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(Notes for the lecture)

„Policies for (re)creating a market economy: the case of the Czech Republic“

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1.Background.

Between the two World Wars, Czechoslovakia ranked among the top ten producers of industrial goods. It traded extensively with Western Europe and large part of its financial and industrial assets were owned by foreign capital, especially by British and French interests. In terms of policies it practiced fiscal and monetary conservativism, and it was an island of relative stability in Central Europe.

In 1948, the Communists took over. Over 40 years of Communist rule managed to destroy almost completely the institutional foundations of democratic capitalism. and to replace them by an autocratic political and economic system.

Remember that there is also a vast "soft infrastructure" of norms of behaviour, habits, etc. that underpins capitalism and is extremely important for its sound functioning. All these institutions of capitalist culture had evolved over decades and generations, at not negligible cost. This all was liquidated by the Communists and replaced by institutions such as one party rule, authoritarian central planning, disrespect for markets, outlawing private enterprise, etc. Let us also remember that

overwhelming nationalization involved not only politics and economics but also other parts of social life like sports, culture, religion, etc.

As a consequence, the political, social and economic development of the country was derailed for about four decades, and it cost Czechs and Slovaks dearly.

Whereas, immediately after the Second World War, Czechoslovak GDP per capita was at least as high as Austria's, and we can reasonably infer that it was most likely higher because Czech economy had not been as damaged by the war as had Austria's economy, by the end of 1989 when the Velvet Revolution removed the Communists from power, Czech GDP per capita was only slightly above half of Austria's GDP per capita when both were measured at purchasing power parity (PPP).

Luckily, by the beginning of the 1980s we were able to abandon the wrong track and to start reconstructing the foundations of capitalism, though practically from scratch.

2. The Search for a strategy of transition at the beginning of the 1990s: two concepts of transition.

Now I will speak only about what I call an aggressive, comprehensive and consistent transformation course proposed by then Federal Minister of Finance, Vaclav Klaus, and reformers who supported him.

[We did not want any "third way", a concept reminiscent of a reform attempt ofthe 1960s, which in our minds was simply a kind of muddling through lacking a clear transformation goal. Instead our vision was a

"market economy without any adjectives" based on private property, driven by private initiative and opened to the outside world. In short, a return to capitalism.]

Let me recall that <u>Klausean blueprint for transformation was approved by the Federal parliament in 1990</u> only after heated political battles in the executive as well as in parliaments though with some compromises. In brief, it was a package of reform/policy measures to be introduced as of January 1, 1991. It consisted of liberalization of prices (opening of markets), liberalization of foreign trade and introduction of convertibility of the crown, stabilization orientated monetary and fiscal policies – restrictive monetary and fiscal policies, wholesale privatisation and establishment of social net to help those who will be affected by a necessary deep restructuring of the economy and society.

It was quite clear to the Klaus group that regime changing measures in order to cross the Rubicon have to be applied as a whole, in a package, in a sense simultaneously as they were mutually reinforcing.

<u>Was it so-called shock therapy approach</u>?

Only some measures such as liberalization of most prices and introducing internal convertibility of the crown together with devaluation of the currency, etc., could and had to be introduced, in a sense, overnight, but in the context of prudent macroeconomic policies so as to avoid a danger of an inflation spiral after price and trade liberalization.

On the other hand it was also quite clear that the envisaged system-changing wholesale privatization would require some time to accomplish,

say several years or so, including creating the necessary legal framework, and that it would take some more time to really get newly established free market economy work rather smoothly .

More concretely, the liquidation of communist-era regulations could be and must be somewhat rapid, yet these laws and regulations could hardly be immediately replaced by well functioning property rights, markets, laws, rules, behavior and other basic institutions of mature capitalism. We, the reformers could learn a bit from the successes and failures of various reform attempts in developed as well as less developed Western countries, but the institutional, legal and other foundations of a new socio-economic system could not simply be imported. We expected, I expected, that to reach a kind of final stage of the Czech model of capitalism would take some time, that it would be a lengthier process of "learning by doing" in which, as is usual in parliamentary democracies, the outcomes can only to some extent be shaped from above.

German unification was a kind of shock therapy. GDR taking over institutions, laws and regulations rather fast, in a sense they were imported from Western Germany overnight, including West German politicians, managers, lawyers etc. which obviously involved also huge long-term transfers of money from WG to former GDR. With good institutions like property rights they also imported bad ones like excessive labour protection and similar. (See Rudiger Dornbush.)

Let me note now that we that is the group of reformers allied with Klaus succeeded in imposing a macroeconomic framework that made it possible to liberalize prices and open markets as well as liberalize foreign trade. Also, we

were able to push through wholesale privatization, the implementation of which was a crucial and final system-changing measure.

On the other hand, by the beginning of the 1990s we had much less influence on developments in the social and health sectors, on environment regulations and partly also on labor market and business regulations like commercial law, licensing of businesses and trades, land and environment use, etc.. These sectors and regulations, which fortunately were not critical in the early phase of reform implementation, simply had to wait for a major overhaul. Some of them are still waiting even now.

As Mancur Olson (The rise and decline of nations: Economic growth, stagflation and social rigidities, 1982) though in a different context predicted, subsequent attempts to correct excesses or shortcommings in the reform of the legal and institutional framework, committed perhaps with the best of intentions (in our case at the early stages of transition), have been rather difficult because vested interests get established in the new system.

3.Realisation of Klaus' Vision

3.1. 1990: The Warming-up Lap

It is to be noted that reformers inherited an economy which, contrary to Poland or Hungary, was practically completely nationalized, suffered from deeper structural distortions like excessive industrialization, with an especially high share of heavy industries, and a declining or negative rate of growth. In particular as the rate of so called useful output is concerned.

On the other hand, there was less repressed inflation and little foreign debt to Western countries and less general disorganization, certainly in contrast to, e.g., Poland. This relatively stable though deteriorating economic situation gave us some breathing space that we used in 1990 to push through important preparatory reform steps.

Within a short period of time a number of <u>legal, institutional and liberalizing acts and measures were introduced that effectively created the legal and institutional basics of a capitalist market</u> economy. Most important among them were <u>constitutional changes legalizing privately-owned firms,</u> limiting state property only to some natural resources and allowing expropriation only for public purposes and with remuneration. Next, legal norms allowing private businesses as well as joint stock companies were approved. Needless to say, a new legal framework and other institutions could only be in a kind of rudimentary form. Perhaps it is even preferable in times of major economic and social changes. Yet, it was certainly good enough to allow orderly implementation of all major reform steps.

One of those early steps in 1990 was a major overhaul of fiscal policy. From a macroeconomic point of view, the aim was so as <u>to achieve slight budgetary surplus in order to reduce aggregate demand in the economy</u> as well as to signal that fiscal policy would be oriented toward maintaining stability in the near future in order to forestall any possible destabilization after the expected full liberalization of prices and foreign trade. At the same time, there were substantial structural changes in the budget as a reflection of the first systemic <u>changes toward an open market economy in which the redistributive role of the state would be limited.</u> Hence, the share of government expenditures in GDP, which at the beginning of transformation was nearly 60%, was decreased to about 52% by substantial reductions in

various expenditures, for example, by reducing defense expenditures, which had reached 7% of GDP by the end of 1980s (see Kocarnik, date), reducing subventions to enterprises, etc.. These reductions in state expenditures were obviously accompanied by decreasing corporate income taxes, e.g., for non-financial enterprises from 75% to 55%.1

Also in 1990, reformers took <u>steps towards the opening of the economy to global markets.</u> First steps included e.g.auctions for foreign currencies that helped to break the state's monopoly over foreign trade, through which the communist state had isolated the domestic economy from outside events and which was an essential feature of authoritative central planning.

Many new commercial agreements were signed with Western countries, including the association agreement with the EU, to improve access of Czech goods to foreign markets (difficult negotiations, steel quota)as a necessary support for the transition process. Also part of the opening, already in 1990, was Czechoslovakia's renewal of its membership in the IMF as well as membership in the World Bank. These steps enhanced the credibility of reforms.

3.2. Launching a set of major transformation policies

After warming up lap during 1990 a major set of reforms was actually launched on January 1,1991 Most of the prices were liberalised and Czech crown was devalued and its rate of exchange fixed against USD and DM and made convertible for current account transactions. This happened against the background of continuing prudent macropolicies, fiscal and monetary, so as

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to mitigate any possible destabilisation tendencies in the economy released by price, trade and currency liberalisation.

Let me stress here that the resolute and rapid opening of the country through trade and currency liberalisation was considered to be an extremely important part of reform package because it brought strong import and export competition into the still mostly non-privatized economy. And served as an important anti-inflation and restructuring role and created institution-changing pressures throughout the economy.

4.Response of the economy to transformation policies: some statistics

Let us now see some statistics showing the response of the economy to a set of groundbraking policy reforms.

After the full liberalization of prices as of January 1, 1991 the Czech price jump was by far the lowest among post-communist economies about 56% in 1991, 11% in 1992 and under 10% until 1995. (Poland over 500% jump after price liberalization in 1990.) This helped to diminish the loss of the real value of the population's savings, which was one of key goals of reformers. ***(On the other hand, it left enterprises and the state with rather large debts to be repaid in the future, obviously contributing to eventual problems of the Czech banking sector in the mid 1990s.)***

Also, relatively low inflation helped to ease possible tensions in the newly established social safety net so that there were practically no occurrences of outright social deprivation and poverty as occurred in some other transition economies. This remained a kind of "constant' throughout the transition

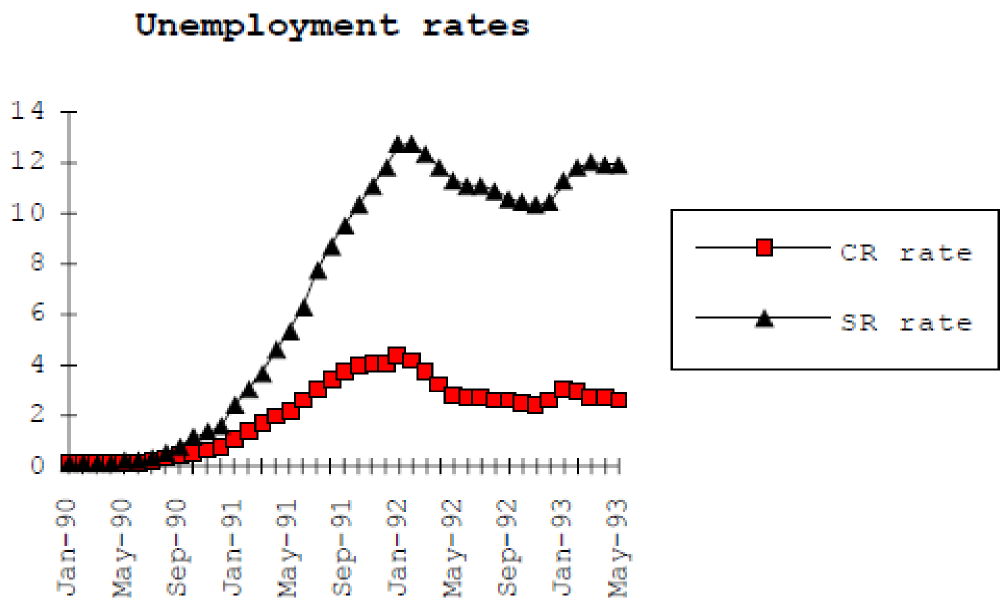
years up to now, as the data on the rather low percentage of people living under poverty line show.

What about output? <u>Was there really an output collapse at the beginning of 90 or is it only a mythus?</u> I belong to those who at least for the Czech republic do not buy the idea of the output collapse after the start of transition. It is an open question to what extent official statistics of the decline in output in early transition times may be biased downwards because of many problems of measurement related to such factors as sharp movements in relative prices, new goods and services entering the market, appearance of a large number of new producing and selling units which in the final analysis leads to upward biases in price indices and hence to downward biases in real incicators like GDP. In this respect I refer to my article Transformace, hdp and economický blahobyt, Statistika 1/2008 in which I argue that data on GDP and welfare for a socialist economy are biased upwards, whereas for a market economy, especially in early transition years are biased downwards. A kind of summary in English may be found in my contribution to Festschrift to VK called Today´s world and VK 2012.

Let me now turn to have <u>unemployment data after the start of transition.</u> (In the socialist economy there was not an open unemployment but what was called hidden unemployment or unemployment on the job.) As expected open unemployment appeared and as you can see from the graph 1. It was considerably bigger in Slovakia than in the Czech lands. Much higher open unemployment in Slovakia than in the Czech lands shows that the Slovak economy was structurally considerably different from the Czech economy and hence more vulnerable and sensitive to a strong dose of common reform policies . Given a heated political and emotional atmosphere in those times

<u>much higher unemployment in Slovakia was not a factor which would contribute to the preservation of Czechoslovakia.</u>

Graph 1: Czech and Slovak unemployment rates, 1990-199



Source: Smidkova K. Exhcange rate system between the Czech and Slovak republics. Praha 1994, str. 22.

<u>Privatisation proceeded rather fast</u> as we can see from table 2. This brought plenty of dynamics into the economy and contributed to its deep and fast structural changes too.

Table 2: Private Sector Contribution to GDP

	1990	1991	1992	1993	1994	1995	1996	1997
%	12	17	28	45	56	64	75	78

At macrolevel, e. g. the share of people employed in agriculture declined from about 12% in 1990 to slightly more than 4% in 1996, similarly in industry the respective figures were about 50% in 1990 and close to 30% in 1996 whereas the share of those who are employed in service sector increased from about 38% in 1990 to about 56% in 1996.

At micro-level reform policies in effect reduced the size of firms, through facilitation of entry of new firms, exit and/or break-up of state-owned firms. Hence in terms of size of firms the structure of the economy moved considerably in favor of small and medium size firms and started to resemble the structure of a comparable country such as Austria.

Moreover, the geographical pattern of trade has in a sense "normalised " itself, that means that under the influence of market forces it moved fast in favour of Western Europe, and Germany in particular, at the expense of former Comecon countries and the Soviet Union in particular who used to be the most prominent among the Czech trade partners during communist era.

(The shareof exports to WE was about 30% in 1989 whereas in 1995 it was above 60%. Correspondingly the share of exports to former socialist countries including Soviet union which was close to 60% in 1989 decreased to around 30% in 1995.)

(These developments were obviously the result of a "delicate mixture of intentions (of policy-makers) and spontaneity (of firms, consumers)"in a reborn democratic capitalism.)

5. Joining the OECD in 1995

As mentioned earlier we were granted OECD membership already in 1995. I read it as a kind of recognition that our transformation course was a right one, that it brought us back a functioning open market economy rather fast , that we fullfiled the criterion of „likemindedness“ to become a member of the club of advanced capitalist economies. Nice but certainly not the end of problems as real capitalism is not perfect (cycles, etc.) either. But history and my own experience tells me that it is performing much better than real socialism .

Adendum.
<u>What is OECD and what it does</u>

OECD – Organisation for economic cooperation and development is an <u>offspring of the Marshall plan</u>. It started as a kind of economic complement of NATO.

Curently the OECD has <u>35 members</u> which are „likeminded“. Likemindedness means that they practise democratic government and market economy:
Anglosaxon capitalism, social market economies of Europe, coutries like Czech rep, Poland, Slovakia, Hungary which bring in their special experience of transition from communist noneconomy to democratic capitalism, Asian capitalism – Japan, south Korea. OECD provides a forum where governments can compare and exchange policy experience, identify good practices – hopefully – and get recomendations.

Club of rich countries, not necessarily, Mexico? Turkey, and Chile?

OECD is about consensus, peer review and peer pressure, not about lending money like IMF or World bank.
OECD also pursues so called „enhanced cooperation“ with the emerging economic powers which is China, Brazil, India, South Africa and Indonesia, with „a view of their possible membership“ in the club. These countries are not applying for membership, OECD is sort of luring them, OECD is the demander.

Why: They are increasingly gaining share in global GDP and OECD club is losing it. 20 years ago the share of OECD countries in the global GDP was about 70% before the crises it was about 50%. Now it will be even less. Obviously for OECD to remain relevant in the changing world it has to try to cooperate closely with this „big five“which the current economic crises strongly underlined.

((Convention, only few pages, says that OECD aims its activities at the promotion of the economic growth, employment, free trade and raising living standard of its members but also nonmember countries (development).

Czech Republic and OECD

The Czech Republic is a member of the OECD since 1995, V. Klaus, by then prime minister sent in the aplication. Poland joined a year later…OECD accession already by mid nineties meant that the foundations of democratic capitalism in our country were firmly in place and it was recognised by „likeminded“ countries.

Let me now jump to an example how the OECD members, including the Czech republic, may make use of the OECD expertise. It may also give you some glimpse how OECD works.

<u>There are regular reviews</u> of the member countries economic policies, and not only of member countries (China, Russia). According to my opinion reviews belong to the core business of the OECD. They belong to its flagships.

Once the theme of a review is mutually agreed , two visits of OECD experts to Prague are organised. They talk to various government people, to the top CNB people, they also visit social partners and see some analysts from private companies or academia and ask questions related to the themes of the survey.

Next, the <u>draft of the review is written by the OECD</u> experts and sent to government people back to Prague to prepare for its discussion in the respective EDRC committee in Paris. Members of the committee are experts sent by the OECD member countries. After the discussion in the committee there might be some redrafting to prepare a final version of the survey which is to be presented in Prague. Most likely jointly by the prime minister and OECD SG Angel Guria.

<u>What is the significance of the REVIEWS</u> ? Perhaps I should quote here Val Koromzay who used to be chairman of the department preparing OECD country surveys for many years. He retired couple of years ago.. At the seminar on Economic growth strategy of the Czech republic organised in Paris in 2006 he said:

„Finally, reform institutions have a critical role to play. Domestically, agencies such as the Australian Productivity Commission can provide powerful support for reform, as can economic think-tanks more generally – particularly when (like the Dutch CPB or the Belgium Federal Planning Bureau) they have intellectual independence but a formal mandated advisory function. Internationally, EU institutions are obviously of great importance; and I believe that OECD is also very important. Our country reviews are (with admittedly different impacts across OECD countries) often a useful catalyst. This is not because OECD reviews can somehow put pressure on governments to do things that they don't want to do; but because they can encourage governments to do what they in fact want to do (even if they can't say so out loud for political reasons) and hopefully provide ammunition to use against domestic opponents of reform.“