth
2. The introduction and guarantee of property rights and the initiation of structural reforms, namely price and trade liberalization
3. A phased process of privatization and commercialization of industry and services, in order to replace the hitherto political management of the enterprises with private bureaucracies

Development strategies

Neither the capitalist market system nor the socialist economy have proved to be perfect in satisfying individual or collective needs or bringing about a fair income distribution.

Most capitalist economies are characterized by a mixed system with a vigorous private sector and a strong public sector (averaging 40% of GNP). To determine the nature of the most efficient mix is the key challenge for each economy.

The role of Government in fostering economic development is essential, even in a capitalist system. Its function is to ensure an allocation of resources compatible with certain goals and values of society, to achieve a fair distribution of income, to provide infrastructure, and to keep the economy stable by avoiding excessive fluctuations.

“One world is emerging”

The goals and processes of development must be redefined beyond the simple indicators of GNP–measured economic growth and welfare. New sets of indicators should be introduced, capable of reflecting diverse and normative cultural goals.

Time-sequencing is critical for the success of any economic and social transformation and for avoiding the high cost of social dislocation. Every transformation must be addressed in multi-disciplinary ways. Above all, transforming economies must make haste slowly.

In a transformation, market discipline must be introduced at the enterprise level through import competition, insulation of management from political pressures, and controls over credit and subsidies.

Privatization entails a process of identifying areas where economic activities should be organized and owned or controlled by the private sector, in order to raise efficiency and productivity.

“Neither the capitalist system nor the socialist economies have proved to be perfect”

As the previous social order is being destroyed, standards of living are likely to decrease. Therefore, this process must be smoothed by sufficient economic assurance and income security measures for the population in order to maintain the social stability of a country.

Transfer of technology and capital from the West will be indispensable to facilitate the transformation and the related modernization process.

All the political forces of a country must display a clear and strong commitment towards the reform goals. The time frame of the transition will be affected by political pressures and struggles and by the people's

perception of the political legitimacy of the new leaders and institutions. Societies must be fully informed of new programs and their likely implications. Without strong political leadership, popular participation and pluralism, economic transformation is bound to produce undesirable results.

“The role of Government is essential”

The experience with industrial and structural policies in the industrialized countries may contain lessons for the development of comparable policies by economies in transformation. One of the essential features of Western industrial policies was that governments rarely engaged in creating industries but acted in indirect ways: as purveyors of public goods, providing infrastructure, education, (re)-training facilities and related employment schemes, encouraging entrepreneurship, private initiative and innovation, by facilitating the emergence of strong and stable financial institutions and the adoption of conducive legal frameworks and tax policies.

“Make haste slowly”

Industrial policies were tailored in accordance with the cultural peculiarities and specific circumstances of each country. This experience proves that capitalism does not necessarily entail the absence of planning. But it does not involve central planning of a whole economy. Thus, there cannot be a universally applicable blueprint.

The adoption of proper macroeconomic policies aimed at stabilization and at stimulating economic growth is of paramount importance both for developing countries and the Central and Eastern European ones. In the short run (nine to twelve months) a series of measures must be taken, but not necessarily a *shock therapy*, to enable the market to function. Stabilization must be linked to the development of appropriate strategies for sustainable economic growth.

The period of implementation for such a program –normally agreed on with the IMF– is set, in the medium term, at three years. It implies a cut in real wages if consumption is excessive. But if the standard of living is to be protected and social hardship minimized, production and employment should not be allowed to collapse.

Price liberalization is aimed at eliminating a variety of price distortions and administrative impediments. Sustainable economic development and growth must be induced as quickly as possible through a government

industrial policy, the building of a reformed public sector, privatization, support to small and medium-scale businesses and export promotion.

Privatization and commercialization

Privatization is not a goal in itself in isolation from the overall transformation process, but only privatization will guarantee a process of educating and setting up a new managerial class. In several countries, reprivatization of previously confiscated land and assets to their former owners or their compensation must be distinguished from the genuine privatization process.

“Societies must be informed of the programs and their likely implications”

The process of privatization involving the sale of companies should initially begin with small-scale shops, businesses and the service sector. In this case, the auction system may serve as an effective mechanism, while in the agricultural sector, land can be privatized or leased.

Most heavy industry and large-scale enterprises will for some time remain protected, given the lack of finance, apprehension about foreign control of key sectors and the inefficiency of production. Heavy industries will need to undergo first a process of restructuring, including demonopolization and commercialization of their activities.

“Capitalism does not necessarily entail the absence of planning”

Privatization of select large-scale businesses could be accomplished through a voucher system, or sale to the public. Care should be taken that not just the most profitable enterprise, or ones from just a few sectors, are sold off –often at relatively low prices– but also that Government is not left with the least viable, least effective and technologically outdated enterprises that could be a drag on the budget.

An overall review and reorientation of safety nets should accompany the privatization and commercialization processes, with a view to reforming and adapting them in line with the requirements of the new situation and not necessarily emulating Western models which are also now affected by changes.

Channeling resources

New small business development should be encouraged as such enterprises require little capital, absorb labor and meet real existing consumer demand.

The destruction of what is old and the management of the economic system requires a massive transfer of capital, technology and resources. There is, at the same time, a

“There cannot be a universally applicable blueprint”

need to produce sufficient levels of internal savings. Internally, the mobilization of capital and savings for productive investment and capital formation through savings institutions becomes a critical element. A system of institutional investors must be built up to provide for a regular savings effort.

There is an absolute necessity to reduce Government balance of payments debt in order to mobilize and dynamize private and institutional savings for the purpose of ensuring higher production. To this end, public revenues

“Privatization is not a goal in itself”

and taxes must be increased, while public expenditures must be cut. Governments that are bankrupt are unlikely to attract foreign investment. One way of generating a stream of income for the public budget may be the monetization of vast Government-owned housing stock that has no market value, after problems of ownership have been settled.

External finance from public sources, including international agencies, and the Western private banking sector will be required for long-term private and public investment in order to allow the developing countries and their markets to emerge as viable economic players and

partners. However, there is doubt that sufficient excess capital exists in the West to support such transformations.

The catastrophic and rapid increase in the external debt of the countries in transformation must also be urgently solved through effective debt reduction and relief packages. Recent debt rescheduling agreements will undoubtedly hasten the process of debt reduction.

The end of the Cold War has made reductions in military expenditures by all countries a possibility. This should provide another source of long-term domestic and external financing.

The trade picture for the Central European countries in transformation is rather bleak, due to the complete collapse of the Soviet system, an event which is speeding up the

“Governments that are bankrupt are unlikely to attract foreign investment”

need for transformation of the former member countries of the Council for Mutual Economic Assistance (CMEA) in order to compensate for loss of trade with the USSR and the former German Democratic Republic. The immediate task is to re-establish trade among the former CMEA countries, where market connections and technological fits already exist. Western assistance for long-term intra-regional trade financing will be crucial.

The liberalization of foreign trade cannot be unilateral. Free access to markets cannot be imposed on countries without reciprocity by the OECD countries. If there is no adequate reciprocity, the solution will be inefficient and will lead to the demise of GATT into regional trading blocs. The openness of Western markets to exports from the countries in transformation will be critically important for the success of the transformation process **M**