

# SYSTEMIC CHANGE: THE DELICATE MIXTURE OF INTENTIONS AND SPONTANEITY

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## The Transformation Process

In this paper I shall not present a more or less standard and descriptive summary of the current stage of the transformation process in my country and elsewhere in Central and Eastern Europe. I find it appropriate to defend the achieved results because, in spite of all existing problems, this historic transformation process has been—in principle—successful. Nevertheless, it is our task to understand more deeply the fascinating social mechanism that makes such a process possible and to describe the delicate interplay of the political, social and economic factors at work.

My theoretical background and my practical experience tell me that systemic change—and that is what we have been undergoing while dismantling communism in our countries—is an evolutionary process and not an exercise in applied economics or political science. It is based on a very complicated mixture of planned and unplanned, of intended and unintended events, or, to put it differently, on a mixture of intentions and spontaneity. By participating in such a process we have opened another chapter in the never completed book devoted to the study of the relative role of human action and human design in the history of mankind, the book devoted to the study of “made orders” and “catalaxies”—to use well-known Hayekian terms. I hope we can add something to that study. We may confirm that successful transformation is not the result of detailed reform blueprints in the hands of omnipotent reform politicians. Rather, success depends on the unconstrained activity of human beings together with “modest

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constructivism” in selecting foundational rules and in shaping transformation policy.

I believe that a negative stance toward an ambitious constructivism and toward all forms of regulation of free citizens is one of the basic revelations of truth for all of us. We have learned that this idea is as relevant for the explanation of changes inside an existing system as it is for the transition from one social system to another. Again and again those of us transforming countries have to caution against attempts to follow scientifically prepared sequencing rules to restructure and construct political, social, and economic institutions.

Our ability to control social events is restricted and no masterminding of reform (or transition) measures is possible. I stress this impossibility because traditionally we have been *a priori* against all forms of political constructivism and social engineering. In addition, we have learned from experience that they are unrealizable in practice. Assisting in the creation of a new social order means, we have to implement liberalization and deregulation measures (which is a more or less passive contribution). However, we also have to devise and enact new rules that define certain abstract features of the new order (which is a more active contribution). Ultimately, we have to accept the existence of an evolutionary, spontaneous process, which establishes new political, social, and economic arrangements.

The question is whether and how the various mechanisms should interact and how the spontaneous side of the process can be supplemented by reason, by intended measures aimed at avoiding chaos and heavy transformation costs. In raising this question I definitely do not want to defend utopian social constructivism. Rather, I want to focus on intentional organized measures that may shorten the transformation process and diminish transformation costs.

Systemic change, which usually starts unexpectedly in a sudden burst of popular discontent, is a complicated mixture of intentions and spontaneity. It seems to me that the transformation process moves through three basic stages and that each stage has a spontaneous and an intentional side.

## The First Stage.

### *The Spontaneous Side*

The whole process starts with the collapse of old institutions and rules. They are either swept away or made inefficient. To achieve that result in the late days of communism was relatively simple and the forthcoming danger was not the possibility of turning back; it was instead the initiation of a vicious circle of half measures and of trun-

cated evolutionary changes, leading to no improvement either in the moral or in the efficiency properties of the new order. This moment represents the first crucial transformation danger. The two potential alternatives are, on the one hand, a long chaotic process and, on the other hand, a more or less controlled and fast formation of a new, coherent system.

Politically, the ruling communist party ceases to govern (and sometimes even to exist). A simple and a very favorable political situation—a temporary nationwide unity—is achieved. This unity, however, exists only in a negative sense (i.e., it is against the old system).

A very unique and an unrepeatable psychological euphoria prevails. There is a widespread readiness to actively participate in reversing the past, in getting rid of old, unpopular institutions and even in “belt tightening.” This moment is suitable for fast implementation of various painful measures.

Economically, central planning (I use this term with some reluctance because nothing like the textbook case of central planning ever existed in our country) disappears practically overnight and with it the old, extremely inefficient, but nevertheless coordinating economic mechanism. Implicit markets, which are very weak and heavily constrained start to function. However, with no formal deregulation, with no price liberalization, and with no widespread implementation of explicit property rights, markets are prevented from performing their functions efficiently. To create real markets, somebody has to react and to implement a coherent set of system-changing measures.

### *The Intentional Side*

As for the political system, we understood that no direct measures against the communist party are necessary or even helpful. It is sufficient to liberalize the political environment, i.e., to secure free entry for newly emerging political parties. As a result, the basically unreformed communist party remains a political entity, unimportant and in opposition; whereas if the original communist party is forbidden, the communists in renamed parties succeed in controlling parliament afterwards—as in Poland or Hungary nowadays.

New political parties, which are spontaneously created, begin to formulate positive visions of the future and try to explain them to the citizenry. This represents the only way of transforming the national unity (and consensus) from a negative to a positive one.

In the economic sphere, the termination of the existing economic paternalism—as a radical, bold, but “nonconstructive” measure—is crucial. Swift elimination of subsidies of all kinds, which brings about a dramatic upward shift in prices, must be done without hesitation.

Later on it becomes difficult or impossible to do that, because the newly formed pressure groups successfully try to block it. The authorities have to resist pleas for “constructive” supplementary measures, for helping firms in trouble by picking future winners and losers. Such a dramatic move changes the whole climate of the country—practically, it changes the system—because goods, services, and all kinds of economic assets suddenly acquire their true values. In this process there is no room for any form of gradualism, and this specific measure must be done in a “shock therapy” manner. The result, then, is the emergence of a totally different way of thinking, which is exactly what is necessary for breaking old behavior and habits. There is no alternative to that. No “teaching” can lead to a new behavior; it can be achieved only as a result of sheer necessity.

Together with the elimination of subsidies, macroeconomic stabilization, as a precondition for liberalization and deregulation of markets, must be initiated. After decades of grave economic disequilibria both at the macro as well as at the micro level, fiscal and monetary policies must be very restrictive. Otherwise, rapid inflation starts to dominate the economic and social peace. A budget surplus (or, at least, a balanced budget) and a very cautious monetary policy (slower rate of growth of money supply than of nominal GDP) are unavoidable. Public finances must be, on the contrary, fully independent. Without such preparatory steps, price and foreign trade liberalization measures represent an irresponsible move that solves nothing, aggravates existing economic difficulties, and makes other reform measures impossible to implement.

Liberalization steps cannot wait. Opening of domestic markets (by means of price liberalization) and of foreign markets (by means of foreign trade liberalization) must follow these steps. Without liberalization, economic agents cannot behave rationally, government cannot step out of economic intervention, and a new coordinating mechanism cannot be efficient. Liberalization should be accompanied by an internal convertibility of the currency. Our experience tells us that, for a small open economy, it is extremely helpful that the exchange rate be fixed, thereby becoming the nominal anchor of the whole economy and the only fixed variable in the system. (Alternative nominal anchors are less reliable and more difficult to maintain.)<sup>1</sup>

To summarize, the main tasks for the first stage include political liberalization, elimination of old subsidies, fiscal and monetary stabili-

<sup>1</sup>See Klaus (1994a) and Patinkin (1993) for other arguments in favor of a fixed exchange rate regime.

zation policies, independence of the central bank, a balanced budget, and liberalization of prices and foreign trade.

## The Second Stage

### *Spontaneous Reaction to the Liberalization and Deregulation Stage*

The expectations of the citizens are enormous, yet positive, tangible results are not to be seen. After decades of zero inflation, zero unemployment, slow, distorted, but undeniable economic growth, relatively simple and undemanding life, the non-zero transformation costs must be paid. Inflation and unemployment appear (their magnitude depends, however, on the success or failure of previous reform steps) and a dramatic decline of GDP and of living standards becomes inevitable. It is difficult to explain to the public that we are not going through an economic crisis or recession caused by macroeconomic mismanagement, but through a healthy transformation shakeout of nonviable economic activities.

As a result of the high and unpleasant transformation costs, the former euphoria evaporates. The nationwide unity (mostly in a negative sense) is lost and the scene is gradually dominated by conflicting positive visions of the future. This conflict results in an enormous degree of political atomization and increasing political instability.

The pressure groups that are formed begin to misuse the existing institutional vacuum, the weak markets, and the various gaps and holes in the rapidly changing legislation and in the initiated privatization process (especially during the spontaneous privatization of state firms in the moment of their privatization agony). Wealth and income disparities grow, markets remain imperfect, and privatization revolutionizes the whole social structure.

At that moment comes the second turning point: either adherence to the original transformation strategy and the consequent positive overcoming of the situation or chaos and a vicious circle of half measures and concessions to pressure groups with the inevitable loss of "the whole."

### *Intentional Fixing Up*

The rules of the new order should be stabilized, new legislation should redefine the rules of the game. The politicians should resist the temptation to rule by means of laws instead of making laws solely for defining the rules of the game.

Macroeconomic stabilization must continue. There is absolutely no room for expansionary monetary policy or for fiscal activism. Disinflation must go further and a fixed exchange rate should be maintained.

New market distortions need not be created, residual deregulation of all prices, the elimination of remaining subsidies, and an aggressive fight against all forms of protectionism should not decelerate. No concessions to vocal pressure groups should be made.

New private firms spontaneously emerge but organized privatization, based on a mixture of standard and nonstandard methods, still represents the core of the intentional part of stage two. Privatization of the whole country has a different scope, style, and meaning than privatization in a country where it is only a marginal activity. Country-wide privatization must be fast, it must discover new owners, it should not attempt to maximize state privatization revenues, and it should not be confused with restructuring (and modernization) of individual firms (see Klaus 1994b).

Politicians must offer clear rules and be accountable. No false promises should be made. There must be an ongoing effort to explain the role of privatization with the objective of maintaining or even strengthening the fragile political consensus. Without broad support, the transformation process cannot continue.

Standard political parties (instead of civic initiatives, national fronts, and civic forums) start to prevail. The extreme political atomization is slowly transformed into a normal political structure with only a handful of ideologically well-defined political parties (with standard names).

Reasonable social policy—concentrated on helping those who really need it—must accompany the above-mentioned political and economic changes. Wrongly targeted, extremely costly welfare programs should be avoided—a social “spotlight” approach should replace the social “sun” approach. Social policy must be done with due respect to those social groups that are the short-term losers of the transformation process.

Rewards should be reconciled with performance—both individually and nationally. At the individual level, wages (and other forms of income) should temporarily lag behind productivity; at the national level, the exchange rate (dramatically devalued before foreign trade liberalization) must temporarily stay below purchasing power parity. Those two principles represent the basis of my recently formulated “hypothesis of two transformation cushions.” Weak markets and newly born private owners need such a cushion for some time; the higher the speed of transformation, the thinner the cushion (see Klaus 1994c). To achieve that task, indirect methods (restrictive macroeconomic policies) together with the resistance to the excessive trade union demands are more important than direct measures (wage regulation).

To summarize, privatization is what distinguishes the first and second stages; it must be accompanied by continuing macroeconomic stabilization and by the rationalization of social policy.

## The Third Stage

If the fixing up suggested in the previous section is successful, a stage that may be called the *early post-transformation stage* is reached. The extraordinary, temporary, constructive role of the state is over; it should start to play—once again—a standard, more or less passive, nonconstructive role.

The country in this early post-transformation stage is, of course, characterized by weak economic and political markets and structures. Their deepening and widening, something that cannot be directly done by the state, is the main challenge. The government must only try to eliminate all the barriers to political and economic freedoms before the Schumpeterian heroes finally take over the stage and the standard evolutionary process begins. The Czech Republic has reached this early post-transformation stage. Of course, the dangers and pitfalls inherent in this stage need our close attention and scrutiny as much as the previous stages of the transformation process did.

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