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Development Policy Lessons for Eastern Europe

Amidst a grave economic crisis, the disintegration of social values, political instability and escalating strife between ethnic groups and nations, the transformation problems facing the Eastern European states are unprecedented. Nevertheless, the transformation needs in many Eastern European countries are bound up with typical development policy problems. Much experience gained in the Third World can thus be of relevance to development policy in Eastern Europe, both for national and sectoral economic reform, as well as for bilateral and multilateral development cooperation.

Development policy experience has taught us the following basic economic principles: reforms should be coherent, carried out within realistic time spans and enjoy the clear political support of government at all levels. Reform programmes appear to need a social buffer, among other reasons because social unrest and political instability could otherwise jeopardize them. Essential to carrying out successful reforms is the establishment of effective institutions. This entails setting up public bodies to perform the basic tasks of government and establishing a code of conduct for the economic agents (e.g. contractual law).

In some respects, the current economic challenges facing the countries of Eastern Europe are comparable to those facing many Latin American states since the mid-eighties. Experience gained by successful reform countries, such as Chile and Mexico, can be instructive in the following policy spheres: stabilization, privatization, foreign debt management and liberalization of trade and investment.

The prime focus should be on efforts at achieving and maintaining overall economic stability, because only then can microeconomic reform processes have any lasting impact. To do this, the excess money supply must be eliminated and the budget deficit reduced. In order to keep inflation down persistently, the budgets of public enterprises must be kept within strict bounds, subsidies reduced and an efficient tax system established. The large distortions in relative prices stemming from over-regulated or non-existent labour and financial markets must also be remedied.

Although individual countries in Latin America, such as Mexico, have implemented far-reaching privatization programmes since 1983, the magnitude of the privatization required in Eastern Europe is immeasurably greater. Government enterprises should be privatized or liquidated for the sake of economic efficiency, to overhaul public finances and to realign government to performing its prime tasks in a market economy. Experience in Latin America would indicate that privatization should proceed gradually so as to test the market and allow for

learning processes. With growing confidence in the economic reform and as the structural adjustment programmes progress, government-owned enterprises can be sold at higher prices.

A number of Central European and Eastern European countries are burdened with excess foreign debt. Unlike the situation in Latin America, only a very small percentage of obligations in foreign debt are owed to commercial banks; the bulk consists of obligations to public creditors. Managing foreign debt should aim at solid, comprehensive and long-term rescheduling rather than maximizing interim debt payment. Effective rescheduling can have positive effects and inaugurate a self-sustaining, confidence-building process attended by national and foreign investment growth, a return of flight capital, access to international capital markets and a further consolidation of public finance and inflation control.

Trade reforms should also be accorded high priority, as the Eastern European countries can expect welfare gains from integration into the world economy. To do this, quotas must be converted into duties, high duties reduced and investment and labour rechannelled from the production of non-tradeable goods to export-oriented production. This policy of factor reallocation can however be jeopardized by the immobility of labour, weak financial markets and bureaucratic bottlenecks. The Western industrial countries can provide particularly effective support to the efforts at liberalizing trade by opening their markets to Eastern Europe, thus affording it a foreign trading area.

A positive or at least neutral external resource transfer is essential for the development of the Eastern European countries. Private foreign direct investment plays a major role here in supplementing internal savings and investment. Direct investments do not increase foreign debt; they facilitate access to new technologies, make foreign currencies more easily available and create jobs. They also have positive psychological effects on prospective investors within the country. It must, however, be borne in mind that foreign investors will be reticent to commit themselves at the initial stages of the structural adjustment process.

In bilateral and multilateral cooperation with the new Central Asian developing countries, success will depend on the political parameters, regulative policy and general economic policy of the recipient countries. Development assistance can enhance the credibility of economic reforms and reduce their cost. It can, however, also induce the recipient countries to defer reforming their economic policy and mobilizing national resources, or it can – as in the case of food aid – destroy the incentives for increasing local production. An inordinate net transfer of resources causes uncertainty, fosters corruption and impedes inflation control.

Policymakers, institutions and administration in the developing countries are key to the success of external aid. If the donor organizations do not coordinate their activities and compete with each other, they can end up as agents of contradictory economic policy reform approaches and projects and incompatible technologies and methods. It is thus essential for its success that Western help be coordinated when drafting support programmes and implementing these in the field.

Priority must be accorded in reform to policy dialogue and programme assistance. Given the low absorption capacity, the already high level of foreign indebtedness and the probable low impact of projects under adverse general conditions, financial support should only be granted in combination with structural adjustment loans from multilateral organizations (IMF, World Bank). In the area of technical cooperation, too, account should be taken of the low absorptive capacity in order to ensure that the selection of projects is efficient. The strategic goal of technical cooperation should be geared more to building up capacity in the long term rather than the short-term improvement of performance. Particular stress should be placed on better planning of coordinated support for sectoral objectives and policies as part of the programme approach.

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