8-2007

Leadership Perspective: Country Development and Transition to Free Market Economy

Kinfu Adisu
Grand Valley State University

Leadership perspective: Country development and transition to free market economy.

Kinfu Adisu

Grand Valley State University

Abstract

In the following essay, the author will examine the need for a clear understanding of the transition process and economic development in Ethiopia. The country's move towards a free market economy will be critically analyzed as an important step to fight poverty. This will also raise the question of what policies need to be changed to make the nation competitive.

A case method is taken into consideration to examine various experiences from African and Asian developing nations. The analysis will be from leadership perspective and takes a business approach to examining the issues and primarily utilizes free market transitional theories.

The following factors are carefully examined in the study of transition to market economy: 1- Porter's Diamond 2) Higher education 2) Present policy and changes needed to accommodate this transition process.

In conclusion, a summary of suggestions and recommendations will be presented. The recommended ideas will specifically take into consideration the present economic status of the country and will outline how leaders may proceed through the process of transition.

Introduction

In the last couple of decades, a number of countries around the world have attempted to implement economic reform. While some succeeded in their reform, others failed miserably (BTI, 2003; BTI, 2006; Parente & Rios-Rull, 2005, & Ellman, 2005). Some took many radical steps, while others implemented gradual reform (Marangos, 2002, 2003 & 2004; Keren & Ofer, 2002). In all cases, the implementation was based on the rationale that a centrally controlled economy must be replaced by a liberal market driven national economy. All the countries seem to have common goals for reform: to alleviate the poverty rate in their respective countries, to make themselves competitive with developed nations, to build technologically advanced manufacturing plants, and to design economic policy that supports reform. The role played by the leadership becomes very critical as it impacts the success of the reform.

In the following essay the author will look at 1) present Ethiopia's country profile and economic progress, examining future strategies based on Porter's Diamond and competitive theory, 2) the need for proper implementation of this economic reform as an important tool to fight poverty, and 3) transition theory, and present some examples of experiences from some East European, and Asian countries. In the last section, a brief discussion of future research and recommendations will be presented.

Country profile

Ethiopia, with population of about 75 million, is among the poorest countries in Africa. Although perceived as democratic by some, a pro-U.S. autocratic government rules the country. The economy of Ethiopia is based on agriculture, which accounts for 50% of GDP, 60% of exports, and 80% of total employment (CIA, 2006). The same reports also estimates purchasing power parity at $71.63 billion, official exchange rate at 8.69 birr per US dollar, per capita GDP at $1000, population below poverty at 38.7%, inflation rate of 13%, and real growth rate at 9.6%. The GDP composition is estimated at 46.7% for agriculture, 12.9% for industry, and 40.4% for service sectors.

According to Andrews, Erasmus, and Powell (2005), frequent drought and shortage of food, coupled with inadequate roads and communications, has presented challenges to the country's development. Transformation of the country's centrally planned economy to a market-oriented one began in 1991, the overall GDP rose from 2.8 percent in 1991 to 4.0 in 2003. During the same period, the agricultural growth was mostly in the due to cultivation, rather than improvement in productivity. According to the Ethiopian government's Development and Poverty Reduction Program (SDPRP), average growth rate has to average 7% per year in order to show significant progress in poverty level by 2015. For the country to achieve or meet its Millennium Development goals, Ethiopia requires not just additional external resources, but also a marked acceleration of reforms aimed at supporting agricultural production, private sector development, and exports (Andrews et al.).

To plan for a successful transformation and an improved national economy, one should examine the following two important transition theories: the theory of competitive economic model as prescribed by Porter (1998) and the necessary institutional changes required to create a sustained market economy (Redek & Susjan, 2005; Haan, Lundstrom, & Sturm, 2004; Gupta, Leruth, De Mello & Chakravarti; Lin, 2003).

Diamond Model

Michael Porter's diamond model for competitive advantage helps to explain the comparative position of a nation from global competition point of view (1998). If traditional factors like land, location, natural resources (mineral, energy), labor, and local population are taken into consideration, a country could have good economic position. Since these are categorized as inherited factors, the much required industrial growth cannot come into existence. The country's competitiveness can only be attained if these natural resources are converted into valuable products. In the same token, for a country to be competitive and attract investment, it must have the next four factors.

1. Dynamic business conditions, because direct competition forces firms to increase productivity and innovation.
2. As customer demand increase within the economy, the pressure will improve the firm's competitiveness through innovation of products.
3. A dynamic business environment that will facilitate upstream or downstream industries with a continuous exchange of ideas and innovations.
4. The last one, Porter argues are very important factors created: specialized skilled labor, capital, and infrastructure, which are needed for a sustained competitiveness.

The government plays a very important role in the last factor. By heavily investing in education, technology, and infrastructure and promoting business and trade policies that are conducive to competition and innovation, the government can create sustained economies and, therefore, can alleviate poverty.

A study conducted by Coyne & Boettke (2005) found that "investment in physical capital was not the only factor of production, also important was investment in human capital." According to this study, "with human capital model gaining momentum, there was an explosion in education spending. As of 1960, only 28 percent of countries worldwide had 100 percent primary enrollment. The worldwide median primary school enrollment increased by 99 percent in 1990, up from 80 percent in 1960. Further, between 1960 and 1990, the median college enrollment rate of countries worldwide increased from 1 percent to 7.5 percent (Easterly 2001). Coyne & Boettke also highlight the weak correlation between growth and schooling. This, according to the study, is because "consider that education and skills provide a benefit in an uninhibited marketplace where labor resources are free to move and where institutions create a relatively high pay-off to an ethic of workmanship and entrepreneurship." In other words, while education is important for a nation's competitiveness, due to the demand for skilled labor outside one's country, educated persons often move to where the pay is better.

Knowledge base, secondary and post secondary education, is one of the best investments policy decisions that can support transition to market economy. World Bank() emphasizes that education "is a critical determinant of a country's economic growth and standard of living as learning outcomes are transformed into goods and services, greater institutional capacity, a more effective public sector, stronger civil society, and better investment climate." As mentioned under the funding and promotion of ICT and education, World Bank is playing an important role in helping developing countries meet their goals in transforming their economies. Globalization and rapid technological change have made knowledge an important component of a country's competitiveness.

Institutional change

As a government prepares to transform its economy to a market driven one, it becomes important to establish institutions that can support the new process. Explaining this process, Redek & Susjan (2005) cite that "economic transition is a process of institutional change, a process of building new institutions required by a capitalist economy. Transition brought about the destruction of socialist coordination mechanism, while the market coordination took time to be established and agents had to become cognizant of it." In similar terms, Gupta, Leruth, De Mello, and Chakravarti (2003) also reinforce the above finding through their assessment of changes in size and scope of government in 24 transition economies. While the governments under their study reduced public expenditure in relation to GDP, some indicators suggest that the size remains high and the scope of government activities has not necessarily become appropriate. Gupta et al. (2003) also mention that new institutions should emerge with the new structure and government expenditure to help shape the interface with the test of the economy.

Transition Economies

The peaceful transition from centrally controlled governance to a market oriented economy has created great challenges to many countries of Africa, Asia, and Eastern Europe in the last three decades. According to Staehr (2005), a central issue in transition economies is Adam Smith's century old question: How do countries become prosperous? During most of the reform implementation, the policy objective of transition countries is to raise the living standards of their citizens by boosting output. In addition, Ray (2003) reiterates, this generally requires countries to end the era of centralized planning through persistent measures working towards deregulating the domestic markets, increasing their integration with global economy, reducing the role of government, and promoting market mechanisms to regulate the economy. Ray also explains the advantages of economic liberalization: a) it gives economical access to foreign technology, raw material to domestic firms, b) the government reform package includes special emphasis to improve infrastructure by attracting direct foreign investment in transpiration, communication, and energy, and c) thus economic liberalization means not only competition from domestic and foreign competition; it encourages more autonomy to do business, more strategic options and higher opportunities for growth.

Cleaver (2002) has a similar concept, but emphasizes four important contrasting features of command and market systems that are key to the transition:

1. Privatization of land and capital as the most fundamental reform requirement. This is a departure from the previous system, freedom to pursue private rather than communal interest. This encourages entrepreneurial participation.
2. Price reform is very important to eliminate subsidies and open up market in all consumer and producer goods. Price increase for short supplies encourages more people to attempt to produce these products because of potential profit.
3. Free entry of new business must be ensured by breaking up the old state monopolies and support new start-ups or take-overs, which will encourage re-investment and higher profit.

4. Tight control of the money supply is very important if any of the above are to work. Although difficult policy to implement, a government should not give in to public demand to raise wage, unemployment compensation, or any other subsidies. This will lead to out of control government deficits; money supply will increase and create inflationary situation.

Shock therapy or gradual change

Scholars generally support one of two main reform strategies, the effectiveness of one over the other, however, is currently under debate. Staehr (2005) presents two types of reform strategies in her study on “Reforms and economic growth in transition economies.” Two camps emerged, World Bank (1996) and Stiglitz (2001). One camp suggests that reforms should progress as fast and on as many fronts as possible because various reform elements can substitute for each other. On the other side is a group that emphasizes timing and sequencing of specific reforms and tends to support slower implementation.

Similarly, (Marangos, 2002) notes two types of reform. One is a shock therapy model that implies an interdependent, mutually supportive and interactive economic relationship and suggests that reforms should be introduced simultaneously. The other, a basic concept of a gradualist approach to transition, emphasizes the need to establish economic, institutional, political, and ideological structures before any attempt to liberalize. According to Kornai (1993), the aim of the gradual neoclassical transition process is to initiate a unique change, a transformational recession, and to overcome the shortageflation syndrome (Kolodko, 1993). The countries that followed with the shock therapy approach were Czechoslovakia (starting January 1991), Bulgaria (February 1992), and Poland (January

1991), and countries that followed gradual reform include Hungary. The following are some of the points highlighted in this debate:

Price liberalization and stabilization. Price liberalization and stabilization are a requirement for the reform process (Blanchard and Layard, 1993). Shock therapy economists support the adjustment approach, which will cause an immediate jump in price level. In contrast, gradualist adjustment supporters emphasize that changes to the new price level need to be gradual (Kornai, 1994).

Privatization. Privatization and financial restructuring manifested the greatest intellectual and politics of the entire transition program (Sachs 1991; Aslund, 1992). In this case, the goal of the shock therapy process was to develop an economy based on market relations without discretionary power (Marangos, 2002). In this case the only difference between the gradualist and the shock therapy supporters was the timing of privatization, not its speed.

Monetary and fiscal policies. Shock therapy supporters believe that an independent central bank has to establish a credit target to hold money growth to a level consistent with a rapid elimination of inflation (Sachs 1993), but laying the institutional foundations to ensure an independent central bank is lengthy process. The gradualist economists argue that the imposition of hard budget constraint on enterprises is the driving force for adjustment. Both approaches are in favor of maintaining the budget deficit and achieving a balanced budget. The disagreement lies in the financing of the deficit.

International trade policies. Liberalization of trade and the establishment of convertible exchange rate are the most important steps for successful capitalism (Aslund 1995). Convertibility and external liberalization are natural allies. Sachs and Aslund (in Marangos, 2002) are in favor of a pegged exchange rate at the start of the stabilization program, changing to a more flexible rate after one or two years. The gradualist neoclassical economists argue that it is in the interest of transition economies to have price liberalization, budget, and credit reforms.

In general, both shock therapy and gradualist neoclassical process appear to be quite similar. However, while both approaches argue that market forces create market institutions, gradualists allow institutions to develop concurrently with market relations. Shock therapy supporters assert that developing market relations come first and assume that the institutions will follow (Marangos, 2002).

Case of South East Asian countries

In their findings, Pereira & Tong (2005) demonstrate that state intervention, as seen in Singapore, China and Malaysia, is designed to bring economic growth and development in addition to addressing unique social and political agendas. The experience in the three countries tells us that they overhauled the domestic economy, particularly by allocating and re-allocating capital. The following are examples stated in Pereira & Tong's study:

Singapore

The state had a comprehensive power within Singapore as the people's Action Party held a huge political majority in parliament throughout the post-independence period. This lack of a challenging party allowed the government to intervene in the economy. Thus, the government directed the country towards industrialization. However, due to lack of private industrial entrepreneurs in Singapore, the state decided not to pursue import-substitution industrialization; instead it pursued export oriented industrialization supported by multi-national corporations (Pereira, 2000). The key to development policy was the way in which the government invested capital within the country. Using funds from the United Nations

Development Program, as well as loan from World Bank, the government invested in infrastructure and the building up of human resources.

The effort to shift the economy from dependence on trade to manufacturing has been successful. By the late 1980s, the government embarked on another entrepreneurial program known as the economic regionalization strategy. Thus, the early stages of economic development focused on attracting foreign capital to Singapore. By the 1990s, Singapore had become a net exporter of capital (Tan & Lee, 1999).

China

Another case of heavy state intervention was evident in China. Although not very efficient, the state implemented a program of heavy industrialization, led by large state owned enterprises. The partial "marketization" dealt with three important facets, privatization of state owned enterprises, the opening of China to FDI, and the encouragement of private domestic enterprises. The special economic zones are also part of the marketization process. After 5 years, the Special Economic Zones experienced some of the higher growth rate in the world.

In China's case, the government initiated the country's progress towards capitalism in 1979, after admitting that the socialist route was not viable.

Malaysia

In the first Malaysian plan (1957-1969), 61 percent of government expenditure was invested in the industrial economy, while close to a third of it was invested in agriculture and raw material extraction (Ismail & Meyanathan). In order to address the economic inequality among the different racial and ethnic groups, the Malaysian government instituted the "New Economic Policy" (NEP) as part of the official Third Malaysians Plan. NEP was created to achieve some very ambitious goals, such as reducing poverty from 49% in 1970 to 16% in 1990. The latest version of National Development Plan contained Mawasan 2020 (translated as Vision 2020). The emphasis was Mahthir's intent for Malaysia to achieve "developed country status" by 2020. This included new policy instruments. The most important of which included a financial liberalization program and a program to further encourage foreign investment. The Malaysian government also sought to spur growth through foreign capital accumulation. It expanded its free trade zone and export processing zone program (Chin, 2000).

Issue of Leadership

According to a study done by Bertelsmann Foundation (2003), political management is the key to successful market-based democracy. This study also emphasizes that the experience of previous transformation process shows a number of possible paths to democracy and a market-economy. At times, democracy and economic reforms support each other. In other cases, however, the economic reform did not occur at the same pace as democracy. It is clear that, "good governance is the key variable in implementing reform and modernization goals." Therefore, the success of each depends on actors capable of guiding the process as effectively as possible through prudent management.

The importance of leadership is also supported by a recent study on leadership and growth. Jones and Olken's (2005) study found that "countries experience persistent changes in growth rate across these leadership transitions, suggesting that leaders have a large causative influence on economic outcomes of their nations. The paper shows that the effect of leaders are very strong in autocratic settings but much less so in the presence of democratic institutions."

In addition, the Bertelsmann Transformation Index of 2006 reports a positive correlation exists between progress in development and sound political management:

> Many positive examples such as Chile, Madagascar, Mauritius, Botswana and South Korea prove that the political will for reform and skillful political management are a condition sine qua non for sustainable political and economic development. Those countries in which political leadership has proven itself reliable have made progress in transformation towards a socially responsible market economy and democracy under the rule of law.

So, what is the status of the government's performance and what would be the best way of assessing the leadership without political bias? The Bertelsmann Transformation Index is used to do this. One of the main reasons is the fact that all the data collected to evaluate the countries in this report is collected and analyzed by Bertelsmann Foundation. The Bertelsmann Transformation Index (BTI) is a global ranking that analyzes and evaluates development and transformation processes in 119 countries. The Bertelsmann Transformation Index provides the international public and political actors with a comprehensive view of the status of democracy and a market economy as well as the quality of political management in each of these countries.

While the BTI report indicates Mali and Botswana as having among the best progress in Africa, Ethiopian political and economic progress is equated with Zimbabwe, and suggests that "the elections have been clearly manipulated by repression and discrimination of the opposition." In respect to the economic sector it is indicated as "far-reaching state intervention." It also indicates that to a lesser degree successful stabilization policy has been conducted. Since most of these are controlled by the International Monetary Fund, countries in this category are considered semi-sovereign in the field of macroeconomic policies. The quality of the education system and the effort in the field of research and development are reported as very low. Also, the situations at schools and universities are reported as calamitous: inadequate equipment with teaching materials, improper rooms, overloaded classes, and undisciplined and unmotivated teaching staff are usual. Finally, in category of "effective use of resources," Ethiopia is rated as one of the most corrupt countries with Zimbabwe, Kenya, and Angola.

Conclusion and Recommendation

In this section, I will present two important points. One is the need to do more research and scholarship in matters related to economic and democratic transitions in developing countries of Asia, Africa, and Latin America. Since there are similarities in experience and history in these regions, reflection on any of the countries can benefit understanding and postulating what would work for the future endeavors in other nations.

The second part of this brief recommendation is based on the assessment pertaining the economic development and leadership in Ethiopian. The following are summary of the literatures presented in the above discussion concerning challenges of transition economies:

1. There is no one clear formula for a successful transition to market economy.
2. The correlation between democracy and successful transition is weak.
3. There is good possibility for a country to succeed if gradual transition process and democratic steps are converged together.
4. The leadership issue remains a very critical factor for successful transition to market economy.

5. Policy change must be following by institutional change that can support the practice of market economy.

The government's ability to transform the nation's economy is determined by willingness of the leaders to envision a dynamic and functional economic future in which the people can enjoy freedom of owning property (land).

If majority of Ethiopian population depends on agriculture, it is a prudent decision for anyone to prioritize the issue of land ownership, since this will lower the poverty level. Such step should be within the main plan of creating "National Economic Development Plan" that is organized under a commission of non-political and non-partisan professionals. This requires the need to enforce the politics-professionalism dichotomy. Unless such step is taken, the present practice of patch work by corrupt politicians will not bring a viable solution to the nation's economic problems.

References

Andrews, D., Erasmus, L., & Powell, R. (2005). Ethiopia: Scaling up. *Finance & Development: A quarterly magazine of IMF, 42, 3.*

Aslund, A. (1992). Post-Communist economic revolutions. How big a bang? Washington, D.C: Center for Strategic and International Studies.

Aslund, A. (1993). "Comments on 'gradual versus rapid liberalization in socialist economies' by McKinnon," proceedings of World Bank annual conference on development economies. Washington, D.C: World Bank.

Bertelsmann Transformation Index 2006: On the way to Democracy and Market Economy. Vol. IV, Issue 12(2005).

Bratton, M. & Mattes, R. (2001). Essays: African triple transition popular perspectives. *African Security Review, 10, 1.*

Burns, J. M. (1978). *Leadership*. New York, N.Y: Harper & Raw Publishers.

CIA- The World Fact Book. Ethiopia. Copied on 3/24/2007 from www.cia.gov/cia/publications/factbook/print/et.html

Cleaver, T. (2002). Understanding the World Economy, Pg 32-52. Oxfordshire, UK: Taylor & Francis Ltd.

Croissant, A. (2005). Democracy, market economy, and the political management of transformation in 119 countries: The findings of the Bertelsmann Transformation Index 2006. *Strategic Insights, 5, 12.*

De Haan, J., Lundstrom, S., & Sturm, J. (2006). Market-oriented institutions and policies and economic growth: A critical survey. *Journal of Economic Surveys, 20, 2.*

Dipeolu, A. (January 17, 2007). Trade is essential in the poverty reduction toolkit. http://www.embassymag.ca/html

Doing business in Africa. (Printed on January 17, 2007). http://www.embassymag.ca/html

Ellman, M. (2005). Transition: intended and untended process. *Comparative Economic Studies, 47, 595(20).*

Global Envision (February 22, 2007). Foreign investment for poverty reduction in Africa. www.globalenvision.org/library/1/1481

Gupta, S., Leruth, L., De Mello, L., & Chakravarti, S. (2003). Transition economies: how appropriate is the size and scope of government. *Comparative Economic Studies, 45, 554(23).*

Hillenbrand, O. & Thierry, P. (2005). The Bertelsmann Transformation Index 2006. On the Way to Democracy and Market Economy: Strategic Insights, vol. IV, 12.

IMF (2005). Picture This: Aiding Development. *Finance & Development*, 42, 1-8.

Jones, B. F., & Olken, B. A. (2005). Do leaders matter? National leadership and growth since World War II. *The Quarterly Journal of Economics, 835-864.*

Kolodka, G. W. (1993). Stabilization, Recession and growth in socialist economy.

Kornai, J. (1990). The road to a free economy. New York: W. W. Norton.

Kufuor, J. A., & Versi, A. (2004). Formula for African growth. *African Business*, 301, 14-23.

Lin, J. Y. (2003). Development strategy, viability, and economic convergence. *Economic Development & Cultural Change, 51, 277(32).*

Marangos, J. (2002). A political economy approach to the neoclassical model of transition. (New perspective on transition economies: Europe). *The American Journal of Economics and Sociology, 61, 259(18).*

Marangos, J. (2003). Was shock therapy really a shock? *Journal of Economic Issues, 37, 943(24).*

Marangos, J. (2004). Was shock therapy consistent with democracy? *Review of Social Economy, 64, 221(23)*

Neustadt, R. E. (1986). Presidential power: *The politics of leadership from FDR to Carter*. New York, NY: Macmillan Publishing Company.

Parente, S. L. & Rios-Rull, J. (2005). The success and failure in transition economies. *Journal of Money, Credit & Banking, 37, 23(20).*

Park, J. (2004). New comparative advantage: a re-evaluation of state-led development. *Harvard International Review, 26, 34(4).*

Parker, D. & Kirkpatrick, C. (2005). Privatization in developing countries: A review of the evidence and the policy lessons. *The Journal of Development Studies, 41, 531-541*.

Pereira, A. A., & Tong, C. K. (2005). Power Development regimes in Singapore, China and Malaysia. *Global Economic Review, 34, 129-144.*

Porter, M. E. (1998). The competitive advantage of nations. Boston, MA : Harvard Business School Publication.

Ray, S. (2003). Strategic Adaptation of firms during economic liberalization: Emerging issues and research agenda. *International Journal of Management, 20, 271-281*.

Robison, R., & Hadiz, V. R. (2005). Neo-liberal reforms and illiberal consolidations: The Indonesian paradox. *The Journal of Development Studies, 41, 220-241.*

Schmidt, S. (2005). Democracy without development? Unbalanced transformations in Eastern and Southern Africa. *Strategic Insights, 5, 12.*

Staehr, K. (2005). Reforms and economic growth in transition economies: Complementarity, sequencing and speed. *The European Journal of Comparative Economics, 2, 177-202*

Susjan, A. (2005). The impact of institutions on economic growth: the case of transition economies. *Journal of Economic Issues, 39, 995(33).*

United Nations(2001). Development planning in a market economy. Least developed countries Series, No. 6, United Nations, New York, NY.

Youssef, S. M. (2003). Role of state as a salient stakeholder in a transition economy: the case of Egypt. *Journal of Academy of Business and Economics, 2, 19(15).*

Yukul, G. A. (1989). *Leadership in organizations*. 2nd ed. Englewood Cliffs, New Jersey: Prentice Hall.