Two Decades of Post-Communist Change in Europe and the CIS:
What Has Been Achieved? What Is Still To Be Done?

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Central Europe (1)
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Discussion Leader: Laszlo Csaba - *On the Political Economy of Policy Reform*
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Transition by Internationalisation: Case of the Czech Republic
Successes and failures of Czech reforms

Introduction

Every country that aimed to change its centrally planned economy (CPE) to a market economy faced similar tasks: to carry out profound microeconomic reforms - liberalization, privatization and enterprise restructuring and, at the same time, achieve and maintain macroeconomic stabilization – growth, low inflation and unemployment. It was not an easy task. While macroeconomic stabilization and liberalization can be achieved quite quickly - via decisions related to monetary policies and deregulation of prices and entry to the market, enterprise privatization and restructuring are more complicated and long-term processes.

Although there were historical, cultural and political specifics as well as different starting conditions and links to outside world that altered the reforms, all countries followed a similar set of universal policies. Differences however were in both pace and depth of liberalization, as well as in privatization methods and enterprises restructuring besides inflation pressures and unemployment. In addition new institutional framework had to be created. Building institutions namely a legal framework, well performing courts, and business ethics is an important assumption of transformation. However it requires time, resources and skills.

Laws existed but were not enforced: For instance bankruptcy law was in place from the early days of transition, but enforcement in the Czech Republic was inefficient. In fact it was impossible to let large enterprises go bankrupt during the privatization programme since the government feared massive layoffs. Later bankruptcy filings might have increased and so did the number of declared bankruptcies. However the procedure was very drawn out and thus Czech bankruptcy law failed to allow for restructuring during the first decade of transition.

There were missing laws and institutions and courts were not functioning. There were serious problems related to the capital market functioning in the Czech Republic during the first decade. Thousands of stock titles were traded under suspect business practices - fictitious and insider trading became frequent transaction (asset stripping or 'tunneling'). Legal protection of minor stockholders did not exist until 1996. Despite the Czech Securities' Commission being established in April 1998, it had no real authority to regulate capital market functioning until 2001. It has proved that privatization requires strong legal framework and courts.[1]

Moreover, the legislative situation during the whole transformation was rather unstable. The laws that were approved were often amended and adjusted to the economic situation and later to EU norms as well as to pressure from particular lobbies. Parts of the new legal framework are still at various stages of preparation. For instance in case of the Czech income tax law there were 43 amendments during 1993-2002. The tax law became extensive, is full of exemptions and thus contains more loopholes and opportunities for tax avoidance.

I want to briefly examine some of the Czech experience and specific features of the transformation strategy. First specifics were the use of the non-standard method of privatization, the so called voucher privatization which aimed at high speed, large scale and creation of capital markets. Voucher privatization was a first big experiment that had potential for success but proved a failure.

The second specific feature of Czech transformation was the orientation on domestic investors during first decade of transformation. The fact that the country was relatively stable from the macroeconomic point of view at the beginning of 90s provided space for another experiment. This was to create "own bourgeoisie" – national champions owned by domestic investors like some other small economies such as Japan, Netherlands or Finland. Therefore, foreign investors have been excluded from the privatization programme. This experiment also failed: Paradoxically, as a result, most of the old brand marks such as Poldi, CKD, Skoda Pilsen or Tatra disappeared.

Government policy during economic transformation was based on an assumption that a successful privatization would guarantee restructuring of the corporate sector, hence there was no specific programme for enterprise restructuring during the first decade of transformation. The recession of 1997-1999 revealed not only weaknesses of privatization: poor institutions, poor corporate governance, but also lack of restructuring of large firms that were owned by large still state owned banks or by the State. Deterioration of the macroeconomic situation in turn accelerated the delayed privatization of residual state stakes in banks and state owned enterprises to strategic foreign investors during 1999-2002.[2] Delayed large bank privatization and related massive bank restructuring is another important specific of the Czech transformation.

I do not want only to discuss failures of the Czech transformation. I should like to first list a few successes of the Czech transformation (creation of small business and opening Czech economy as for foreign trade and foreign capital, stabilization strategy keeping inflation at a low level), and I have a few remarks related to the financial crisis and recession that also hit the Czech economy during 2008-2009 [Graph 1]. Finally I would like to turn to the future plans for reforms in the Czech Republic.

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[1] Consequently, besides the imperfect legal framework, there were also insufficient material and personal resources devoted to capital market supervision. Moreover, there was a lack of other "watch-dogs" in the capital market. Neither professional associations of securities traders nor controlling bodies of the Prague Stock Exchange provided effective self-regulation in the emerging markets.

[2] Paradoxically bank privatization was carried out by Social Democratic Party that came to power in 1998 after ruling of right wing parties during 1990-1997.

Key successes of market competition

During CPE, prices have been distorted by subsidies, taxes and by the exchange rate. In order to create a price system allowing enterprises to respond to the market signals and allowing for competition, in 1990 and 1991 major *price deregulation and market entry deregulation* took place in the Czech Republic.[3] Wages in the state sector remained regulated for some time – that together with price signals was a substantial incentive for small size private firms that did not exist during CPE contrary to Poland or Hungary.[4] Creation of SME sector was spontaneous, small scale privatization or restitution were not the major factors in establishment of small business sector, new start-ups have been more important in this respect. As of 1992 some 1.5 million people had become entrepreneurs, and the small business sector grew into an important part of the economy that creates competition – real or potential in most markets.[5]

The fact that unemployment remained at a low level during first period of transformation can be explained by unprecedented growth of small and medium size enterprises sector. Small businesses were creating new jobs and absorbed most of the labour released from large state enterprises during the first years of transformation and contributed to low unemployment. As by 2000 SMEs (with less than 250 employees) provided about 60% jobs in the economy and more than half of the output and value added.

At the beginning of the 90s the government decided to remove the monopoly of foreign trade and gradually *liberalized trade.* During first years government protected domestic markets from foreign competition via under valuated currency, tariffs on selected products as well as by custom surcharge. Most of the trade barriers – at least with the EU countries – were removed step by step by 1997.

Foreign trade liberalization has been followed by massive redirections of exports and imports from eastern bloc countries to the western economies, which is considered one of the big successes of Czech transformation.[6] Both exports and imports were growing since 1994 and the Czech economy became very open. Exports amount to almost 80% of the country's GDP, while imports reached 74% as of 2007. The importance of foreign trade is further increasing. [Graph 2]

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[3] Later energy and telecommunication prices have been deregulated. Transport prices and rents are still administered by state. Some energy prices and telecommunication prices are being recently re-regulated due to European policies (access prices to the network, roaming, subsidies of renewable sources of energy).

[4] Small and medium size enterprises (SMEs) are indispensable segment of any economy in terms of innovations, value-added and employment. SMEs are one of the driving forces of economic growth and structural changes, whilst quickly responding to the changes of internal and external economic conditions. Socially, the SME sector is closely linked to the middle class and accordingly, the growth of this sector has implications for long-term stability. Small businesses fulfill important roles in the economy due to their flexibility and contribution to sectoral adjustments. Small and medium size enterprises are not restricted only to service sector but play important role also in manufacturing, although are not as productive on average as are large companies.

[5] In 1989, still only 93,126 entrepreneurs (constituting 1.2 percent of the total labor force) were registered albeit the number of people working outside the public sector was rapidly increasing in the mid-1980s (see Statisticka rocenka CSFR, 1991). Similarly, only 2 percent of the registered property belonged to private owners. Contrary to Hungary, Poland or even the GDR, the role of small private businesses or private agricultural production remained strongly limited in the country until the collapse of the Communist regime For instance, there were negligible 4,204 private farmers registered in Czechoslovakia in 1989.

[6] The share of EU markets on all Czech exports increased from 28% in 1989 to 64% in 1998, while the share of non-OECD countries declined from 54% in 1989 to 23% in 1998. The decline in trade with non-OECD countries was the trade diversion from post-Soviet countries to the geographically closest EU countries, namely Germany.

A great part of the property controlled by the state had been privatized during 1998-2002. The most important companies were those which had a monopoly position or played a key role in the economy, namely companies operating in the banking, petrochemical, metallurgy, mining, telecommunications and energy sectors. In contrast to the past period, in which the privatization program was oriented toward domestic investors, during the residual privatization the government was targeting foreign investors. Government recognized the role of *foreign strategic investors* in improving companies' competitiveness due to the strengthening of their capital, management skills, know-how, technology transfer, the quality of services, the integration of Czech production into the networks of multinational companies and thus assisting economic growth and business culture.[7]

Foreign direct investment inflows started to grow in 1998. Although a large share of the inflows consisted of green-field investment and reinvested profits of existing foreign enterprises, FDI inflows have been influenced by large privatization deals.[8] Recently foreign enterprises produced almost two thirds of total industrial output and employ about half of the country's active labor force. While in the past, Foreign Direct Investment (FDI) was prevalently flowing *from* developed economies *into* the Czech Republic, recently, FDI has started to flow at a faster pace from the Czech republic. [Graph 3]. [9]

Stabilization strategies

Similar to other post-communist countries, the Czech Republic chose a fixed exchange rate as part of their stabilization strategies at the beginning of economic transition. In 1997 floating of the exchange rate has been adopted, and the inflation-targeting regime introduced. [10]"Inflation target range of the Czech National Bank (CNB) 3% ±1 percentage point that was valid until December 2009. Finally it also undershot the new target range of 2% ± 1 percentage point that has been in place since January 2010. During most of the transition inflation remained at moderate level [Graph 4].

In 1999, the Czech koruna began to appreciate and continued its long-term appreciation trend [Graph 5]. This trend can continue as long as productivity gains in the Czech economy outpace those in the Eurozone and if inflation remains at moderate level. Appreciation of the Czech crown is long-term positive signal of real convergence. In 2009, average price level in CR amounted 66% of EMU-average. As concerns GDP per capita at purchasing power parities, the Czech Republic reached 80% of the EU-27 average in 2008 – in 2000 it was 68%.

[7] An exemption was early investment of Volkswagen into Skoda car factory in 1991 that was concluded prior the privatization program started in 1992.

[8] In 2002 the takeover of Transgas, a major gas distribution company, by German RWE , in 2005 51% of Telecommunication company sold to Spain Telefonica for 3,5 bn USD and Unipetrol, oil and gas giant, 63% acquired by Poland-based PKN Orlen

[9] CEZ, electricity company 67% (250 bn. CZK?) still waiting for privatization, meanwhile CEZ contributes to outward foreign direct investment (OFDI) which is still rather low as compared to foreign investment inflows.

[10] The only instrument that the central bank then has is its short-term interest rate. Central bank can support the banking sector with cheap liquidity. The Czech National Bank (CNB) in May 2010 lowered its key 2-week repo rate to an all-time low of 0.75% and keeps it there.

As illustrated above, the Czech Republic is a very open economy with internationalized markets, which makes it potentially more vulnerable to exogenous shocks. Despite that, the Czech economy showed resilience during the global financial and economic crisis 2008-2009. Although real GDP contracted by 4%, trade balance and current account balances even strengthened. The Czech economy started to grow again in Q3 2009, but at a slow pace. By the end of Q1 2011, growth had barely compensated for the loss of real GDP during the recession. [Graph 6]

The global competition is further strengthening, while Czech wage costs are, and will continue to be, rising. Therefore, the country must move on along the trajectory of transition from cost competitiveness toward quality competitiveness. Czechs need to transform their economy towards growth driven by knowledge intensity, innovation, and high value added. The question is "how" and what should be role of state subsidies to R&D and innovation of enterprises?

What has to be done?

The Czech fiscal deficit reached almost 6% of GDP in the recession year of 2009. In 2010, the deficit was reduced to 4.7% of GDP. Public debt of the Czech Republic was close to 40% of GDP by the end of 2010, which is moderate in international comparison. But without policy changes the Czech public debt will reach 50% of GDP by 2013, and 60% of GDP by 2016. Parliamentary elections in May 2010 brought a three-party centre right-wing coalition (ODS, TOP09 and VV/Public Affairs) into government, which promised a fast consolidation of the budget due to some austerity measures and tax reforms.

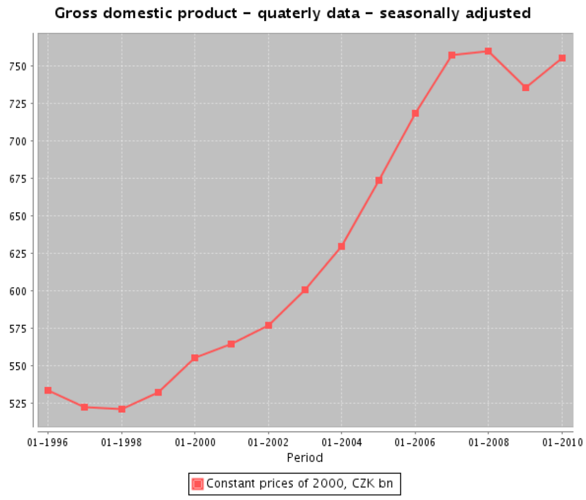
The Coalition cabinet led by civic democratic party (ODS's) chairman Petr Necas promised also systemic reforms including extensive reforms of pension system and health care financing, introduction of university tuition fees, and a liberalization of the labor market (e.g. virtually no restrictions of temporary labor contracts) and increasing the efficiency of public administration. If the coalition survives, the Social Democrats will be out of the game for the next four years.

The new government also promised to fight corruption, however Public Affairs, a new party that received surprising electoral support in the 2010 legislative election thanks to promises to fight against the old and corrupt political scene controlled by clienteles' connections and private interest groups, has to face numerous political scandals. Public Affairs / VV, is led by investigative journalist Radek John whose main platform is opposing political corruption. After the election in 2010 he became Minister of the Interior and the joint leader is Vit Barta who became Minister of Transport but was accused of bribery in April 2010 by his own party members and had to resign his post. Radek John quit as Interior Minister.[11]

[11] The problem was that the party has never managed to distance itself successfully from close ties to ABL, an influential security agency. Vít Bárta, Minister of Transport was the founder of ABL. Although Bárta sold the company to his brother shortly after Public Affairs' electoral success, the party is still seen as linked to the private business - and the party's rivals, including its uneasy coalition partners.

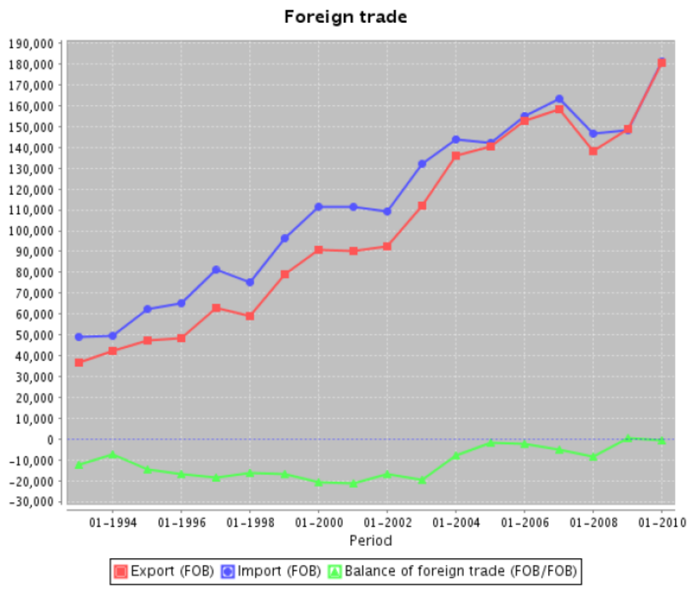
Appendix

Graph 1 Czech Republic, GDP 1996-2010[12]



Source: ARAD, CNB, in CZK millions

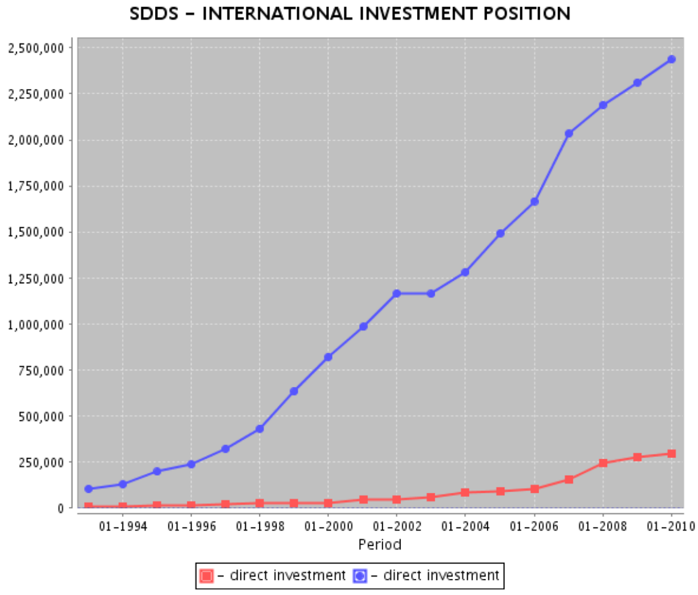
Graph 2 Exports and Imports 1994-2010, Czech Republic



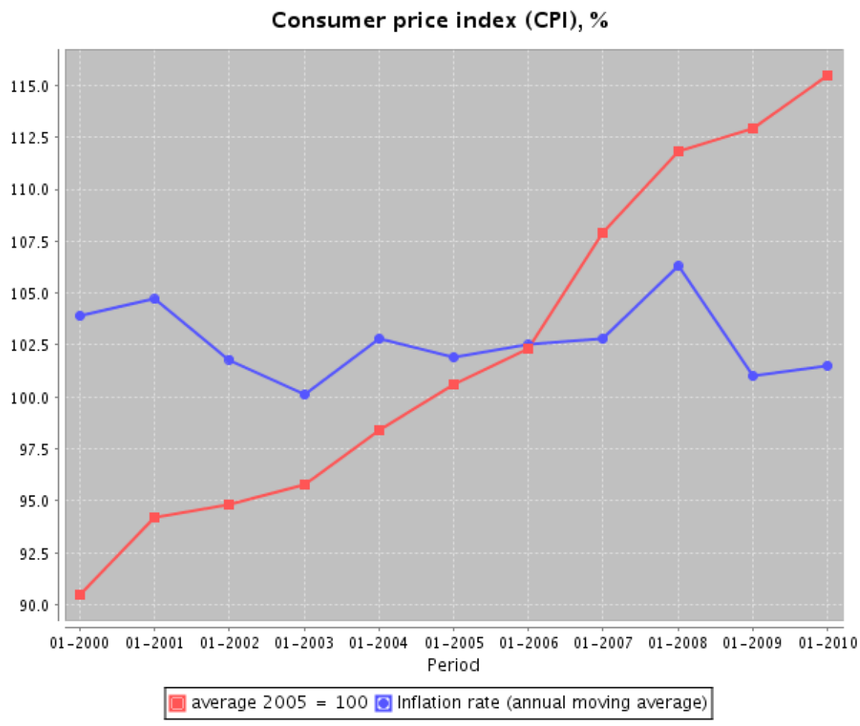
Source: ARAD, CNB, in CZK millions

[12] While as by 1992, GDP per capital at purchasing power was estimated of EBRD at $ 7,160, GDP per capita at purchasing power parity was $26,100 in 2008 in the Czech republic, which is 82% of the EU average.

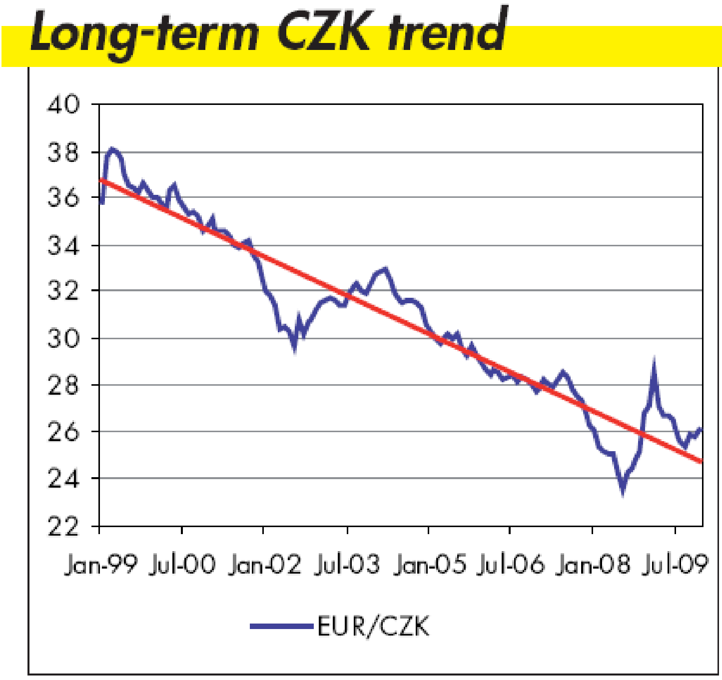
Graph 3 Foreign direct investment 1994-2010



Graph 4 Inflation (CPI), Czech Republic 2000-2010

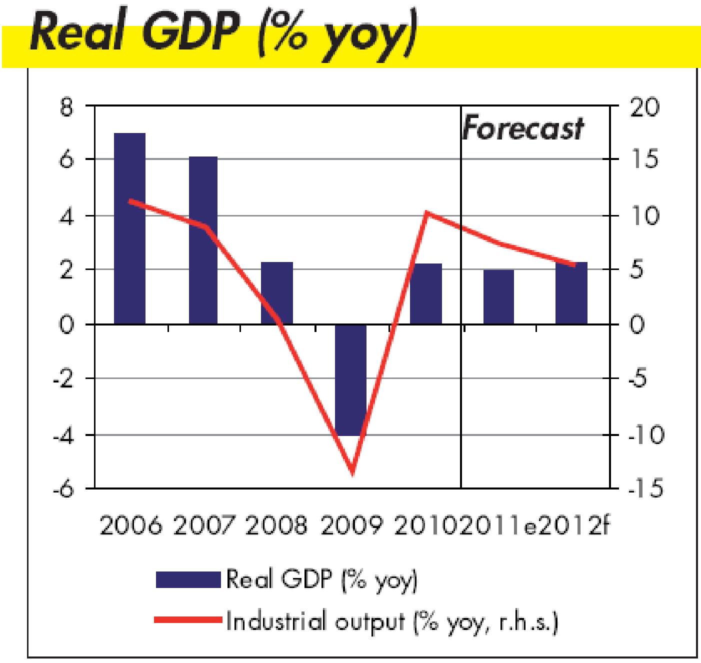


Graph 5



Source: Thomson Reuters, Raiffeisen RESEARCH

Graph 6



Source: Bloomberg, Raiffeisen RESEARCH