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PRIVATIZATION PROCESSES IN EASTERN EUROPE: THEORETICAL FOUNDATIONS AND EMPIRICAL RESULTS

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1. It is a great pleasure and an honor to introduce this conference on privatization in Eastern Europe. The transformation that is under way in these countries, from central planning and state ownership towards a market-based economy and private property, has brought the problems of privatization to the forefront of discussion among policy makers and economists.

I recently had the privilege of chairing the Deputies of the Group of Ten in the preparation of a report on the "Issues raised by the transition in Central and Eastern Europe". In addition, the Bank of Italy is following developments closely and has provided technical assistance to central banks in the region. My remarks today draw on both these experiences and are intended as a stimulus to the debate on the policy and technical aspects of privatization that the distinguished speakers gathered here will address during the conference.

2. As underscored by the G-10 Report, privatization is crucial to the reform process in Eastern European countries. Private property rights are the chief feature distinguishing market and centrally planned economies: in their absence, a market economy cannot begin to function and it will only be possible to attract private capital, particularly foreign direct investment, after they have been established. This, I believe, is of crucial importance for the success of the reform efforts, since the transformation of the Eastern

European countries' productive systems will require far more external resources than the official sector can provide. The privatization of state-owned enterprises, combined with their restructuring and the attendant increase in financial discipline, appears bound to play a vital role in ensuring that productive efficiency is improved, technical progress incorporated and investment opportunities exploited.

In this context it is worth examining the relevance of the privatization programs that several industrial countries have undertaken in recent years. In my view, the expertise that has been acquired is of only limited assistance in designing privatization programs for Eastern Europe. The transfer of state assets to private ownership in these countries is a unique undertaking. The scale of the operation, which involves almost the whole economy, is unprecedented. Moreover, the environment in which the transactions are to be carried out is very different: market signals indicating relative scarcities are lacking or badly distorted; entrepreneurial and profit-oriented managerial skills are in very short supply. Consequently, there appears to be only minimal scope for the application of standard western privatization techniques, i.e. public sales and private placements.

3. The privatization schemes that have been proposed range from outright sale to mechanisms for distributing assets based on voucher systems and the creation of specialized intermediaries. Some of these schemes will be presented here by their authors, and I shall therefore focus on the broader issues involved.

Let me start by mentioning the question of economic assessment. This refers both to the difficulty of evaluating the assets and profitability of state enterprises because of the serious price and non-price distortions obscuring their past performance and to the need to develop capital markets in order to assess the performance of newly privatized firms.

Another major issue to be considered concerns the general macroeconomic effects of privatization and those specific to the schemes proposed. Initially, privatization will have adverse budgetary effects for two main reasons: in the first place, state enterprises have been an important source of government revenues, but the earlier level of taxation cannot be sustained in a competitive market setting; secondly, their restructuring will require a large volume of uncollectable bank loans to be written off. In addition, social safety nets will have to be designed to cushion the impact of privatization and the restructuring of enterprises on employment and saving. Adequate fiscal and monetary measures will therefore have to be devised to compensate for the lost revenues and the new expenditures.

There is also, of course, an enormous logistical problem to be taken into account: by no means an unimportant point in view of the magnitude of the assets to be transferred, the number of persons involved, and the need to ensure that all potential beneficiaries receive proper information and fair treatment.

4. Irrespective of the privatization schemes adopted, certain conditions appear essential to improve the chances of success. I shall summarize them, drawing on the G-10 Report.

The first point to emerge is that there does not appear to be a universally applicable blueprint for reform; countries' special features require a case-by-case approach. Secondly, it can be argued that privatization should proceed as rapidly as possible: by extending private property, the authorities would provide the clearest confirmation of their commitment to the creation of a market economy; by enhancing the credibility of the reform program, they would help to reduce the costs of the transition by making economic agents adjust more rapidly. No less importantly, by spreading private ownership, they would foster the creation of vested interests that will help to resist pressures to reverse the reform process.

In this connection it is worth examining the view that a certain "critical mass" of privatization is required before reform can be successful and conducive to development. Personally, I am somewhat skeptical of the piecemeal approach that has sometimes been advocated on the basis of the experience of Western European countries in which public sector enterprises still play a major role. In the West the market economy and developed capital markets enable the performance of state-owned enterprises to be effectively evaluated using the yardstick provided by the private sector, something that is not possible in the East.

As recommended by the G-10 Report, privatization needs to be open to foreign participation. This is particularly important for countries in which domestic saving is inadequate. More generally, foreign ownership should lead to the transfer not only of technologies but also of the entrepreneurial and managerial skills otherwise lacking in the former centrally planned economies.

It is, I believe, important never to lose sight of the fact that privatization has to be an integral part of a comprehensive package of reform measures. The interdependence between the many components of a market-based system suggests that the privatization of state-owned enterprises will have to proceed hand in hand with price and trade liberalization, macroeconomic stabilization and the reorganization of the monetary and financial system.

5. The privatization of the economy and the restructuring of the monetary and financial system are mutually supportive objectives: private ownership of a large portion of the financial system appears essential to its appropriate functioning, while the reorganization of banking and financial enterprises appears a necessary condition for the privatization process to be effectively sustained.

I shall spend a few more words on monetary systems because of the key role they play in market economies, where they have developed in response to the need to minimize transaction, information and wealth-holding costs in a setting characterized by a myriad economic relationships between individuals and enterprises that both cooperate and compete. Since the abandonment of commodity money and, later, of specie convertibility, the entire structure has been based on trust, which, in turn, depends largely on the quality of the assets held by "the producers of money", i.e. on banks' lending and ability to evaluate the creditworthiness of prospective borrowers.

The monetary structures that existed until recently in Eastern Europe did not correspond to these criteria. Simplifying somewhat, it can be claimed that the only transactions in which money performed a comparable function were those involving households. Money naturally served as a medium of exchange for firms and financial intermediaries, but their public ownership excluded any element of trust. For firms, the availability of funds or credit was not a sign of solvency; it merely reflected a decision by the planning authority. For banks, granting credit was not the result of an internal economic decision; it was simply the implementation of the plan. There was no place in the financial system for evaluating firms and allocating resources to the most efficient.

What conclusions does this analysis suggest for the reorganization of the monetary and financial systems in Eastern Europe? I see a priority need for the creation of a screening mechanism, based on the fiduciary component that government planning is inherently unable to provide. This can be achieved by developing markets and intermediaries able to assess the creditworthiness of economic agents and contribute to the evaluation of the assets to be transferred to the private sector and the efficient allocation of resources.

In examining the aims of the reorganization, it is also important to stress the question of providing adequate incentives for private saving, which was never a priority for centrally planned economies. Unless effective steps are taken in this field, it could prove very difficult to generate the domestic resources and attract the foreign inflows that reform, and especially privatization, require.

Finally, the importance of macroeconomic stability should not be underrated. As the experience of developing countries indicates, it is a key condition for expanding investment and growth and for the ultimate success of structural reform. In designing new monetary and financial systems, special attention will need to be paid to monetary authorities' regulatory and supervisory functions to avoid the risk of reforms having a destabilizing effect.

6. I shall conclude these introductory remarks with some thoughts on how the West can best support privatization programs and the reform process in Eastern Europe.

Although responsibility for the success of reforms lies primarily with the countries themselves, the western world can contribute significantly through technical and financial support. Technical assistance designed to build up a local class of managers and entrepreneurs and develop the skills needed to run market-based institutions and firms, is probably the most valuable form, and is likely to be needed for some time. The success or failure of an enterprise in a market environment hinges on its "management culture", and time is needed for this to take root.

Official bodies can be expected to provide extremely valuable technical assistance. The major international organizations, such as the IMF, the World Bank, the OECD and the EBRD, possess considerable expertise and experience in this field and are therefore in a good position to promote international cooperation. In my view, however, the private sector should also make a major contribution, in view of the potential benefits of developing business relationships with the emerging leaderships of these countries.

As for financial support, there is little doubt that the bulk will have to be provided by private capital, particularly in the form of foreign direct investment. I agree with the view that official financing should be devoted largely to sustaining stabilization efforts and structural reform and made subject to appropriate conditionality to ensure that the stimulus for sound policies is maintained. The IMF and the World Bank could take the lead in establishing conditionality at the macro as well as at the structural level. Official support aimed at fostering the development of private ownership should be directed to financing the infrastructure needed to increase the productivity and competitiveness of the private sector (such as telecommunications and transport). The World Bank, its specialized affiliates and the EBRD could also play a key role in providing financial support directly to private entities or to state enterprises undergoing privatization.

Lastly, there is the question of social safety nets. Official resources could also be used to this end. The programs should be designed to give the maximum incentive for individuals to respond to market forces during the transition period compatible with maintaining support for the reforms in the face of the social costs that they will inevitably entail.

In conclusion, privatization represents both a fundamental objective and a key instrument in the difficult and lengthy reform process; its success will require capable design and resolute implementation.