



Review of Economies in Transition

Idäntalouksien katsauksia

1992 • No. 3

15.5.1992

Reprint in PDF format 2002

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Economy: Results, Prospects,
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Bank of Finland
Institute for Economies in Transition, BOFIT

ISSN 1235-7405
Reprint in PDF format 2002

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The opinions expressed in this paper are those of the authors and do not necessarily reflect the views of the Bank of Finland.

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Transformation of Czechoslovakia's Economy: Results, Prospects, Open Issues

Transformation of the former centrally-planned economies in Central and Eastern Europe is a long, painful and in many aspects complicated process. No coherent theory of transformation exists, though many results of standard economic theory can be applied in forming a strategy of transformation. Moreover, a systematic comparative analysis of the progress of transformation in individual post-socialist countries is also missing; thus, it is at this point difficult to generalize the empirical evidence and evaluate the costs and benefits of different strategies.

The aim of this study – emphasizing the analysis of results, open issues and potential reform traps – is to narrow this information gap at least to some extent. The success of the transformation of post-socialist countries is vital to the political stability and economic prosperity of an increasingly integrated Europe.

1 Main Pillars of Czechoslovakia's Transformation

The initial conditions in Czechoslovakia were – at the end of 1989 – different from those of other transforming economies, particularly Poland and Hungary (with whom Czechoslovakia is usually compared). First, Czechoslovakia had some advantages:

1) There was a long tradition of tight monetary policy. Not only was Czechoslovakia an island of monetary stability in the hyper-inflationary Central Europe of the Twenties; it even managed to retain this tradition during the long decades of central planning. The financial discipline of the government and enterprises was relatively strict, state budgets were balanced and the balance of payments showed no big deficits or surpluses.

2) Inflation, both open and suppressed, was low. According to recent analysis (see Drabek – Janáček – Tuma, 1992), the overall annual inflation rate did not exceed 5 % in the 1980s.

3) Czechoslovakia's external debt was low by all international standards.

4) The country has well-educated and relatively skilled labour. In this respect, the gap vis-à-vis advanced economies is probably lower than in other transforming economies.

On the other hand, there were some disadvantages:

1) The system of command economy was very complete; there was no private sector, almost everything being socialised.

2) Almost all prices were centrally controlled. Only in the second half of the eighties did some slow and half-hearted steps toward decontrol of prices take place. Enterprise managers were also tightly controlled by government planning organs, and they had little autonomy in decision-making.

3) Exports were predominantly aimed at C.M.E.A. markets (more than 70 % in the second half of the eighties). Especially high was the share of the Soviet Union (almost 40 %). A considerable part of these exports are not saleable in western markets.

In light of these initial conditions, the following major measures were chosen as the pillars of economic transformation:

1) Massive and rapid privatization. Privatization is a top priority in all truly transforming economies, and it has special importance in Czechoslovakia. A massive shift of property rights from state (e.g. government) to private hands is essential if the economy is to become a market economy. There is a real effort being made to privatize as much as possible as fast as possible. Privatization must be done quickly, because it is the only way to fundamentally change the behaviour of economic agents, expose them to the pressures of the market, and initiate the structural changes that will prevent the prolongation of the post-socialist, hybrid economy, that is highly prone to economic collapse.

2) Price liberalization – a necessity for a functioning market economy, and for efficient allocation of resources. The atrophied price structure which had become totally distorted by forty years of central planning had to be liberalized immediately, since attempts at gradual change would simply lead to a prolongation and deepening of the distortions.

3) Opening of the Czechoslovak economy to the world, i.e. liberalization of external trade and the introduction of internal convertibility of the Czechoslovak crown. These are the most effective ways to create a competitive environment. The establishment of a monetary market and providing of free access to foreign currency bring domestic prices closer to world prices. A realistic exchange rate reduces pressure on the balance of payments (which is threatened by the collapse of traditional markets and by the low competitiveness of exports).

4) Restoring and preserving macroeconomic equilibrium is a *conditio sine qua non* for progress. Tight macroeconomic policy, based on a state budget surplus and prudent monetary policy, is absolutely necessary; otherwise, a vicious circle of inflation and stagnation would evolve, and direct controls would have to be reintroduced.

5) Maintenance of social consensus, i.e. sufficient support by the population, is of prime importance to successful transformation. Transformation is inevitably accompanied by an increase in unemployment, increased poverty in certain social groups, retraining needs etc. For this reason it is necessary to create a social safety net which would provide an adequate safeguard against unrest and – simultaneously – motivate the people to take initiative in solving their economic problems. It requires continuous testing of the feasibility – from the social point of view – of the transformation process. So far, transformation in Czechoslovakia has been very successful in avoiding social unrest, strikes etc., while taking steps which adversely affect the standard of living of the population. Czechoslovakia is an exception among East European countries in this respect.

2 Macroeconomic Performance in 1991

The year 1991 was characterised by deep economic depression, due to a decline in domestic and external demand. The markets of the former C.M.E.A. countries collapsed, the Gulf War adversely affected trade relations with some Middle East countries; Czechoslovakia was also hit by the slowdown in international trade. According to some estimates, 40 – 50 % of the decrease in Gross Domestic Product can be attributed to external factors.

There was a slump in domestic consumer and investment demand owing to significant rise in prices that followed price liberalization (Jan.1,1991) and adverse climate that preceded privatization in almost all state-owned enterprises. GDP declined by some 16 %, industrial production by 21.2 % and investment by one third. Inflation – as measured by the consumer price index – was 57.9 %. (See section 7 for a description of the interesting monthly pattern of inflation.)

The current account balance showed a surplus of about 0.7 billion US dollars, (USD 0.2 billion in convertible currencies, 0.5 billion in clearing).Gross external debt reached USD 9.4 billion, and debt service amounted 15 %. Convertible currency reserves amounted to USD 3.3 billion at end-1991 – in comparison with USD 1.1 billion at the beginning of the same year. (For more detailed data, see Table 1).

Table 1

Main Economic Indicators, 1991

GDP (rate of growth, constant prices)	-15.9 %
Personal consumption (rate of growth, constant prices)	-33.1 %
Investment (rate of growth, 1991 prices)	-33.8 %
Industrial production (rate of growth, 1991 prices)	-21.2 %
Construction (rate of growth, 1991 prices)	-30.5 %
Inflation (consumer price index)	57.9 %
Change in nominal wages	16.4 %
Change in real wages	-26.2 %
Unemployment (end-1991)	6.6 %
Savings rate (from disposable income)	9.3 %
State budget (billions of Cz. crowns)	-18.6
Export growth (1991 prices)	-6.0 %
Import growth (1991 prices)	-15 till -20 %
Trade balance (billion USD)	-0,3
Current account balance (billion USD)	0.7
of which convertible currencies	0.2
Gross debt (billion USD)	9.4
Official reserves (convertible currencies, billion USD)	3.3

Source: Federal Statistical Office, Czechoslovak State Bank

Foreign direct investments amounted to more than USD 600 million. The exchange rate – after three devaluations in 1990 – was not changed in 1991. The growth of the money supply (M2) was very slow due to the strict credit policy of commercial banks and the credit ceilings imposed by the State Bank.

In external trade, there was a shift from former C.M.E.A. countries toward developed market economies. Exports declined by 6 %, imports by 15 – 20 % (interval is due to unrecorded imports). The unemployment rate reached 6.6 %; there were 527 000 unemployed at the end of 1991.

Now to the more detailed analysis in some sectors.

3 Household Sector

According to analyses of consumer behaviour, most consumers recovered from the first shock caused by liberalized prices (for the development of inflation see Table 3 below), adapted to the new situation and began to behave rationally, with increasing thriftiness. After April 1991, the propensity to save began to grow. By the end of 1991, it had reached 9.3 %, which was the highest level since 1954.

Thriftiness and self-restraint in demand and consumption are gradually becoming durable traits. Fewer households are eager to spend all their money immediately. The decreasing propensity to consume results, on the one hand, from this changed behaviour of households, whose preference of savings is growing and on the other hand, it reflects the decline in purchasing power. Purchases are also being delayed, as consumers expect prices of goods of Czechoslovak make to fall.

This is in sharp contrast to the behaviour of households under a command economy characterized by shortages in consumer markets. A common characteristic of Czechoslovak consumers under the shortage economy was an extremely high propensity to consume in times of recession and severe shortage of consumer goods. Such consumer behaviour reflected the fact that those periods were always characterized by increased inflation – open or hidden, which dampened the propensity to save. This reaction differs significantly from consumer behaviour in a market economy, where the propensity to save usually rises in times of recession, as households try to cope with the growing uncertainty of future incomes.

Under the command economy, the typical consumer reaction to economic recession aggravated inflationary pressures. Moreover, inflation was also fed by high inflationary expectations based on past experience: the government usually sought a solution for growing shortages in centrally-made price increases.

Despite the fact that consumer habits show a high degree of inertia, consumer and saving behaviour has already begun to change. Nevertheless, the unprecedented price rise of foodstuffs and industrial goods constitutes a shock that, given the low growth of nominal incomes (mainly wages), exceeds the capacity of long-term adaptive mechanisms. And the conflict between adaptability and inertia in consumer behaviour may cause some tension in the future.

At present, consumption has stabilized. However, some risks remain. The gap between foodstuff prices and prices of industrial goods, which has traditionally disfavoured industrial goods, grew yet wider. Adaptation to world price relations is thus still far from an accomplished fact, and will tend to assert itself in future, as a consequence of the opening of the economy.

For 1991, we found that the price elasticity of demand for foodstuffs to be -0.80 and for industrial goods -1.15 . Both elasticities are so close to -1 that we can say that the effects of price changes on demand for the two groups of goods are still very similar. Up to now, there has been little room for the classical difference in price elasticities of demand for necessities and luxuries. Furthermore, the demand structure of both types of goods implies that the possibility of postponing purchases has more influence on demand than the possibility of substitution. All this speaks for the conclusion that consumers' budget behaviour is influenced more by the above-mentioned rise in the cost of living than by the present stability of prices or expectations regarding the future.

The way households perceive the future is beginning to vary more with age, income level, type of job, etc. Nevertheless, more than half of the households had a negative outlook as to their own financial situation in May 1991. (And a quarter of the households responded that they normally had no money left over for building up a necessary reserve cushion).

In spite of this, the stabilization of consumer prices in the second and third quarters of 1991 and the growth of incomes (thanks, *inter alia*, to social policy measures) positively influenced the economic public opinion: the "index of the consumer climate", which measures economic opinion of households, improved markedly in May 1991 (by 46 points) and in September 1991 (by another 8 points). It fell again, however, in December 1991 (by 10 points), as a result of a renewed, albeit slight, price rise in the fourth quarter.

At the same time, the number of households expecting a deterioration of their finances rose in 1992. The worsening economic outlook is much more pronounced in Slovakia, where the population is much more critical of the overall economic situation, the transformation process, living standards and the supply of consumer goods. This is a result not only of the gap in unemployment rates, but also of an inflation rate in the Slovak republic that was 5 percentage points higher than in the Czech republic.

Economic public opinion has been positively influenced by the fact that the households have been able to adapt their consumption to their financial means – expenditures to incomes. The decrease in purchasing power hits durables much harder than foodstuffs, services and other items. Durables are losing their long-standing special position within household expenditures: their relative importance has decreased considerably. Only in the expenditures of young households do they play a bigger role.

The slackening of demand for equipment and durables in 1991 has been confirmed by the survey of purchase intentions, taken regularly by the Research Institute of Trade: for two-thirds of the 29 durable goods items studied, intended purchases declined as compared to autumn of 1990. Purchases are being postponed in expectation of price declines among goods of domestic origin. Where a purchase intention exists, there is usually a preference toward purchasing abroad or acquiring a foreign made durable: consumers prefer quality, high technical level and good shopping conditions, even if the price is higher. Domestic products are not usually seen as being of high quality.

These trends indicate that rationality, thriftiness and self-restraint in demand and consumption are gradually taking on a long-term character. Households are diversifying their economic activities, as well as their financial and other stores of value (crown savings, hard currency savings, securities, real estate, goods). Such behaviour as a response to insecurity shows many characteristics indicative of the (often unconscious and intuitive) application of portfolio theory – the diversification of economic activities which secure the finances of the household and the spreading of the risks posed by a deteriorated economic situation.

At the same time, this type of consumer behaviour helps to tame inflation; inflationary expectations also have gone down after the original inflationary outburst which followed the liberalization of prices. Stabilization policy had a salutary effect, successfully reducing inflation quickly to one-digit figures (on a month-to-month basis) and dampening inflationary expectations.

To sum up, household behaviour reflects a clash of old and new consumption patterns, and there is a strong likelihood that the two patterns will alternately dominate. A more precisely defined pattern of consumer behaviour is only beginning to emerge in Czechoslovakia.

The slackening of economic activity and the inflation affected the trends in money incomes. Wage incomes and co-operative farmers incomes were low both in relative and absolute terms, while the social incomes (transfers) grew much faster – as a result of the endeavour to soften the impact of rising costs of living. Nominal wages went up by 16.4 % and real wages declined by 26.2 %.

Wages, like the total incomes, show greater disparity in 1991 (after long decades of nivelization), though the trends varied among different industries. It is also worth mentioning that in the private sector average wage was higher by almost one half as compared to the state sector. Further growth of the private sector could result in a sizeable wage differentiation, both within single industries and between them. And it is very hard to predict how the Czechoslovak population – historically characterized by very egalitarian attitudes – will react to this development.

The social and economic phenomenon of poverty is gaining more and more importance in Czechoslovakia, with the rise in the costs of living associated with transformation and, more specifically, with price liberalization. Solving the problem of poverty is vital for the maintenance of social consensus and for ensuring the social feasibility of the systemic change that comes with transformation.

The number of households living at or below the poverty level is determined by the dynamics of the costs of living and money incomes. In Czechoslovakia, as from January 1992, the official poverty level is defined by the law on minimum income. The minimum income depends on the number of household members and on the children's ages. It amounts to roughly 50 % of the average per capita net income.

According to a study made by the Institute of Economics, the share of households at or below the official minimum income level is around 13 %. Another 17 % of households have incomes that exceed the official minimum by 25 % or less. These households, which can be characterized as poor (or potentially poor) on the basis of money income, include more than 20 % of all children under 15. Any change such as unemployment, birth of a new baby or higher inflation, can pose an imminent threat to such a family and push it under the minimum income level.

In this category, the following types of households prevail: households with several children, newly-weds and households without economically active members. This should be considered also in the design of social policy. As the means available to the Czechoslovak social system are very limited, it will be necessary to end the over-all approach and to concentrate on measures that selectively help the most vulnerable groups. In this way, the overall effects of the social care system can be substantially improved, which is especially important given the limitations inherent in the present economic situation in Czechoslovakia.

4 Unemployment

Transformation of the economy is inevitably accompanied by declining employment, and sharply rising unemployment. The state sector remains decisive with respect to employment trends. The emerging private sector has not yet had an important influence on total employment – with the exception of construction, retail trade and services.

The structure of unemployment varies much among the different republics and regions. The federal unemployment rate stood at 6.6 % at the end of 1991 and that of the Czech republic was 4.1 %, whereas for Slovakia the rate was 11.8 %. The gap between unemployment rates in the two republics widened throughout the year. (For more detail, see Table 2).

Table 2

Unemployment Rates, 1991 – 1992, (%)

	Jan.91	Feb.	March	April	May	June
Czech republic	1.10	1.39	1.67	1.99	2.20	2.60
Slovak republic	2.37	3.04	3.71	4.56	5.38	6.32
Czechoslovakia	1.51	1.92	2.33	2.82	3.23	3.80

	July	Aug.	Sept.	Oct.	Nov.	Dec.
Czech republic	3.08	3.40	3.77	3.94	4.05	4.10
Slovak republic	7.71	8.72	9.55	10.30	11.06	11.80
Czechoslovakia	4.58	5.12	5.63	5.99	6.31	6.61

	Jan.92	Feb.92	March 92			
Czech republic	4.40	4.14	3.72			
Slovak republic	12.74	12.74	12.27			
Czechoslovakia	6.95	6.78	6.48			

Source: Federal Ministry of Labour and Social Affairs

Unemployment varies greatly among the different regions, depending on the structure of production. Regional differences, which arose in the first half of 1991, still persist. The relation between the shares of the two republics in total unemployment (45 % for the Czech republic, 55 % for the Slovak republic) is inverse to the relation of their shares in total employment (CR 68 %, SR 32 %).

These trends are partly the result of different accent laid in the two republics on active employment policy. In the Czech republic, some 157 000 new jobs were created through public policies (of these, 50 000 assistant jobs, paid by the labour offices, for fresh school leavers). In Slovak republic, such activities began with a delay, and there were only 24 000 new jobs created by public policies.

Differences in unemployment among regions and districts are connected with the gradual restraint of some types of production, and with starting structural change. For example, the unemployment rate in Prague is constantly around 1.5 % (and in March 1992, it fell under 1 %), while in some districts in Northern and Eastern Slovakia, the rate exceeds 20 %. No significant changes of these trends can

be expected in the short run. Growing regional differences also point to the absence of a regionally specified employment policy.

In Czechoslovakia as a whole, only about 2.5 % of the registered unemployed were being retrained at the end of 1991. Regions with the highest unemployment rate have the smallest retraining rates. One of the reasons for this is the labour offices' reluctance to retrain a person without some reasonable hope of finding him a new job. The solution is to be sought in a broader concept of retraining, in its substantial decentralization, and in the participation of more institutions in retraining programs.

Looking at the age structure, the most productive age groups (20 to 40 years of age) are hit the hardest by unemployment. These groups represent almost 60 % of total unemployment. This is significantly different from the West European economies (where, in addition to fresh school leavers, the oldest groups within the labour force have the highest unemployment rates). The situation in Czechoslovakia is probably influenced by the fact that there as yet have not been economic reasons to lay off the older workers (no modernization is taking place, for example). The existing social climate at most workplaces instead shifts the burden of unemployment to the younger workers, who are not yet as firmly integrated in the enterprise collectives. Another reason might be the younger workers' relative lack of knowledge and experience.

Unemployment among new graduates from universities and secondary schools is a very serious problem. Some estimates say that up to 60 % of graduates have problems in finding their first job. However, their employment as assistants (paid by the labour offices) has been one of the few really successful job-creating measures.

Women are hit harder by unemployment than men. On December 31, 1991, the share of women in total unemployment was 55 % (their share in the total labour supply is 46.5 %). Also the unemployment among the Gypsy population grew in 1991, and it is estimated that their unemployment rate is about 20 %. Almost 80 % of the Gypsy unemployed are in the Slovak republic (e.g., in the East-Slovakian region, Gypsies account for 40 % of the unemployed). In the Czech republic, the unemployment among Gypsies in North-Bohemian region is the highest (16.5 % of the total unemployed in the region). Growing unemployment among Gypsies entails substantial risk to the society, and it probably contains a racial element.

One positive fact is that only about 3 % of the unemployed remain without job for more than one year. However, the possibility which existed in 1991 of getting the maximum unemployment allowance for as long as a year, reduced the job-hunting motivation of some groups of unemployed (unskilled workers, Gypsies, young people). According to an analysis completed by the labour offices in the Czech republic, about 35 % of the unemployed are not seriously interested in finding a new job. Owing to their requirements and the opportunities available, a number of these people are likely to enter the ranks of the long-term unemployed.

Not only did the above-mentioned possibility of getting an unemployment allowance for one year destimulate some groups of unemployed to re-enter the labour market, but also the fact that (in contrast to advanced countries) the amount of allowance was not limited by other conditions, exacerbated the situation. The situation was further complicated by a high level of minimum income and minimum wage.

For these reasons, the Federal government changed the scheme as from January 1, 1992. The unemployment allowance is limited to six months, and new conditions were imposed to increase job-seeking efforts. As the figures in Table 2 show, these measures have had some positive results.

According to opinion polls, the population regards resolution of the unemployment problem as one of the main tasks of government economic policy. Simplifying, one can say that the fear of unemployment is felt mainly among those groups that are presently most vulnerable (the least skilled, the elderly, women). The most apprehension was felt by cooperative farmers and blue collar workers and the least by employees of the service and public sectors.

Sixty-three per cent of the respondents of the last poll felt that the unemployment allowance should be minimal, so as to force the unemployed to accept a less qualified job, or undergo retraining, move to another city or region etc. A relatively high percentage (e.g., 30 % of all women respondents) were ready to accept a lower-paid job if unemployed (14 % of women were willing to work for less than the minimum wage).

Willingness to accept a lower-paid job diminishes with growing education and qualification, varies with age (being lowest for the middle-age group), is low in agriculture and high in the service sector. It is also generally lower in the Slovak republic. Around 25 % of the respondents feared that they themselves could become unemployed (this percentage exceeds all official and unofficial estimates of expected unemployment – see below).

On the whole, however, liberalization of the labour market is supported by the populace, although the support differs in the two parts of Czechoslovakia.

5 Enterprises Before Privatization

As has been duly stressed, the "transformation of centrally planned economy into a market system implies not only a different role of government in the economy: it requires also substantial change in the character and behaviour of microeconomic agents. Such change is a gradual, time-consuming process; it will take several years, at minimum, before some "critical mass" of change is achieved within the enterprises inherited from the planned economy". (Janáčková, 1992).

Differences among individual enterprises in efficiency and competitiveness are several times greater in Czechoslovakia than is usual in a market economy. (For example, in Czechoslovakia differences in the value of total output per worker and in export performance among enterprises of the same industry were up to seven times greater than in industries of the advanced countries at the end of the eighties. Such large differences existed also in the former GDR; they were an inherent feature of the centrally-planned economy). This is also the feature inherited from the past, and it partly explains why microeconomic response to macroeconomic policy and systemic change is much more differentiated and sometimes conflicting.

Most (one can say the majority) state-owned enterprises are awaiting privatization, and operate with a very short time horizon. They are cutting investment sharply and trying to maintain the level of production and, above all, employment. Exceptions are some joint ventures and firms with good export prospects.

A very pressing problem is mass indebtedness of the state-owned enterprises, evaluated at 140–150 billion crowns, and leading to insolvency. The situation was partly eased by a decision of the State Bank to recapitalize – via special bonds issued by the National Property Fund – the commercial banks (15 billion crown) and to write off 35 billion crown of the past debts of enterprises. This operation, being undertaken by the commercial banks, is now almost completed.

For government economic bodies, it is at present very difficult to formulate appropriate policies for the enterprise sector. Declining production, high enterprise indebtedness, and rising unemployment lead to cries for protection and support of traditional domestic producers; yet such policies may also prolong inefficient production and monopolistic practices. A broader scheme of support of newly-emerging small and medium-size private firms just went into operation at the beginning of 1992. Foreign capital is not being attracted to the extent desired, and some forms of its entry help to sustain the monopolistic structure.

The so called large privatization is now starting in Czechoslovakia. In spite of the use of novel privatization schemes (e.g. voucher privatization), it has now become clear that the whole process will take several years.

Yet speed of privatization is very important, as insecurity concerning future owners hampers efficient decision-making in enterprises. Enterprise managers work within a very short time horizon; the problems of future profitability escape their attention. They concentrate on the immediate future, shun painful solution (such as reducing staff) and constantly seek government help.

For these reasons, large privatization is the key to further progress in the transformation. If it should slow down, or be blocked for any reason, the chaos and agony of many state-owned enterprises would be prolonged, and the economic recession would worsen. As a result, unemployment might go beyond the limits of

social tolerability; social unrest could threaten, and possibly abort, the whole transformation process.

Even if large privatization succeeds without delays, and finally brings real owner control and rational decision-making to enterprises, the salutary impact on efficiency will not come immediately. On the contrary, during the next few years, the expected, or ongoing, privatization will have highly controversial impacts on enterprise behaviour.

The unavoidable time-lags from the decision to privatize, through the commencement of privatization, to the realization of its positive effects, are one of the most serious problems of transformation. Under these conditions it is not surprising that macroeconomic policy measures often do not bring the expected results, as there is a lack of adequate microeconomic response. Enterprise response is presently one of the key open issues regarding transformation.

This provokes a question whether the present situation, unprecedented in market economies and lacking comprehensive theoretical guidelines, does not require some specific transitory steps regarding the relation of the state, as owner, to enterprises which are still state owned. In the present hybrid state of the Czechoslovak economy, with many non-market features, such steps would be highly desirable. The old methods of central control of state-owned enterprises have disappeared, but control by new owners is still lacking.

It is likely that practical demands will give rise to some such transitory measures. These may not necessarily come from the government alone: banks may play an important role here, as well as chambers of commerce, associations of entrepreneurs, and similar institutions.

Measures aimed at inducing more rational behaviour in presently state-owned enterprises both in the pre-privatization period and during the years of privatization, however, are only one side of the coin. The support of newly-formed private firms is no less important, as it can foster a process sometimes called "privatization from below".

6 External Trade

Czechoslovakia's external economic relations were severely hurt by the collapse of the former C.M.E.A. markets and by a sharp fall in domestic demand, both for consumer goods and investment, as a consequence of first reform measures. According to estimates of some economists in Czechoslovakia and abroad, the fall in exports to former C.M.E.A. area accounts for 40 – 50 % of the decline in industrial production and GDP.

Nevertheless, the enterprises began to react – with some delay – to the new situation, characterized by the loss of eastern markets and by a sharp devaluation of the Czechoslovak currency. (The delay in response to devaluation, which was made in three steps, is estimated at 5 – 8 month.) While total exports fell by

6 %, exports to OECD countries grew by roughly 9 % and to EC countries by more than 10 %, accelerating in the second half of 1991.

Thus the loss of eastern markets has been partly compensated by exports to the advanced market economies. For example, the loss of exports of engineering products to the former C.M.E.A. countries amounted to USD 2.5 billion, whereas the increase in engineering exports to hard currency markets amounted to USD 500 million – covering one fifth of the loss. This, along with the stable exchange rate of the Czechoslovak crown, has had a positive impact on the current account and trade balances.

In 1991 Czechoslovakia indeed experienced a pronounced regional shift in exports and imports. While the share of the advanced market economies was about 25 % in the eighties, it climbed to more than 50 % in 1991; if developing countries are included, the share of market economies represented 58.8 % (of which the share of developing countries was 8.4 %). And after forty years, the Soviet Union was surpassed by Germany as Czechoslovakia's largest trading partner.

Direct foreign investment amounted to USD 600 million in 1991. Foreign capital could play an important role in increasing the productivity and competitiveness of Czechoslovak firms – if its acquisition can be linked to an inflow of technological, organizational and managerial know-how. Experience in other economies shows that this aim is better served by direct foreign investment than by other forms of capital inflow. In Czechoslovakia, so far, the most important form of direct foreign investment is the joint venture. In October 1991, there were 4,735 and 1,186 joint ventures in the Czech republic and in Slovakia, respectively. The data show that in the number of joint ventures, trade and services prevailed over industry and construction. According to the volume of foreign capital invested, however, production led, followed by trade, services and construction.

Only about 20 % of foreign direct investment in Czechoslovakia has gone into the Slovak republic (where more than a third of the population is located). Generally speaking, the Czech republic appears to be a more attractive area for most foreign investment. This is due to several facts. First, in view of the nationalistic disputes between Czechs and Slovaks, Bohemia (the Czech republic) is regarded as a safer region. Second, Germany's industries and entrepreneurs are taking advantage of their country's proximity and long-standing historical and cultural ties with the Czech Republic (according to several estimates, German capital accounts for more than 70 % of all direct foreign investments in Czechoslovakia). Third and last – but not least – efficiency, labour productivity and level of skills are generally lower in

Slovakia than in Czech industry, thus diminishing the potential comparative advantages of this area for foreign investors.

7 Monetary and Fiscal Policies

The restrictive economic policy has managed to keep inflationary pressures under control. As is shown in Table 3, the leading cause of inflation was the decontrol of prices in January, 1991. Inflation rose sharply as soon as prices were liberalized. But after a jump in prices in the first quarter of 1991 (about 40 %), in the second quarter the increase was around 6 %, and there was almost no increase in the third quarter, followed by a slight 3 % rise in the last quarter. The rise of prices in the first quarter of 1992 did not exceed 2 %, either.

The Federal government succeeded to cut subsidies from 13 % of Gross Domestic Product to 7 % in 1991; in 1992, there will be another cut of subsidies to 5 % of GDP. The three-part government budget (one for the federation and one for each of the two constituent national republics) envisaged a surplus of 8 billion crowns for 1991. In reality, however, there was a deficit of over 18 billion crowns, due to unforeseen shortfalls in corporate and turnover tax revenues and to a rise in social spending as a result of the sharp decline in economic activity.

Table 3

Consumer Prices, 1991 -1992 (monthly growth rates, %)

I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII (1991)
25.8	7.0	4.7	2.0	1.9	1.8	-0.1	0.0	0.3	-0.1	1.6	1.2

I	II	III (1992)									
1.0	0.5	0.4									

Source: Federal Statistical Office

The gap in the budget opened when the budgets of the two national republics went far into deficit. Even though these deficits could only be partly offset by the surplus in the federal government budget, the budget surplus at the federal level clearly shows that the Czechoslovak government was and is still committed to a stabilization policy, even in the difficult phase of construction a market economy out of a planned economy.

During 1991, The Czechoslovak State (central) Bank retained direct control over interest rates through a maximum lending rate and credit ceilings (and by moral suasion in connection with deposit rates). Interest rates were raised so as to be positive in real terms, albeit on the assumption that inflationary expectations from the outset would reflect the underlying inflation, rather than the initial jump in prices.

Equally crucial to the stabilization effort was the nominal anchor of the exchange rate. The Czechoslovak crown was pegged to a basket of five currencies of Czechoslovakia's main financial and trading partners (USA, Germany, France, Switzerland, Austria) – thus providing a reference point around which liberalized prices could rapidly settle. At the same time, wage control was implemented by means of a punitive tax on wage increases above the level agreed with employers and trade unions (the tax not being applied to emerging private companies with less than 25 employees).

From the events of 1991 it is evident that a stable exchange rate demands control over inflation. It seems that good results in this area are of vital importance for the outcome of the entire transformation process.

8 Outlook for 1992 and some Open Issues

Despite the higher unemployment, lower real wages, and decline in aggregate income, government policy managed to get through the first stage of transformation in 1991. Social indicators for 1991 give evidence that the Czechoslovakia's transformation has not yet exceeded the limits of social tolerance. The government has managed to sustain a high – if declining – level of public support for the transformation process.

The year 1992 has been, and will continue to be, influenced by past and present trends, by the social and political climate, and by the political business cycle (elections in June), which brings various pressures to bear on the economy and leads to intervention into economic activities.

On the whole (according to a forecast published in Janáček et al., 1991), it can be expected that Gross Domestic Product will continue to fall, by 3 to 6 %. Other forecasts (Czechoslovak State Bank, Federal Ministry of Finance, IMF) also indicate a drop in GDP of around 5 %. Yet it is impossible to predict with any confidence either the after-effects of the liberalization of prices and external trade in 1991 or the initial results of the large privatization. Unexpected development cannot be ruled out. A shake-out of enterprises will begin to reveal how much of the production is viable in the new situation, and investment may revive only some time after privatization.

A reversal of the downward trend can hardly come before the end of 1992 or in 1993. The pre-election and immediate post-election periods will in all probability exert a negative influence on the decisiveness and rigor of economic policy; this may prolong the period of recession and economic stagnation. There is no sign of a significant revival in consumer spending in 1992, especially in domestically produced goods. There is therefore every likelihood of a significant further decline in industrial output of 10 – 12 %.

In enterprises, short-sighted decision-making and uncertainty will prevail. Privatization is only just beginning and it will be a time-consuming process. Even if the first stage of large privatization proceeds apace, any positive effects can be expected only in the medium run.

Nevertheless, efforts will accelerate to replace stagnating domestic demand (and falling demand in former C.M.E.A. countries) with exports. Even if exports are often realized "at any price", they will help to improve the current account and trade balances and give the country additional time for restructuring the economy.

Trends in investment will vary greatly. Demand will grow for public investment, reconstruction and repairs. A turn in enterprise investment activity will come only later, at the earliest in the last quarter of 1992. The effects of revived investment activity will differ: it will mean increasing production of building materials, but not in the large heavy machinery industry, where production will stagnate further or decline. The problems connected with the conversion of military production will continue, especially in Slovakia.

Inflation – provided we have prudent monetary policy and non-inflationary fiscal policy – will be between 12 % and 16 % in 1992. (The annual inflation rate, having declined from the beginning of the year, stood at 15 % at end-March 1992.) Households will continue to restrict their durables purchases, preferring to build up savings.

Labour market conditions in 1992 are being influenced by conflicting factors on the supply side (demographic factors increasing the labour force by 100 000; fewer women on maternity leave) and the demand side (growing pressure to cut overstaffing in enterprises and privatization, which will also have a labour-saving effect). In general, the gap between the trends of aggregate economic activity and employment will be smaller in 1992, i.e. employment will respond more closely to production trends.

Assuming a fall in GDP of 3 – 6 %, unemployment will reach 900 000 or 1 million by the end of 1992, which implies an unemployment rate of 12 to 14 %. Again, it will vary among different regions. In some regions it could reach (or surpass) the limits of social tolerability. As a result, pressures will grow from the trade unions and different political parties to keep employment above the economically efficient level.

The Czechoslovak economy is, and for some time will continue to be, a mixture of market and non-market economies. The presence of features inherited from the command economy is evidenced by a distorted price structure, a high degree of monopolization, and still the continued dominance of state ownership. In this type of situation, enterprises react to government policy in ways that are much more diversified and conflicting than is a case in a well-established market economy. This makes any proposal for an over-all stimulation of demand to revive economic growth very risky.

Proposals for unselective support of demand and growth, though they sound very tempting in the throes of a deep depression, are based on the following unrealistic assumptions:

- Practically the entire increase in demand would be for domestically produced products. That perhaps could have been guaranteed in a centrally-planned economy but not in today's Czechoslovakia. It is estimated that one third of the additional demand for consumer goods, and up to three fifths of the additional demand for investment goods would be for imported products. This would exert considerable pressure on the balance of payments, with further adverse effects in regard to indebtedness, inflation, and the rate of exchange of the Czechoslovak crown.

- There would be a flexible response of supply to the growth of demand. Substantial differences in the ability and willingness of mostly state-owned enterprises to respond to market signals (especially in the pre-privatization period) bring a significant risk that an inflow of money into the economy would foster inflation, rather than stimulate appropriate response by producers.

Thus, a broad boost in demand would have strong inflationary effects. These would very quickly negate the salutary effects of the devaluation, which has – from the second half of 1991 – promoted the growth of exports to hard currency countries.

Contrary to the over-all approach, economic policy should – while continuing the strict control of the growth of the money supply – selectively support those promising activities which speed up the transformation process. Analyses that have been done show quite clearly that the dividing line between competitive and uncompetitive enterprises runs across individual industries, not between them. Consequently, a pro-export policy supporting efficient enterprises would both speed up the necessary structural change and strengthen the sound growth elements. Similar effects could be achieved by public investment in infrastructure (transport,

communications) that is needed for a modern economy and which has been badly neglected in Czechoslovakia.

Another way to revive the economy lies in the support of new small and medium-sized private firms (direct support through sizable tax relief, easier credits, consultancy and other services financed by the government). All this means a selective support of demand, compatible with the pro-market institutional changes and not leading to renewed inflation.

From the very beginning, the transformation has been complicated and hampered by nationalist tensions and jurisdictional disputes among the three parliaments responsible for forming the legal foundation for the transformation. Unfortunately, the elections coming up in June 1992 can hardly be expected to significantly clear up this situation.

A sober evaluation of the economic prospects for 1992 thus leads to the conclusion that the bulk of the problems of restructuring the Czechoslovak economy are still to be confronted. This means that the painful economic and social consequences of transformation are not over yet.

Consequently, keeping inflation under control and promoting active employment policy is – and must remain – a priority of government economic policy. Only if this is done, can the social tolerability – and social feasibility – of the next stage of transformation be secured.

Social peace, however, must not be sought at the cost of permissive income and wage policy. Wages must be kept in line with the present (relatively low) productivity level in order to secure the competitiveness of Czechoslovak products. The example of the former GDR – where, for political reasons, wages were allowed to shoot up irrespective of the productivity gap – is a warning to all transforming economies.

In every respect, the importance of monetary policy is growing. Monetary and credit expansion must be consistent with short-run potential output: On the one hand, an unnecessarily restrictive stance would prolong (and deepen) the recession; on the other hand, excessive expansion would lead to inflation, thus jeopardizing price stability and the entire transformation process.

Similar constraints apply to fiscal policy. Attempts to revive the economy through budget deficits are sustainable only if they can stimulate enough growth to cover interest and debt repayments without tax increases. Otherwise, the economy would fall into a debt trap.

In general, the experience of transforming economies shows that the success of transformation depends on several fundamental conditions: low inflation, a stable exchange rate, prudent fiscal policy, privatization, price and trade liberalization, hard budget constraints and the maintenance of social consensus. These conditions are necessary but there is no guarantee that they are sufficient. Much will depend on the ability of economic policy to react to economic development. Continuous empirical analysis is of vital importance, along with deeper theoretical understanding.

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