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3 Stabilization and Transition in Czechoslovakia

Karel Dyba and Jan Svejnar

3.1 A Historical Overview of Economic Performance

Unlike most other socialist countries, Czechoslovakia used to be a relatively developed economy that became underdeveloped as a result of an externally imposed system.[1] It is also a country that maintained relative macro stability and thus entered the economic transformation of the 1990s in a better position than the other socialist economies. Finally, both within the Soviet bloc and in comparison with all countries, Czechoslovakia displayed one of the most equal distributions of income (Yotopoulos and Nugent 1976; and Begg 1991). On the political side, Czechoslovakia is currently undertaking a peaceful partition along national lines that will result in the creation of independent Czech and Slovak republics in 1993.

Czechoslovakia was created out of the disintegrating Austro-Hungarian Empire as a single state composed of the Czech and Slovak lands. Before the Second World War, Czechoslovakia was a democracy, with GNP per capita similar to that of Austria.[2] However, owing to historical factors, Slovakia started as an economically less developed agricultural region, while the Czech lands were industrialized and economically advanced. As a result of targeted government policies, these differences diminished substantially over the following seven decades.

During the pre–World War II period, Czechoslovakia was a successful open

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1. For an account of Czechoslovak economic development, see, e.g., Begg (1991).

2. As Gelb and Grey (1991) indicate, in 1938 the GDP per capita in Austria and Czechoslovakia was $400 and $380, respectively.

economy, with about 30 percent foreign capital ownership and well-developed human capital. Its industries were technologically advanced, and its products were renowned worldwide for their workmanship.

By 1990, Czechoslovak GNP per capita was reported by the World Bank at $3,300, thus being in line with those of Venezuela and Yugoslavia, but amounting to only about 25 percent of that of Austria.[3] The discrepancy between the Czechoslovak and Western GNPs increased further in 1991 as the officially recorded Czechoslovak GNP declined by an estimated 16 percent (see table 3.1). The economy was closed and strictly regulated, and many Czechoslovak products were of mediocre quality, selling at a discount and with some difficulty in the West. Compared to Hungary and Poland, Czechoslovakia was more centralized and, according to some observers (see, e.g., Begg 1991), also falling behind in terms of economic growth.

This negative development occurred over four decades. During the post–World War II reconstruction of 1945–47, the country was still a market economy, although large industrial enterprises as well as banking and insurance companies were already nationalized. After the February 1948 Communist takeover, the Soviet system of central planning was introduced into the economy, the remaining private firms were nationalized,[4] and heavy industry was assigned priority in the development strategy. Czechoslovak foreign trade was forcefully reoriented from world markets toward the Soviet bloc countries.

The Czechoslovak government relied on central planning as the operating system throughout the 1950s. The economic slowdown in the early 1960s resulted in reforms, which culminated during the Prague Spring of 1968 with a partial program of price liberalization, an attempt at separating economic policy from political decision making, more enterprise autonomy, and workers' participation in enterprise management. However, the system of central planning was reimposed after the 1968 Soviet-led invasion, and it remained virtually intact until the late 1980s.

Czechoslovakia also had a long history of monetary and fiscal conservatism. Already in 1919, one year after the creation of the country, Czechoslovakia's finance minister, Alois Rasin, took effective measures to terminate within Czechoslovakia the hyperinflation that raged throughout the former Austro-Hungarian Empire. By temporarily closing the border, stamping the Austro-Hungarian currency that was in circulation in the Czechoslovak territory at the time, and recognizing the stamped currency as the only legal tender, he turned Czechoslovakia into an island of stability while hyperinflation continued in all the neighboring economies.[5] This initial conservatism was followed through-

3. The estimated GNP of Czechoslovakia naturally depends on the methodology used. Other studies generate higher estimates.

4. Private agriculture was collectivized or converted into state farms.

5. For details, see, e.g., Sargent (1986, chap. 3).

Table 3.1 Production, Employment, and Unemployment

	1985–89	1989	1990				1990	1991				1991	1992[a]	
			1	2	3	4		1	2	3	4		1	2
Real NMP:														
Index:														
CSFR		100.0	91.8	99.4	96.0	108.6	99.0	87.5	81.8	71.8	77.3	76.9	70.0	69.7
% Δ:[b]														
CSFR	1.95	.7	...	...	...	...	−1.1	−4.6	−11.4	−16.0	−19.5	−19.5	−20.0	−17.5
CR	1.6	.9	...	...	...	...	−1.1	−4.9	−11.7	−16.0	−19.0	−19.0	−18.0	−15.0
SR	2.6	.2	...	...	...	...	−5.8	−5.2	−11.1	−16.0	−18.0	−18.0	...	...
Real GNP:														
Index:														
CSFR	...	100.0	94.5	100.2	97.6	106.1	99.6	91.7	87.4	76.6	79.3	83.8	78.2	77.6
% Δ:[b]														
CSFR	...	...	...	...	...	...	−.5	−3.0	−8.0	−12.5	−15.9	−15.9	−14.7	−13.0
CR	...	...	...	...	...	...	−1.1	−1.9	−10.0	−12.3	−14.1	−14.1	−17.4	−14.0
SR	...	...	...	...	...	...	...	...	−8.0	−13.0	−14.0	−14.0	−18.0	−15.0
Real ind. prod.:														
% Δ:[b,c]														
CSFR	2.4	.7	−2.9	−3.0	−3.7	−3.7	−3.7	...	−15.1	−19.8	−23.1	−23.1	−25.9	−18.9
CR	2.3	1.3	−2.9	−2.8	−3.7	−3.5	−3.5	−8.7	−14.4	−18.8	−22.5	−22.5	−22.7	−18.5
SR	2.6	−.8	−3.1	−3.6	−3.9	−4.1	−4.1	...	−16.7	−20.5	−24.9	−24.9	−25.5	−18.8

(continued)

Table 3.1 (continued)

	1985–89	1989	1990				1990	1991				1991	1992[a]	
			1	2	3	4		1	2	3	4		1	2
Real agri. prod.:														
% Δ:[d]														
CSFR	1.4	1.7	...	...	...	...	−3.9	...	...	...	...	−8.4	...	...
CR	1.0	2.3	...	...	...	...	−2.3	...	...	...	...	−8.9	...	...
SR	2.3	.6	...	...	...	...	−7.2	...	...	...	...	−7.4	...	...
Employment:														
% Δ:[b,e]														
CSFR	.7	.3	−.7	−1.3	−1.7	−2.5	−2.5	−8.4	−9.7	−11.1	−12.5	−12.5	−13.4	−12.2
CR	.6	.6	−.8	−1.3	−1.6	−2.5	−2.5	−8.4	−10.0	−11.2	−12.9	−12.9	−15.0	−13.8
SR	.9	−.2	−.7	−1.3	−1.9	−2.7	−2.7	−8.2	−9.1	−10.7	−11.7	−11.7	−12.3	−11.0
Unemployment rate (%):[f]														
CSFR	...	...	...	...	...	.8	.8	2.3	3.8	5.6	6.6	6.6	6.5	5.5
CR	...	...	...	...	...	.1	.1	1.7	2.6	3.8	4.1	4.1	3.7	2.7
SR	...	...	...	...	...	1.0	1.0	3.7	6.3	9.6	11.8	11.8	12.3	11.3

Source: Federal Statistical Office and Czech Statistical Office.

Note: CSFR = Czech and Slovak Federal Republic; CR = Czech Republic; SR = Slovak Republic.

[a]1992 data for the CSFR, CR, and SR are preliminary. Data for 1990–92 have not yet been made consistent across the CR, SR, and CSFR.

[b]Cumulative percentage change related to the period up to the same quarter in the preceding year.

[c]1991 and 1992 data include small and private enterprises.

[d]Percentage change related to preceding year. Data are not collected on a quarterly basis.

[e]Average number of employees in the state and private enterprises.

[f]End-of-quarter (year) data. Employment = average number of employees in the state and cooperative sectors.

out the two decades of democracy and also until the final phase of Communist rule.

The World Bank estimates of Czechoslovak GNP per capita are based on current exchange rates, and as such they are possibly downwardly biased. Nevertheless, the long-term decline in Czechoslovakia's welfare relative to advanced economies is self-evident. One thus has to accept the official and Western data on Czechoslovakia's long-term economic growth with caution. These data suggest that the most impressive rate of growth occurred during the First Five-Year Plan (1949–53), when the official measure of net material product (NMP) increased nearly 10 percent per annum. However, this rate of growth proved unsustainable. The first half of the 1960s witnessed virtual stagnation and resulted in the subsequent reform. The economy grew at about 7 percent a year during the reform period, 1965–70, and it registered almost 6 percent annual growth in the early to mid-1970s. A major slowdown in the rate of growth to 3.6 percent occurred between 1975 and 1980 as the first oil shock turned the terms of trade against Czechoslovakia within the Council for Mutual Economic Assistance (CMEA). This was also a period of poor agricultural performance.

The 1980s witnessed a further deceleration in economic growth. The world recession, rising input prices, and restrictive government policies resulted in a 1.8 percent growth rate in the first half of the 1980s. As can be seen from table 3.1, the situation did not improve markedly in the second half of the 1980s as the growth rate of NMP was only 1.9 percent a year in the period 1985–89. With economic observers noting that inflation was being underestimated, the 1980s may in fact be seen as a decade of economic stagnation (see, e.g., Dyba 1989).

Other indicators also signaled deterioration in economic performance and increasingly desperate attempts on the part of the Communist government to maintain a degree of public support. The ratio of net fixed investment to NMP fell from 20 percent in 1975 to a mere 13 percent in the late 1980s, and the share of consumption in NMP rose. Export growth slowed down in the 1980s, and exports to developing countries were accompanied to an increasing extent by trade credits. Czechoslovakia became a net creditor within the CMEA, especially vis-à-vis the Soviet Union and Poland. This was increasingly, albeit reluctantly, financed by borrowing in the West.

The long-term deterioration in economic performance was caused by a number of factors. The centralization of the economy after 1948 first created strong growth as the system rapidly mobilized existing resources. Another source of growth was the rapid increase in inputs, which temporarily resulted in a high growth rate. The shortcomings of the command system, which gradually became overwhelming, were the perverse incentives, limited innovation, inefficient allocation of resources, and rigidities. These latter factors became particularly important as demand patterns started to change, input growth could no longer be sustained at the high rates, and the quality of marginal inputs declined. Czechoslovakia also suffered from its isolation from world markets and its extreme reorientation toward trade within the CMEA. This reorientation increased the technological backwardness of Czechoslovak industry and its vulnerability to disruptions in the CMEA markets.

3.2 The Principal Measures during Stabilization and Transition

3.2.1 The Start of Economic Transformation, 1989–90

The November 1989 revolution brought in a liberally oriented transitional government and created expectations of a radical economic transformation from a command to a market economy. The new government immediately devalued the koruna (Kčs) vis-à-vis the convertible currencies, revalued it vis-à-vis the ruble, and tightened budgetary policies for 1990, setting itself the target of a 1–1.5 percent budget surplus. The government also declared that the introduction of a market economy and integration with the Western economies would be the key to reestablishing economic prosperity. Specific proposals for the strategy of economic transformation were quickly put forth (see, e.g., Svejnar 1989), but disagreement also emerged about both the direction of the economic transition and the nature and timing of specific measures. As a result, a government economic strategy reflecting the principles outlined above was not officially adopted until 24 May 1990.

The 8–9 June parliamentary elections brought in a coalition that broadly favored the market-oriented transformation.[6] The new government in principle adopted the 24 May economic resolution, but few significant economic measures were adopted in the immediate postelection period. The two important measures were the elimination of a negative turnover tax, which was accompanied by a Kčs 140 compensation for each citizen on 9 July 1990, and the gradual start of negotiations of new commercial policies with various market economies and organizations such as the EEC.

The main reason for delaying the economic transformation was the fact that other factors made rapid progress in designing and implementing an economic transition problematic. The most important of these factors were the inability to achieve consensus on the details of an economic program within the executive branch of the federal government, the desire of the new Parliament to play a major role in preparing economic laws and policies, the need to create a new set of economic laws,[7] and the start of difficult negotiations about the relative

6. The election brought about major personnel changes in the federal Parliament, with the broadly based Civic Forum and Public Against Violence parties together winning 170 of the 300 total seats, the Communist party retaining only forty-seven seats, and the Christian Democratic Alliance capturing forty seats. Less extensive personnel turnover took place in the executive branch since many of the ministers of the transitional government belonged to the newly formed coalition among the Civic Forum, Public Against Violence, and Christian Democrat parties.

7. An alternative would have been to adopt temporarily a modified set of Western (e.g., German or EEC) laws. However, in view of the voluminous nature of Western legal statutes and the paucity of skilled translators, it turned out to be simpler to create a new set of Czechoslovak laws.

jurisdictions of the federal and the two national (Czech and Slovak) governments.

On 1 September 1990, the government formally submitted to the Parliament a "scenario of economic reform." The document outlined economic and social principles, specific measures, and time parameters. It was also a political document that reflected the compromises that were hastily concluded among the major groups in the Parliament.

On the macroeconomic front, the scenario emphasized a strict anti-inflationary policy. All other macroeconomic goals (growth, employment, and balance of payments) were "within reasonable limits" subordinate. In order to realize the anti-inflationary policy, the government set as specific 1990 policy targets zero growth of money supply and a budget surplus of at least 1–1.5 percent.[8] Measures proposed for 1991 were a continuation of the earlier set of policies, but they were more far reaching in that they included a restrictive monetary policy, a 2–2.5 percent budget surplus, a convertible koruna for current account transactions, and a positive real interest rate.

The proposed micro policies aimed at inducing efficient allocation of resources, introducing new institutions, and minimizing the social costs of transition. The micro transformation was to be achieved through (*a*) a major tax reform emphasizing the introduction of a value-added tax, a personal income tax, and an "enterprise" tax, (*b*) a budgetary reform stressing independence of units and ensuring the transparency of budgetary allocations, (*c*) de-étatization and privatization of property, (*d*) price liberalization, (*e*) internal convertibility of the koruna, (*f*) reduction and retraining of redundant labor, (*g*) legalization of collective bargaining together with a high tax on wage growth exceeding limits set by government, and (*h*) restructuring of social security and health care systems and a gradual separation of their funding from the state budget.

The Parliament speedily approved the scenario, but it immediately faced the problem of how to draft and pass the large number of laws and decrees that needed to be put in place before the transformation would be launched on 1 January 1991. This indeed proved to be a major burden, and the resulting fatigue was increasingly visible. The introduction of some widely expected laws (e.g., those related to the privatization of small enterprises) was consequently delayed.

3.2.2 Transformation Measures Undertaken in 1991 and 1992

On 1 January 1991, the government launched a major set of reforms, consisting of liberalizing 85 percent of producer and consumer prices, devaluing the koruna and pegging it to a basket of five Western currencies, introducing internal convertibility of the koruna together with a 20 percent import surcharge, controlling the growth of wages, and activating a social safety net.

These radical measures were introduced in the context of a proclaimed determination to pursue restrictive macro policies, and they were supplemented

8. These goals were in fact pursued from the start of 1990.

by a strong push to speed up the privatization process, attract foreign capital, promote the growth of private firms, decrease government subsidies to firms as well as some other government expenditures (e.g., on arms), and generally reduce the role of the state in the economy. In many respects, the measures introduced by the Czechoslovak authorities in January 1991 resembled those launched by the Poles a year earlier.

The broad quantity targets declared by the government for 1991 were to limit inflation in terms of the GDP deflator to 30 percent, GDP decline to 5–10 percent, unemployment to a 4.5 percent annual average rate, and real wage decline to 10 percent. The target for the current account was a deficit of Kčs 2.5 billion.

For 1992, the government set itself the target of at least partially liberalizing the remaining controlled prices, especially in the area of apartment rents, transportation and communication, and water and sewage. Money supply was to increase 10–15 percent, while the exchange rate policy was to remain unchanged. Unemployment was expected to rise further, and the government intended to maintain an incomes policy for state enterprises with more than 150 employees. Privatization of small units was to continue,[9] and that of large firms was to be launched on a large scale, covering about twenty-five hundred out of a total of about six thousand state enterprises in the first privatization wave.

Additional likely measures were to include lower interest rates to stimulate investment, stronger indirect support for small- and medium-sized enterprises, regional policies, development of a more efficient banking sector through privatization and greater independence of commercial banks as well as increased competition, greater regulation of certain parts of the capital market (e.g., the investment privatization funds), gradual introduction of a new tax system together with superior tax collection and enforcement, restructuring (deétatization) of social security, and further liberalization of foreign trade.

The government generally persevered in pursuing the policies set for 1991 and 1992, but, as we will show presently, it did not reach all its targets. In terms of policy implementation, one can see from table 3.2 that bank credit to state enterprises and households was held in check, rising somewhat in nominal but falling significantly in real terms in 1991 and declining absolutely in 1992. In contrast, bank credit to private enterprises rose from almost zero in mid-1990 to Kčs 71.4 billion at the end of 1991 and Kčs 125.7 billion in mid-1992. Credit to private firms thus became equivalent to 12 percent of credit extended by banks to state enterprises at the end of 1991 and 22.3 percent in mid-1992. In 1991, the rise in this ratio reflected the growing emphasis on credit expansion for the newly forming private firms. In 1992, the increase also reflected the transformation of large state enterprises into private joint-stock companies.

9. Between January 1991 and June 1992, over 25,000 units were sold in auctions. Prices ranged from several hundred dollars to a record price exceeding $10 million.

Table 3.2 **Credit to Enterprises and Households (Kčs billion)**

			1990					1991					1992	
	1985–89	1989	1	2	3	4	1990	1	2	3	4	1991	1	2
Bank credit to state enterprises:[a]														
CSFR	524.3	530.9	524.4	532.9	540.3	529.8	529.8	558.4	586.6	599.9	575.3	575.3	574.0	564.9
CR	355.1	360.5	314.3	387.6	395.4	383.0	383.0	397.1	414.2	420.0	403.7	403.7	398.1	390.5
SR	169.2	170.4	210.1	145.3	144.9	146.8	146.8	161.3	172.4	179.9	171.6	171.6	175.9	174.4
Bank credit to private enterprises:[a]														
CSFR	...	...	...	.5	1.4	3.4	3.4	9.3	24.7	40.5	71.4	71.4	85.4	125.7
CR	...	...	...	.4	1.1	2.8	2.8	7.7	20.5	33.1	55.5	55.5	64.3	94.4
SR	...	...	...	.1	.3	.6	.6	1.6	4.2	7.4	15.9	15.9	21.1	31.3
Interenterprise debt (credit):[a,b]														
CSFR	25.0	7.2	10.6	13.8	27.8	53.6	53.6	76.4	56.8	...	...	...	...	...
CR	18.7	4.8	6.4	8.3	18.0	37.8	37.8	56.5	32.1	...	...	...	...	...
SR	6.3	2.4	4.2	5.5	9.8	15.8	15.8	19.9	24.7	...	...	...	...	...
Interenterprise debt (credit):[a,c]														
CSFR	...	...	...	...	...	...	44.9	78.6	123.4	147.1	145.4	145.4	143.3	123.7
CR	...	...	...	...	...	...	31.8	55.6	88.8	100.2	101.7	101.7	98.8	79.3
SR	...	...	...	...	...	...	13.1	23.0	34.6	46.9	43.7	43.7	44.5	44.4
Bank credit to households:[a]														
CSFR	42.1	46.9	44.5	47.1	47.2	50.0	50.0	51.2	51.6	52.7	55.4	55.4	56.3	55.7
CR	26.5	29.5	27.2	29.8	29.9	31.8	31.8	32.4	33.2	33.9	36.2	36.2	37.4	37.2
SR	15.6	17.4	17.3	17.3	17.3	18.2	18.2	18.8	18.4	18.8	19.2	19.2	18.9	18.5

Source: Federal Statistical Office, Czech Statistical Office, and the Czechoslovak State Bank.

Note: CSFR = Czech and Slovak Federal Republic; CR = Czech Republic; SR = Slovak Republic.

[a]End-of-quarter (year) data.

[b]Frozen payments due to insufficient balances in the bank accounts of debtor enterprises (bank data).

[c]Unpaid obligations past maturity data (enterprise accounts).

As can be seen from table 3.3, all three measures of money supply (M0, M1, and M2) grew at less than half the rate of inflation in both 1990 and 1991. The more expansive monetary policy, preannounced for 1992, is visible in the-data as of the second quarter of 1992. The restrictive money supply policy of 1990–91 was accompanied by rising (not freely set until mid-1992) interest rates. The government also permitted the protected banking sector to establish a sizable spread between the interest rates on loans and deposits, thus allowing the banks to build up reserves. The official, unified exchange rate, established at the start of 1991, was set near the parallel market rate, and the differential between the two has remained quite small. Czechoslovakia's modest foreign debt increased from $8.1 billion at the end of 1990 to $9.4 billion by the end of 1991 as the country borrowed $2.135 billion in 1991.[10] However, the increased debt was fully reflected in increased foreign currency reserves, which rose from $1.2 billion in December 1990 to $3.3 billion in December 1991. The debt remained virtually unchanged in the first half of 1992, thus testifying to the country's ability to proceed with the economic transformation without incurring a major foreign debt burden.

As can be seen from table 3.4, fiscal policy was initially somewhat less successful. After finishing 1990 with a minor surplus, registering significant budget surpluses in the first six months of 1991, and still achieving small surpluses until October, the government ended 1991 with a Kčs 22.1 billion deficit. While this deficit constituted only 5 percent of budget expenditures, it reflected a potentially problematic dynamics. In particular, the early surpluses were brought about primarily by high enterprise income and profit taxes, which reflected the initial profitability after price liberalization,[11] and the still relatively low level of unemployment compensation and other expenditures. As enterprise profits declined and additional state expenditures on health and education were approved by republican Parliaments in October, government expenditures began to exceed revenues. It is interesting to note that, while unemployment rose dramatically during the year, the level of unemployment compensation expenditures did not reach the level of reserves allocated for this purpose. Rather, the achievement of zero inflation led to pressure to increase government expenditures, which were automatically processed by the banks. The initial success with inflation thus reduced fiscal coordination and resulted in reduced policy control.

For 1992, the government has agreed to decrease agricultural subsidies and improve the targeting of the social safety net. The goal is to reduce current and increase investment expenditures in real terms. As can be seen from table 3.4,

10. The loans were provided as follows: $1,313 million from the International Monetary Fund, $205 million from the World Bank, $248 million from the European Community, $89 million from the G-24, and $280 million from the financial sector.

11. The high profitability reflected both the fact that enterprises accumulated raw material inventories before price liberalization and the custom of paying income and profit taxes on the value of delivered rather than paid-for goods.

Table 3.3 **Money Supply, Interest Rate, Exchange Rate, and External Debt**

			1990					1991					1992	
	1985–89	1989	1	2	3	4	1990	1	2	3	4	1991	1	2
Money supply (% Δ):[a]														
M0	5.5	8.8	2.9	6.5	7.7	8.4	8.4	−1.1	3.4	9.5	20.0	20.0	−2.5	7.5
M1	4.0	.5	−7.4	−2.5	−5.3	−6.4	−6.4	−3.4	−1.1	9.8	28.8	28.8	−4.1	.8
M2	5.8	3.5	−2.3	−.2	−1.5	.5	.5	−.3	5.6	12.4	27.3	27.3	2.0	7.1
Nominal interest rate (%):[b]														
Loans	5.1	5.0	5.4	5.4	5.6	7.6	5.9	14.7	15.1	14.2	13.9	14.5	13.5	13.7
Deposits	3.1	3.2	2.6	2.7	2.8	3.3	2.8	7.6	8.2	8.6	8.0	8.1	8.7	6.9
Exchange rate (Kčs/$):[b]														
Commercial	15.1	15.1	16.5	16.6	16.0	22.7	18.0	...	...	...	...	...	...	...
Tourist	...	...	37.6	30.2	27.0	31.0	30.9	...	...	...	...	...	...	...
Auction	...	121.2	78.8	48.0	34.3	41.1	50.4	...	...	...	...	...	...	...
Parallel market	33.70	42.4	41.5	36.3	33.3	41.0	38.0	34.1	31.7	32.5	30.8	32.3	30.2	30.0
Official (unified)	...	...	...	...	...	...	...	27.9	30.3	30.5	29.2	29.5	28.8	28.8
External debt ($ billion)[c]	6.2	7.9	7.4	7.1	7.6	8.1	8.1	8.3	8.8	9.3	9.4	9.4	8.9	9.8

Source: The Czechoslovak State Bank.

[a]End-of-quarter (year) data reflecting changes relative to the end of the previous year. M0 = currency; M1 = M0 plus demand deposits; M2 = M1 plus time deposits and foreign currency deposits.

[b]Average rate in respective quarter (year).

[c]End-of-quarter (year) data.

Table 3.4 **Fiscal Budgets of the Czech and Slovak Federal Republic (billions of current Kčs)**

	1989	1990	1991	1992[a]
Revenue	306.7	339.9	460.9	307.5
Turnover tax	74.7	108.5	123.1	79.0
Income & profit tax	74.1	79.0	129.2	77.7
Payroll taxes	78.2	79.6	150.4	107.8
Other revenue	79.7	72.8	58.2	43.0
Expenditures	312.2	339.1	483.0	304.8
Subsidies to enterprises	51.4	48.7	59.4	24.7
Social security	91.6	95.8	123.8	90.7
Subsidies to local budgets	52.5	58.1	72.0	23.2
Other expenditures	116.7	136.5	233.8	166.2
Surplus (deficit)	(5.5)	.8	(22.1)	2.7

Source: Federal Ministry of Finance.
[a]January–August data.

the consolidated budget was maintained in surplus during the first eight months of 1992, with the Czech Republic running a slight surplus and the Slovak Republic running a deficit.

3.2.3 External Shocks

In assessing the effect of the Czechoslovak stabilization and transition policies, one must bear in mind that these policies were carried out in the context of the disintegration of the CMEA and the decline in economic activity among the traditional trading partners. The absorption of East Germany by West Germany in 1990 represented the first shock as East Germany was a major trading partner, accounting for approximately 10 percent of Czechoslovakia's foreign trade. Further shock came from the disintegration of the Soviet economy and the reduced demand from recession-stricken East European trading partners. Finally, the switch from CMEA trade to free trade based on world prices on 1 January 1991 resulted in a significant shift in the terms of trade against Czechoslovakia. Official calculations point to a 26 percent worsening of Czechoslovakia's terms of trade in the first quarter, 28 percent in the second quarter, and a cumulative 22 percent decline in the first three quarters of 1991.

3.3 Economic Developments in 1989–92

As can be seen from table 3.1 above, the slowdown in NMP growth to 0.7 percent in 1989 turned into a 1.1 percent decline in 1990 and a further 19.5 percent decline in 1991. The sizable decline in 1991 was accounted for primarily by a 23.1 percent fall in industrial production as agriculture declined by a more modest 8.4 percent. Slovakia experienced a somewhat greater decrease in industrial production (24.9 percent) than the Czech lands (22.5 percent) but also a shallower decline in agricultural production (7.4 vs. 8.9 percent, respectively). The Czechoslovak authorities started to calculate GNP in 1991, and their estimates suggest that this indicator of performance registered a 16 percent decline in 1991.

As the indices as well as the cumulative percentage change figures in table 3.1 indicate, the decline in officially measured NMP continued into the second quarter of 1992. In contrast, GNP has remained relatively stable since the third quarter of 1991, thus confirming the stronger performance of the service sector relative to the rest of the economy.

It is important to stress that there are several important deficiencies of the official data. First, price increases tend to be overestimated as a result of structural changes in reporting. In particular, data from stores indicate that there has been a lower decline in sales than is generally assumed, thus pointing to an overestimation of price increases for a given value of sales. Second, the official data underestimate the growth of the private (informal) sector, which escapes the official statistical and tax coverage. Hence, although table 3.1 is meant to cover all enterprises, it is not clear to what extent the attempt has been successful. Finally, foreign trade appears to be severely underestimated as mirror statistics from the OECD report higher levels of Czechoslovak exports and imports than appear in the Czechoslovak customs data (see table 3.5–3.7).

As is evident from table 3.1 above, the modest growth in employment over the mid- to late 1980s turned into a decline in 1990. With a 2.5 percent employment decrease in 1990, a 12.5 percent fall in 1991, and a 10 percent decline in the first half of 1992, enterprises clearly carried out sizable reductions in employment. This is further accentuated by the fact that average hours worked declined in most enterprises owing to the elimination of overtime and other measures. Nevertheless, through the end of 1991, employment declined in a less pronounced way than production. The data for the first two quarters of 1992 suggest that performance is improving, especially in construction.

The employment pattern that has emerged is that the initial labor force re-

Table 3.5 Czechoslovak Foreign Trade (billions of current Kčs, f.o.b.)

	1989	1990	1991	1992[a]
Exports	217.5	216.5	321.2	176.7
"Socialist" countries	132.3	106.7	126.3	43.5
Market economies	85.2	109.8	194.9	133.2
Imports	214.7	246.3	293.7	171.7
"Socialist" countries	133.8	125.7	125.9	62.7
Market economies	80.9	120.6	167.8	109.0
Surplus (deficit)	2.8	(29.8)	27.5	5.0

Source: Federal Statistical Office.

[a]January–July data.

Table 3.6 **Czechoslovak Imports from OECD Countries in 1989–92 (all data are monthly averages, $million)**

			1991					
Country	1989	1990	1	2	3	4	1991	1992:1
OECD	306.0	406.0	518.0	461.0	458.0	658.0	565.0	. . .
EEC	219.0	277.0	406.0	347.0	340.0	487.0	394.0	. . .
EFTA	68.2	106.3	86.3	92.1	98.3	138.7	103.4	. . .
United States	4.5	7.4	10.2	9.7	8.0	13.5	10.3	33.5
Japan	4.6	4.2	7.3	4.2	5.4	6.0	5.7	9.0
Austria	31.6	64.1	52.2	55.0	63.0	91.6	65.5	84.44
France	19.4	23.9	80.2	27.7	22.6	33.9	40.1	35.3
Germany	121.9	160.7	231.4	216.6	232.3	320.5	250.2	337.4
Italy	23.8	32.4	30.9	40.6	29.2	49.1	37.9	52.6
Netherlands	14.1	16.3	18.7	17.7	16.1	26.2	19.6	27.4
Spain	4.3	4.7	5.6	4.5	2.4	5.0	4.3	5.87
Sweden	9.0	12.2	11.0	9.8	10.0	15.61	11.63	19.15
Switzerland	18.1	20.8	19.0	19.4	18.9	23.7	19.8	19.75
United Kingdom	17.9	19.7	18.9	16.3	14.8	26.5	19.0	26.0
Yugoslavia	35.2	38.6	24.7	27.0	N.A.	N.A.	N.A.	N.A.

Source: OECD, monthly statistics of foreign trade.
Note: N.A. = not available. EFTA = European Free Trade Association.

Table 3.7 **Czechoslovak Exports to OECD Countries in 1989–92 (all data are monthly averages, $million)**

			1991					
Country	1989	1990	1	2	3	4	1991	1992:1
OECD	347.0	408.0	476.0	500.0	546.0	678.0	551.0	. . .
EEC	238.0	285.0	359.0	381.0	416.0	532.0	423.0	. . .
EFTA	76.2	84.3	80.7	77.5	83.0	100.9	85.5	. . .
United States	7.2	7.3	9.2	10.1	13.0	15.8	12.0	17.8
Japan	10.8	10.7	10.3	11.4	7.7	12.9	10.5	10.5
Austria	42.4	47.1	44.2	46.7	53.1	68.1	53.0	61.78
France	22.4	29.0	28.9	30.4	31.3	35.4	31.5	39.8
Germany	110.7	140.2	215.1	220.5	259.8	328.2	255.9	33.49
Italy	33.8	39.9	38.5	49.0	43.5	72.5	51.5	68.1
Netherlands	16.0	18.6	22.2	21.7	21.2	25.3	22.6	16.0
Spain	7.3	7.3	7.3	9.2	8.3	11.2	9.04	12.68
Sweden	9.6	10.4	10.9	9.8	9.8	10.67	10.29	12.86
Switzerland	10.4	9.9	9.9	10.3	8.9	10.77	9.96	10.39
United Kingdom	21.4	20.1	16.5	19.1	19.8	21.5	19.3	22.3
Yugoslavia	40.8	43.1	52.6	68.2	N.A.	N.A.	N.A.	N.A.

Source: OECD, monthly statistics of foreign trade.
Note: N.A. = not available. EFTA = European Free Trade Association.

ductions usually took the form of retirements and the termination of guest workers. This was followed by hiring freezes and, eventually, layoffs. Among the Czechoslovak workers, hardest hit at first were hence the labor force entrants (especially young people) as insiders in state enterprises temporarily insulated themselves from the effect of the external shock and the transition. Interestingly, as layoffs began to take place, the effect was inversely proportional to age, with the older (preretirement-age) workers suffering the lowest unemployment rate. However, as the transition entered its second full year in 1992, one began to observe significant layoffs among the workers of preretirement age as well.

As the unemployment data in table 3.1 indicate, unemployment was a virtually unknown phenomenon in Czechoslovakia until the second half of 1990. Unemployment became serious in 1991, the overall rate rising from less than 1 percent at the start of the year to 6.6 percent at year's end. The Czechoslovak government estimates that about one-third of reported unemployment in 1991 was fictitious, covering individuals who were gainfully employed but collecting unemployment benefits or those who did not actively look for work. The reduction of the unemployment benefits and the halving of the eligibility period from one year to six months at the start of 1992 contributed to the fall in the unemployment rate from 6.6 to 6.5 percent in the first quarter and 5.5 percent in the second quarter of 1992. Other factors that are cited by officials in the federal as well as the Czech and Slovak labor ministries as possibly contributing to this unexpected decline in the unemployment rate are the boom in the private sector of the economy, the active labor market policies of the government, and the unwillingness of directors of state enterprises to lay off workers and risk conflict before privatization.

There has been a remarkable asymmetry across the Czech and Slovak republics in unemployment dynamics. While employment declined by about 2.5 percent in 1990 and by 12–13 percent in 1991 in both republics, unemployment has risen much more rapidly in Slovakia. By the end of 1991, the unemployment rate was 4.1 percent in the Czech lands and 11.8 percent in Slovakia. Moreover, in the first quarter of 1992, the unemployment rate fell from 4.1 to 3.7 percent in the Czech Republic but increased from 11.8 to 12.3 percent in the Slovak Republic. The discrepancy in the unemployment rates of the two republics reflects a faster rise of the private sector in the Czech Republic, a more liberal application of unemployment compensation and severance pay policies in Slovakia, a stronger tendency for older workers to take (early) retirement in the Czech Republic, and the higher propensity of Czech workers to find employment in Austria and Germany. Interestingly, starting in the second quarter of 1992, one can observe a downward trend in the unemployment rate in Slovakia as well. Both republics registered a one-point decline in the unemployment rate in the second quarter, resulting in a 2.7 percent rate in the Czech lands and 11.3 percent in Slovakia. The preliminary data for October 1992

Table 3.8 **Prices, Wages, and Consumption**

			1990					1991					1992[a]	
	1985–89	1989	1	2	3	4	1990	1	2	3	4	1991	1	2
Consumer price index:[b]														
CSFR	1.0	1.4	2.4	3.1	13.6	18.4	18.4	40.9	49.2	49.5	53.6	53.6	1.8	3.0
CR	1.0	1.5	2.2	2.7	13.3	17.5	17.5	39.3	48.0	48.1	52.0	52.0	2.2	3.8
SR	.9	1.3	2.3	3.8	14.0	19.2	19.2	44.9	51.6	53.4	58.3	58.3	1.4	1.9
Producer price index for industry:[b]														
CSFR	.2	−.7	.3	.4	.5	16.6	16.6	48.1	53.7	53.0	54.8	54.8	2.9	5.2
CR	.4	.1	.5	.6	.7	15.6	15.6	48.7	54.2	54.5	56.6	56.6	3.2	6.0
SR	−.2	−2.7	−.2	−.1	.0	19.4	19.4	45.3	51.5	48.7	50.6	50.6	2.3	3.6
Nominal earnings (% Δ):[c]														
CSFR	2.0	2.4	3.6	2.7	2.8	3.6	3.6	6.0	10.5	12.2	16.4	16.4	21.2	22.1
CR	2.0	2.4	3.5	2.6	2.7	3.4	3.4	5.8	13.8	12.3	16.3	16.3	21.3	23.0
SR	2.1	2.6	3.7	2.9	3.0	3.9	3.9	6.1	10.8	12.2	16.6	16.6	20.5	19.7
Real personal consumption (% Δ):[b]														
CSFR	2.9	1.8	...	...	...	...	1.1	−26.0	−37.1	−34.3	−33.1	−33.1	−4.6	5.0
CR	2.8	1.6	...	...	...	...	1.7	−24.0	−29.0	−33.5	−29.0	−29.0	...	...
SR	3.3	2.1	...	...	...	...	.5	...	...	...	...	...	...	...

Source: Federal Statistical Office and Czech Statistical Office.

Note: CSFR = Czech and Slovak Federal Republic; CR = Czech Republic; SR = Slovak Republic.

[a]1992 data are preliminary.

[b]Refers to end-of-quarter (year) data, which are cumulative, reflecting changes relative to the end of the previous year.

[c]% change related to the same period in the preceding year.

suggest that the unemployment rate in the two republics stood at 2.6 and 11.2 percent, respectively.

After decades of seeming stability,[12] consumer prices registered an 18.4 percent increase in 1990, a major 53.6 percent jump in 1991, and a mere 3 percent rise in the first two quarters of 1992 (see table 3.8). The 1990 increase was brought about primarily by the removal of the negative turnover tax in July and the devaluation of the koruna in the fall. The 1991 and 1992 price increases, the dynamics of which are captured in detail in table 3.9, reflected the liberalization of 85 percent of all prices on 1 January 1991, followed by the liberalization of 10 percent of prices in the rest of 1991 and in the first half of 1992. As can be seen from table 3.9, the 1991 price liberalization resulted in a 26 percent jump in consumer prices in January and a gradual tapering off of inflation in the following five months. Indeed, consumer prices still increased by 7 percent in February and almost 5 percent in March, but the monthly rate of increase remained at or below 2 percent in the second quarter of 1991. The economy registered complete price stability from July to October, but then consumer prices rose again by 1.6 percent in November and 1.2 percent in December. Monthly inflation fell well below 1 percent in the first eight months of 1992 but jumped by 1.8 percent in September. The authorities expect a 10–12 percent inflation rate for all of 1992.

While the price rise associated with the July 1990 elimination of the negative turnover tax was accompanied by a compensating adjustment in incomes, other price increases and the price liberalization of 1991 were carried out in the presence of relatively tight controls on wages, at least through the first half of 1991. As can be seen from table 3.8 above, nominal earnings increased by a mere 3.6 percent in 1990 and 16.4 percent in 1991. Real earnings, measured as nominal earnings relative to the consumer price index, hence declined by 12.5 percent in 1990 and 24 percent in 1991. Personal consumption, which still registered a modest 1.1 percent increase in 1990, declined precipitously, falling 33 percent in 1991. The decline in the conventionally measured living standard has thus been considerable for an average consumer. At the same time, the rise of unemployment was stemmed and the success of the stabilization program undoubtedly aided by the ability of the authorities to keep the labor cost per worker down. It is worth noting that the situation appears to have changed in the first quarter of 1992 as real wages have surged ahead by about 8 percent.

There also appears to have been considerable widening of income differentials and stratification in social status. For many individuals, especially

12. As mentioned earlier, the long-term price stability under the Communist regime was in part generated at the expense of shortages. In addition, it also reflected data manipulation in the construction of the baskets of commodities for price indices.

Table 3.9 **Consumer and Producer Prices in 1991 (% Δ relative to preceding month)**

	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.
1991:												
Consumer prices:												
CSFR	25.8	7.0	4.7	2.0	1.9	1.8	−.1	.0	.3	−.1	1.6	1.2
CR	25.8	6.1	4.3	2.4	1.9	1.8	−.3	.0	.3	.2	1.4	1.1
SR	25.9	8.8	5.8	.8	1.9	1.8	.5	.5	.1	−.4	1.7	1.9
Producer prices in industry:												
CSFR	24.0	19.3	.1	2.9	1.7	−.8	−.5	.4	−.4	.0	.9	.6
CR	20.4	22.4	.9	3.0	1.5	−.8	−.1	.6	−.3	−.2	1.2	.4
SR	33.0	12.3	−2.7	2.6	2.2	−.6	−1.5	.2	−.5	.4	.1	.7
1992:												
Consumer prices:												
CSFR	1.0	.5	.4	.5	.4	.3	.8	.6	1.8	...	...	...
CR	.9	.7	.6	.6	.5	.4	.6	.6	1.9	...	...	...
SR	1.2	.2	.0	.1	.2	.2	−.2	.6	1.7	...	...	...
Producer prices in industry:												
CSFR	1.0	1.9	.1	.5	1.1	.6	.6	.0	.3	...	...	...
CR	1.0	2.0	.2	.8	1.3	.6	.7	.2	.5	...	...	...
SR	.9	1.7	−.3	−.1	.8	.6	.5	−.4	−.1	...	...	...

Source: Federal Statistical Office and Czech Statistical Office.
Note: CSFR = Czech and Slovak Federal Republic; CR = Czech Republic; SR = Slovak Republic.

those losing in relative terms, this has been hard to accept. The ability of the government to keep the social peace has thus been a remarkable achievement, and it remains to be seen if the situation will remain as peaceful in the future.

The restrictive economic policy, external shocks, and the nature of the transformation process also resulted in a major decline in investment activity. As can be seen from table 3.10, real net fixed investment rose by a mere 2.9 percent in 1990 and declined by a full 20 percent in 1991. Preliminary estimates indicate that the decline has continued in 1992. Given the low product demand, restrictive macro policies, and uncertainty over the transfer of property rights, enterprises have thus opted to cut down on investment.

The savings data, reported in tables 3.10 and 3.11 in nominal terms, imply a major decline in the propensity to save in koruny in 1990 and the first half of 1991. There was a more substantial increase in koruna savings in the second half of 1991 and the first two quarters of 1992, but the increase still fell short of the increase in nominal earnings of the population. Over the last two years,

Table 3.10 **Investment and Savings**

			1990					1991					1992[a]	
	1985–89	1989	1	2	3	4	1990	1	2	3	4	1991	1	2
Real net fixed investment (% Δ):														
CSFR	2.8	3.1	...	...	...	...	2.9	−10.0	−28.3	−22.0	−20.0	−20.0	...	...
CR	2.3	1.7	...	...	...	...	2.7	−12.0	−20.0	−15.0	−13.0	−13.0	...	...
SR	3.5	4.1	...	...	...	...	3.2	...	...	...	...	...	...	...
Savings of population in Kčs (% Δ):[b]														
CSFR	2.3	4.6	.8	1.2	.9	−2.6	−2.6	−1.2	.1	2.6	12.7	12.7	3.0	4.7
CR	5.8	4.0	.9	1.4	1.1	−2.0	−2.0	−.8	1.9	4.6	14.7	14.7	3.0	5.5
SR	4.4	5.8	.7	.9	.4	−3.9	−3.9	−2.3	−3.7	−1.8	8.5	8.5	3.1	3.0
Savings of enterprises in Kčs (% Δ):[b]														
CSFR	6.0	2.8	−18.7	−14.1	−15.4	−15.8	−15.8	−.0	7.4	11.3	34.9	34.9	2.8	4.7
CR	...	...	...	...	...	...	...	3.3	10.4	15.0	31.3	39.3	6.5	8.0
SR	...	...	...	...	...	...	...	−7.5	.6	2.9	25.3	25.3	−6.3	−3.6

Source: Federal Statistical Office, Czech Statistical Office and The Czechoslovak State Bank.

Note: CSFR = Czech and Slovak Federal Republic; CR = Czech Republic; SR = Slovak Republic.

[a]1992 data are preliminary.

[b]End-of-quarter (year) data reflecting changes relative to the end of the previous year.

Table 3.11 **Savings in Foreign Currencies (Kčs billion)**

	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.
1990:												
Enterprises	...	...	3.9	4.3	4.8	6.0	6.1	7.6	8.7	11.2	12.7	18.0
Households	2.1	2.3	2.8	1.8	2.0	3.7	3.9	4.2	3.2	7.1	6.5	10.2
1991:												
Enterprises	15.0	15.5	14.1	21.7	21.2	21.1	21.5	21.6	22.8	21.8	19.5	19.8
Households	11.3	12.6	14.0	15.4	16.7	18.2	19.2	21.1	22.3	23.2	24.4	26.6
1992:												
Enterprises	20.0	19.4	21.9	21.9	26.6	26.0	26.1					
Households	29.8	31.2	35.1	36.3	37.6	39.8	42.3					

Source: The Czechoslovak State Bank.
Note: End-of-month data.

there has also been a steady increase in the savings in foreign currencies. These figures, reported in billions of koruny in table 3.11, reflect not only the savings patterns but also the relative fluctuations of the major Western currencies over time.

As can be seen in table 3.2 above, a major response of enterprises to the restrictive monetary and fiscal policies has been an increasing reliance on interenterprise debt (credit). There are two data series that permit one to assess the extent of this phenomenon in Czechoslovakia. The first one—frozen bank payments due to insufficient balances in the bank accounts of debtor enterprises—captures the extent of insolvency of firms as reflected in this one measure. The series shows a major and continuous rise through the first quarter of 1991 in both republics, exceeding 10 percent of total bank credit to all enterprises from the third quarter of 1990 on. The series reportedly registered a significant decline in the Czech Republic in the second quarter of 1991, the period when the banks decided to discontinue the collection of these data.[13]

The second data series refers to unpaid obligations of enterprises as shown in enterprise accounts. This series has been collected continuously since 1990, and it has the advantage that it also contains direct interenterprise debt that is not channeled through banks. The series depicts a major rise in interenterprise debt from Kčs 45 billion at the end of 1990 to Kčs 145 billion at the end of 1991. Hence, while the interenterprise debt was equal to 8.4 percent of the total bank credit to enterprises at the end of 1990, by the end of 1991 it had jumped to over 28 percent. This is a significant rise, one that potentially represents an enormous problem for the government and the banks. It also in large

13. The decision to discontinue the collection of the data was related to the disintegration of the traditional monobank system and the reported difficulty in tracking frozen payments across the growing number of commercial banks.

part explains why virtually no state enterprises have gone bankrupt in the presence of the seemingly very restrictive macroeconomic policies and great external shocks. The government has been aware of the problem, and in the fall of 1991 it allocated Kčs 50 billion from its (future) privatization income to the banks for the purpose of increasing their capitalization and partially (selectively) reducing the bank debt of promising enterprises. The data on interenterprise debt show a major decline in the first half of 1992 to Kčs 123.7 billion. This is welcome news for the government, but the accuracy of this series for recent months needs to be checked.

As far as foreign trade is concerned, Czechoslovakia carried out a major structural transformation. After registering a significant trade deficit in 1990, Czechoslovakia appears to have achieved a surplus in 1991 (table 3.5 above). Other official data also indicate that trade with the (former) socialist economies accounted for more than 60 percent of the total trade in 1989 but that this share dropped to about 50 percent in 1990 and 40 percent in 1991. Trade in nonconvertible currency basically disappeared in 1991, and Germany replaced the Soviet Union as Czechoslovakia's main trading partner, accounting for almost one-quarter of Czechoslovakia's foreign trade.

A major controversy surrounds the question of whether trade contracted or expanded during the transition. Official estimates suggest that the physical volume of exports declined 30 percent and imports 31 percent in the first six months of 1991 and that a slight rebound in exports occurred thereafter. A relevant source of data in this context is the OECD. The OECD data, presented in tables 3.6 and 3.7 above, suggest that Czechoslovak exports to OECD countries have grown strongly and continuously between 1989 and the first quarter of 1992. These data also indicate that Czechoslovak imports from OECD countries grew until the first quarter of 1991, declined by about 10 percent in the second and third quarters of 1991, and rebounded strongly in the fourth quarter. The OECD data hence paint a much more optimistic picture of trade expansion than the official Czechoslovak data. Since the official Czechoslovak data are based on incomplete customs statistics, it appears that the OECD data may provide a better reflection of trade performance with the advanced countries.

3.3.1 Privatization

Privatization is the cornerstone of the transformation program, and arguably the success of the transition hinges on the ability of the government to transform the inefficient state-owned enterprises into efficient private ones. The privatization of small- and medium-sized enterprises and other economic units has been relatively successful. While perhaps proceeding more slowly than originally forecast, in 1991 the Czechoslovak government sold over 15,000 units, and by the third quarter of 1992 the figure was close to 30,000. An even more important means of privatizing small- and medium-sized properties has been the restitution of property to previous (pre-1948) owners or their heirs.

By mid-1992, over 120,000 units were restored through a process that also included housing, thus creating a precondition for the future establishment of a real estate market. The proceeds from the small-scale privatization have amounted to about Kčs 15 billion (about $500 million) in 1991. In comparison, the amount of foreign investment for 1991 was about $600 million.

The process of privatizing approximately 6,000 large firms is divided into two waves. The first wave covers 2,930 firms (2,210 of them in the Czech Republic), and it has been taking place since the spring of 1992. The firms being privatized are selected from among a number of competing projects proposed to the Czech and Slovak ministries of privatization as well as the federal Ministry of Finance. The projects can be prepared by any domestic or foreign individual or group, who can propose to follow any one or a combination of the permissible privatization methods, ranging from direct sale to an individual or a private domestic or foreign firm to distribution of virtually all shares to citizens at large through a system of vouchers.

In the first wave, 1,491 of the 2,930 firms have allocated part of their shares for the voucher privatization scheme, which consists of the following procedure. Each adult Czechoslovak citizen who is a permanent resident of Czechoslovakia is entitled to purchase a voucher book with 1,000 investment "points" for Kčs 1,000 (somewhat less than one-third of the average monthly wage). Some 8.56 million adults (i.e., most of the eligible individuals) have purchased these voucher books, and, during the first wave of privatization, they have used the points to bid for those shares of the 1,491 companies that have been allocated for voucher distribution. The voucher-book holders have voluntarily placed 72 percent of their points in the hands of forty-three privately formed investment privatization funds (IPFs), which bid for enterprise shares on behalf of the individual investors. As a result, 28 percent of the points are being invested directly by individuals.

The process of converting points into shares within the wave consists of rounds in which the bidders (individuals and IPFs) know the administratively set price of a share (in terms of points) of each enterprise and submit their written bids accordingly. In each round, shares are exchanged for points in those cases where the supply of shares exceeds the demand by individuals and IPFs, with the remaining shares being offered in the following round at a lower price. In those cases where demand exceeds supply by less than 25 percent and there is a "sufficient" demand for shares by the IPFs, the shares are first distributed to the bidding individuals, and the remainder are then rationed proportionately to the bidding IPFs. *Sufficient* demand of IPFs means that no IPF should receive less than 80 percent of its demand. In cases where demand exceeds supply by more than 25 percent or where the IPFs would have to be rationed by more than 20 percent of their bid, points are returned, no transaction takes place, and the price of shares is raised by the government for the next round.

As of November 1992, the process has gone through four rounds.[14] It was very successful in that a majority of points had already been exchanged for shares after the second round and an overwhelming majority of individuals and IPFs participated in each round. At the end of the fourth round, only 8 percent of points remained unallocated. Similarly, most shares slated for voucher privatization were thus placed. The problem with the scheme is that it generates few complete transactions and tends not to converge. Thus, in the first three rounds, less than 10 percent of all the firms participating in the first wave of the voucher privatization sold all their shares. Similarly, the price adjustments carried out by the authorities have sometimes been excessive, with the result that most firms have been switching between excess supply and demand between rounds. At present, the government expects to terminate the bidding process by force in round 5 before the end of 1992.

The Czechoslovak government launched the voucher privatization process in the expectation that a large number of state enterprises would rapidly improve their economic performance and stop relying on government subsidies. A major process of this kind of course also entails risks, and, as of November 1992, the Czech and Slovak governments were holding different views of the outcome. The Czech government sees the voucher privatization process as a major success and intends to use vouchers for privatizing most of the remaining large firms (including energy, mines, the mail system, and telecommunications) in the second wave in 1993. In contrast, the Slovak government sees the entire voucher scheme as slow and less efficient. As a result, it plans to rely more on traditional privatization means (e.g., direct sales, auctions, sealed bids, and employee stock ownership plans) in the second wave. With the partition of Czechoslovakia into the separate Czech and Slovak republics on 1 January 1993, one will hence observe two different privatization schemes being carried out in 1993.

Let us briefly discuss two potential problems that may appear in the future in connection with the Czechoslovak voucher scheme. The first potential problem is the lack of regulation of the IPFs. The IPFs have formed and until recently operated in a virtually unregulated environment. The precondition for starting a fund was the deposit of Kčs 100,000 (about $3,300), a proof of Kčs 1 million (about $33,000) in net worth somewhere in the world, and a signed declaration of behavior in conformity with a law regulating IPFs that would be drafted and passed in the future. The conditions were trivial, and a large number of IPFs quickly emerged, some being affiliated with reputable organizations (e.g., banks) and others representing fly-by-night organizations. IPFs immediately started competing for voucher books, and, at the start of January 1992, a number of IPFs formally offered to pay fixed multiples of the Kčs

14. For a detailed assessment of the first wave of voucher privatization, see Svejnar and Singer (1992).

1,000 purchase value of the voucher books. In particular, each of these IPFs promised to pay its clients in one year a guaranteed sum (usually Kčs 10,000–15,000) for the shares held for them by the IPF.

These offers were important because they stimulated most Czechoslovaks to buy voucher books. Within a matter of weeks, the number of individuals holding voucher books increased from 1.5 to 8.5 million. The mass purchase of voucher books increased the effective demand for shares, and, with the number of firms tentatively slated for privatization approximately given, it greatly reduced the value of each voucher book. The promise of the attractive payout by some IPFs after one year also spurred a large number of individuals to place their vouchers with these IPFs and created a significant danger of a run on the unregulated funds in one year's time. In the meantime, the funds realized that the value of each voucher book is considerably less than was expected with 1.5 million registrants, and some withdrew from the game. A law regulating the IPFs was eventually passed in 1992, but it does not require that funds promising fixed payouts be obliged to deposit these amounts ex ante with the government. The danger of a run on the funds, a rapid fall in share prices, and some funds becoming insolvent hence remains a possibility. This aspect of IPF operations may become regulated.

A related problem is the fact that the privatization ministries reacted to the growing number of voucher holders by attempting to increase the proportion of shares slated for voucher privatization in individual privatization projects. While motivated by the desire to increase the supply of shares for voucher privatization, the important side effect of this increased importance of voucher holders relative to other owners was a greater dispersion of future ownership among many firms. The problem of dispersed ownership and inadequate corporate governance, inherent in the voucher privatization method, was thus potentially exacerbated.

It is difficult to assess the seriousness of these potential problems arising in the context of the Czechoslovak privatization process. Yet it is important to realize that a process of this magnitude can hardly be designed without flaws. There is no doubt that, apart from the special case of East Germany, Czechoslovakia has embarked on the most ambitious project of large-scale privatization in Central and Eastern Europe.

3.4 Evaluation

By applying restrictive macroeconomic policies, the Czechoslovak government succeeded in rapidly extinguishing the inflationary pressures brought about by the sudden liberalization of about 85 percent of all prices on 1 January 1991. Containing the price explosion within a period of three to six months and maintaining price inflation at around 10 percent a year thereafter while gradually liberalizing the remaining prices has been an impressive accomplishment—one unparalleled elsewhere in Central and Eastern Europe. The economy has also adjusted remarkably in that the private sector has been developing rapidly in response to the removal of administrative restrictions, price liberalization, and provision of bank credit and exports have picked up after an initial period of major decline.

On the negative side, one observes an economy that has plunged into a more severe and prolonged recession than was officially expected. The recession has to a significant extent been caused by external shocks associated with the disintegration of the CMEA and the associated unfavorable shift in the terms of trade. Part of it is spurious and due to systematic errors in data collection, especially the underreporting of private activities.

In undertaking tough measures, the government greatly benefited from the willingness of the population to undergo a painful transition. Unlike the other transitional economies, Czechoslovakia has experienced virtually no strikes and social unrest. Part of the tolerance can be attributed to cultural values; however, a part is due to the government's resolve to move quickly and demonstrate results in such visible areas as privatization.

The ability to maintain social peace is of course only one measure of success. The imminent partitioning of Czechoslovakia into independent Czech and Slovak republics reflects not only cultural and social differences between the two nations but also the different views that the two governments have on how to proceed with economic policy. The Czech government intends to pursue relatively restrictive monetary and fiscal policies and complete the privatization process with the aid of the voucher system. The Slovak government seems to prefer a more expansive macroeconomic policy and to place priority on more traditional methods of privatization. The impressive aspect of the partitioning is the peaceful nature of the process and the concerned effort of the two governments to maintain to the greatest possible extent the existing economic links through a customs union and free mobility of all resources (including labor) and commodities.

A major problem facing both republics in 1993 and thereafter is the restructuring of the large state or newly privatized enterprises. These firms have to a large extent avoided the effect of the restrictive policies by relying to an increasing extent on interenterprise debt (credit). To some extent, the rise of interenterprise credits is to be expected in a newly established market economy. Yet the debt has risen too fast, and, despite the restrictive macroeconomic policies, not enough enterprises have been forced to close down so far. The impressive stabilization exercise has thus been accompanied by only limited enterprise restructuring. The expected remedy for this problem is large-scale privatization, the first wave of which is to be concluded at the end of 1992.

One of the most important questions is whether the large-scale transfer of ownership will result in rapid restructuring and improved efficiency of a great number of enterprises. Yet there was hardly any real alternative to the voucher system of privatization. Without it, new investment would hardly come in. And new investment is indispensable for medium- and long-run growth. Given the generally outdated technology, falling investment, and limited, although growing, extent of foreign investment ($600 million in 1991 and about $1 billion in 1992), the ability of the Czech and Slovak economies to expand and remain competitive as wages rise depends crucially on technological innovation and substantial productivity improvements.

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Comment David Begg

As one would expect, Karel Dyba and Jan Svejnar have given us a balanced and informative account of developments within what, for the moment at least, remains the Czech and Slovak Federal Republic (CSFR). I agree with most of their analyses and judgments, and I welcome their effort to provide us with as up-to-date data as possible. In what follows, I focus on the areas in which my emphasis would have been different, and I try to indicate where I think the authors still leave questions unanswered.

I begin with bank credit and the related issue of the explosion of interenterprise debts. To my mind, the authors give too little attention to the first, too much to the second. It is hard to imagine a well-functioning market economy without a reasonably stable and well-run banking system. If credit contracts are not enforced, budget constraints do not bite, and prices do not allocate resources. Yet, in most of Central and Eastern Europe, this is precisely what is happening. State-owned enterprises (SOEs) began the transition to the market with bank debts from the past, an arbitrary endowment conveying little information about managerial efficiency or prospective profits under the new regime. The response of banks, still state owned, has been to allow most SOEs to ignore scheduled payments and to capitalize arrears. In itself, this may not be undesirable, precisely because the original debt endowments had little economic significance. Unfortunately, however, waiving scheduled payments and capitalization of arrears is quickly extended from original loans to new loans used to finance operating deficits of SOEs.

This latter channel has several very unhelpful effects. First, for a given monetary target, too much credit is automatically preempted by incumbent SOEs. Not only does this impede the allocation of credit to new private businesses—which in table 3.2 would have been larger but for this effect—but it also inhibits restructuring of the enterprise sector. Second, until budget constraints harden and bankruptcies are enforced, corporate governance will remain weak. Third, as the authors observe, the banking sector, worried about the soundness of its loan book, is likely to respond by pressing for wider spreads between lending and deposit interest rates. The authorities in the CSFR have allowed this to occur (although to a lesser extent than in some neighboring countries). But such financial repression is an inefficient method of recapitalizing banks, a lesson of the earlier experience in Latin America.

In such circumstances, the social return to swift recapitalization of banks (which in turn facilitates early privatization of banks and greater competition in this sector) is extremely high. Begg and Portes (1992) discuss how this should be undertaken and explode some common myths. For example, it is often alleged that the public finances, already strained, will not withstand the additional burden of bailing out banks by writing off SOE debts. Yet, properly measured, the public finances bore the cost at the instant that past loans to SOEs became nonperforming. Marking to market merely recognizes that reality. The CSFR has led the way in Central and Eastern Europe in making a (small) start on recapitalizing the banks. The larger amount still required *will* add to the budget deficit. One useful role that external lender-monitors such as the International Monetary Fund can play is to confirm that this better bookkeeping does not violate previous conditionality agreements, whose targets for the budget deficit should be correspondingly adjusted.

In contrast, although, like the authors, I have also lamented the explosion of interenterprise debt in the CSFR and elsewhere (Begg 1991), I now take the view that this problem is greatly exaggerated. First, as the authors are aware, most statistics are gross before any attempt to clear what A owes B, B owes C, and C owes A. Second, one should bear in mind that, in mature Western economies, such as the United States or the United Kingdom, the magnitude of interenterprise debts at any point in time is about the same as the outstanding stock of bank credit to companies. Table 3.2 indicates that, as elsewhere in Central and Eastern Europe, interenterprise debts are rising sharply but from a tiny base: even now, they remain much smaller in relation to bank credit than in the United States or the United Kingdom. Third, interenterprise credits are, to an important extent, the *symptom* of the failures in the bank credit market described above. Suppliers would press more readily for payment if they knew that, otherwise, their cash flow would suffer and could not automatically be replenished via further bank loans.

These remarks aside, I share the authors' judgments about the evolution of the CSFR economy, although in places I wished that their analysis had gone further. The degree of wage moderation during 1991 was spectacular, and I find it hard to assess the success, or, more accurately, the prospects for continuing success, of the stabilization policy without at least an implicit judgment as to the reasons why wages remained so low. Is social cohesion greater than in neighboring countries such as Poland, or was the threat of unemployment the principal explanation? The answer matters since it may prove hard to sustain social cohesion, whereas the threat of rising unemployment is likely to be present for many years to come. Since the authors offer us neither an analysis of the past nor even a guesstimate about the future, we are left intrigued but unsatisfied by their discussion of the labor market.

More generally, if the trailblazing Polish experience is anything to go by, there is at least the possibility that Dyba and Svejnar have taken their snapshot at the very time peculiarly favorable to reform: just before a wage explosion and just before the public finances get seriously out of control through inability to collect taxes, a shrinking tax base, and mounting pressures for public expenditure. Of course, these may not happen in the CSFR, and I am sure that we all hope that they will not. The authors mention some disquieting signals in passing, but I would have liked them to tackle this issue head on.

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Discussion Summary

Josef Zieleniec said that the government is not doing enough to encourage the formation of new start-up firms in the private sector. He noted that new private firms are disadvantaged because they cannot provide collateral when they apply for loans. As a result of this problem, and the general problem of undercapitalization in the banking sector, the banks have been unwilling to extend credit to the new firms.

Jan Winiecki warned that Czechoslovakia's current account surplus would not last. He noted that many of the East European economies have experienced short-lived trade surpluses just after reforms were implemented. At the time of price liberalization, firms held large stocks of inputs and finished goods. After these inputs are used up and the goods are sold, the trade balance deteriorates. This pattern of sales also generates temporarily high accounting profits and associated tax payments.

Kemal Derviş suggested that it may possible for the Czechoslovakian investment privatization funds (IPFs) to provide 1,000 percent returns. He emphasized that these returns are not related to the marginal product of capital. Instead, these returns reflect the peculiar features of Czechoslovakia's voucher scheme. Derviş noted that it is difficult to guess the ultimate market value of the privatized firms. In East Germany, the realized sale value of public assets has been zero or negative. However, public assets in Czechoslovakia might be more valuable because the profitability of East German firms was wiped out by the German exchange rate and wage policy. Derviş said that Czechoslovakia has one of the most competitive exchange rates in the region.

Michael Bruno questioned whether the large spread between deposit and lending rates is linked to tight monetary policy. He said that it is possible that the spread reflects weak balance sheets in the banking sector, notably a large proportion of bad loans. If this is the problem, a monetary expansion will not help. Rather, the banks need to be recapitalized. Bruno also warned that the current account will eventually deteriorate. Because Czechoslovakia is a relatively open economy, a rebound in output will produce a big increase in imports. Finally, Bruno speculated that the sharp rise in Slovakia's unemployment rate is related to the fact that the Slovaks were relatively more vulnerable to the CMEA (Council for Mutual Economic Assistance) shock than the Czechs.

Dani Rodrik criticized the accuracy of the official Czechoslovak trade statistics. He said that OECD data indicate that trade volume increased during the first quarter of 1991, contradicting the Czechoslovak data. Rodrik suggested that the rise in Czechoslovakia's reported trade volume levels during the second half of 1991 might be a reflection of an improvement in bookkeeping techniques. Rodrik also discussed the macroeconomic effect of the CMEA shock. He estimated that two-fifths of the 19 percent output decline in Czechoslovakia can be attributed to the CMEA collapse.

Jeffrey Sachs also questioned the reliability of some of the statistical data in the paper. Sachs was particularly critical of the consumption estimates in the Czechoslovak national accounts. In his work with Andrew Berg, Sachs found that Polish household consumption data did not support the consumption numbers in the Polish GNP accounts. Berg and Sachs discovered that the Polish national accounts focused overwhelmingly on the official sector, missing all consumption coming from the private sector, including the booming retail sector. With this in mind, Sachs questioned the accuracy of the reported 30 percent decline in Czechoslovak real personal consumption. In addition to these observations, Sachs suggested that the authors devote more analysis to the distinctions between Bohemia and Slovakia. Finally, he suggested that the authors should report on the development of new private-sector firms instead of focusing on the process of privatization of state-owned firms.

Karel Dyba made several comments. First, he agreed with Rodrik that the CMEA shock by itself could not account for the decline in output. Dyba said that, if Finland is used as a benchmark, then the CMEA shock explains half the Czechoslovak output decline. Second, he criticized the hypothesis that the banks were facing severe financial problems. He said that the banks tend to exaggerate their problems. Third, Dyba discussed the particular problems of Slovakia, notably that Slovakia has been more oriented toward the Soviet market and that Slovaks have less "economic education" than their Czech counterparts. Finally, he emphasized the need to push forward with reforms quickly. He said that Czechoslovaks have to move ahead and master problems as they arise. He concluded that inaction is much worse than action with possible mistakes.