

Karel Dyba (notes for the lecture), 30.1.2018

(Re)creating a market economy: the case of the Czech Republic

- 1. Historical background**
- 2. What happened after 2nd World War**
- 3. Transformation policies and their results**
- 4. Structural changes, entering OECD**

1. Historical background

Long industrial tradition. First cars produced here at the beginning of last century. Today automotive industry is one of the motors of our economy; more than 1 mil cars produced per year, per cap rather large number, large percentage of our exports and employment generator. 10% of our GDP made by automotive industries. Czech Detroit?

Between the two World Wars, Czechoslovakia ranked among the top ten producers of industrial goods in the world, including armaments. It was a capitalist market economy and parliamentary democracy. 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 economic policies it practiced mostly fiscal and monetary conservatism. Partly because of it its economy was heavily hit by deep world economic crises in the 30s in the last century.

However, in the 30s in the last century in contrast to neighboring Germany it was an island of parliamentary democracy and relative political stability in Central Europe. (Thomas Mann.)

During the 2nd World War Czechoslovakia disappeared. Czech lands were occupied by Hitler's Nazi Germany (Bohemia and Moravia, Boehmen und Maehren). Slovakia split and remained semi-independent under German tutelage.

During occupation there was a kind of war economy in Czech lands and its industry profile was skewed considerably towards producing arms and heavy industries in general to serve Nazi-Germany war machine.

2. What happened after 2nd World War

Immediately after the defeat of Nazi Germany in May 1945 the prewar Czechoslovakia was restored. However in 1948, the Communist party took over. **Over 40 years of Communist rule**

managed to destroy the institutional foundations of the prewar democratic capitalism...

All capitalist system institutions were destroyed and replaced by Soviet-type economic system institutions such as one party rule, authoritarian central planning, disrespect for markets – fixed prices, outlawing private enterprise, monopoly of foreign trade, inconvertibility of Czech currency crown/koruna etc. Overwhelming nationalization involved not only economy but also other parts of social life like sports, culture, religion, etc.

(Remember that there is also a vast “soft infrastructure” of norms of behavior, habits, etc. that underpins capitalism and is extremely important for its sound functioning.)

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

Let me give you just one number how costly for us was 40 years of running socialist or Soviet-type political and economic system in my country. As a benchmark I will use Austria which after the 2nd World war was following a kind of capitalist social and economic system.

Whereas, immediately after the Second World War, Czechoslovak GDP per capita was at least as high as Austria's.

In fact it was higher because Czechoslovak economy was not as damaged by the war as was Austria's economy. By the end of 1989 when the so called Velvet Revolution removed the Communists from power, Czechoslovak GDP per capita was only about half of Austria's GDP per capita when both were measured at purchasing power parity (PPP). Obviously it also means how much our standard of living declined relatively to Austrian standard of living in 1948 -1989 period.

Luckily, by the end of eighties, Soviet Union imploded and deep changes took place in Central and Eastern Europe, including Czechoslovakia. So called "velvet revolution" took place here and we were able to abandon the wrong socialist track and start reconstructing the foundations of a capitalist system, though practically from scratch.

3. Transformation policies and some results

Let me recall that so called **Klausean blueprint for transformation, for a return to capitalist market economy/system, was approved, though with some compromises, by the Czechoslovak Federal parliament in autumn 1990.** after heated political battles in the executive as well as in parliament.

Vaclav Klaus, minister of finance in federal government by then, therefore Klausian blueprint. I have known him for years, supported him and his policies and was a minister of economy in his government when he became the prime minister in the Czech government after elections in mid-1992.

In brief, **transformation blueprint** was a package of policy measures to be introduced as of January 1, 1991. It consisted of liberalization of prices (opening of markets), liberalization of foreign trade and introducing convertibility of the crown, stabilization orientated monetary and fiscal policies – restrictive monetary and fiscal policies, wholesale privatization (all kinds of method of privatization were used-restitution to original owners, small-scale privatization by public auctions, free transfer to municipalities, Thatcher-like privatization, and so called coupon or voucher privatization – learning what is capitalism about) and establishment of social net (like labor offices, unemployment benefits etc.) to help those who would 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, to reach a point of no return, have to be applied as a whole, in a package, in a sense simultaneously as they were mutually reinforcing.

Speed also mattered, situation in USSR, 1968 memories, etc.

Mancur Olson

No big mistakes, restart is difficult. Keep political support by communicating with people, explain the steps.

Was it a kind of **shock therapy**? GDR

Importing laws from elsewhere? **Learning by doing**

I will not go into details of the transformation policies. But I want to show you several **slides how the economy responded to transformation policies at the beginning of nineties.**

Exhibit 1 inflation (slide 9)

Exhibit 2 unemployment Czech Rep vs. Slovakia (**one for the reasons of the split of Czechoslovakia**) (slide 11)

Exhibit 3 Share of GDP produced by newly privatized enterprises (slide 12)

There was some output decline as measured by GDP, not easy to measure what was really going on in profoundly and rapidly changing economy, also I have my doubts to what extent it was really a decline in useful output and welfare of population.

Eg. GDP and electricity production, hidden inflation under real socialism, cheating, incentives to report false production numbers to superiors, production for the sake of production. Following the

fundamental change of economic system the pathological behavior of enterprises died out quickly as managers were rewarded for what they sold and not for what they reported up the line.

Also the onset of transition was accompanied by rapid changes in organization, ownership, quality and prices. Grey economy. This kind of instability makes it objectively difficult for statisticians to measure what is going on in the economy.

Exhibit 4 GDP: Czech Republic and former GDR (slide 13)

Exhibit 5 GDP decline and its duration (slide14)

Official numbers.

4. Selected structural changes, entering OECD

So far I have used some macro data to show how the economy responded to transformation policies. To complete the picture let me mention that there were obviously significant, deep changes in the macro as well as micro structures of the economy. Here are some examples:

- overgrown industry's and agriculture's share in GDP as well as in employment declined significantly and that of the service sector correspondingly grew,
- the number of smaller firms grew rapidly while the number of the largest fell,

- pattern of consumption changed significantly
- export to GDP ratio increased significantly and the destination of exports shifted rapidly from the former socialist countries to the EU countries, (next lecture)

Behind structural changes at the macrolevel there was obviously plenty of restructuring (products, quality, etc.) in companies. Though the adjustment cost to transition in broader sense had to be rather high there were no any significant industrial disputes. No outright poverty and deprivation.

My final remark: Both open market economy and parliamentary democracy are basic preconditions for membership in the **OECD** (Organisation for Economic Cooperation and Development) which is a kind of club of „likeminded“ developed market economies with roots in late 40s. Czech Republic was invited to apply for membership and has become a member of the OECD already in 1995.