

# Transformation – basic steps

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- This lecture is introductory for the whole period of the transformation development.
- We discuss the general way of the overall process - to give you a broad view - framework.
- The following lecture will be targeted at specific problems that are just outlined in this lecture.

# Contents

- A. Situation at the beginning of the 1990s
- B. Political development
- C. General aspects of the transformation
- D. Chronological development

# A. Situation at the beginning of the 1990s

- positives of the Czech situation
  - macroeconomic stability
    - X other countries in the region
    - low inflation, stable fiscal position and balance of payments, zero unemployment
  - geographical position
  - quality of the labour force
  - developed economy (+/-)

# negative aspects of the situation

- central planning
- state ownership of the economy
  - extreme in comparison to other CPE
- deformed structure of the economy – heavy industry X understated services
- fixed and distorted prices
- poor technologies
- economy closed
- lack of capital in the economy
- monopolistic structure of the economy
- ⇒ lagging behind the developed countries

# Institutional aspects

- no adequate thinking and functioning of the whole system
  - unawareness of freedom
    - self-reliance of people
  - moral situation
    - life in a lie
    - corruption
  - legal system ...
    - unsuitable for market economy
  - politics
    - political monopoly in the hands of the communists
  - ignorance of market functioning – nearly everybody !
- very long run tasks to change

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## B. Political development

- political changes in November 1989
  - non-violent demonstrations
  - the communist government toppled
  - ⇒ Government of national unity – communists and dissidents till the election in the mid-1990
- Václav Havel president since December 1989
  - with breaks till 2002
- common state – Czechoslovakia

# Electoral system

- proportional
  - proportional representation – every party that gets over 5 % vote in the whole country
  - X majority system (eg. in the UK) – the winner in the county takes all
- ⇒ coalition governments
- very important impact on the functioning of the whole system and the economic transformation

# Elections of 1990

- first free elections
- victory for pro-changes powers in both parts of the country
- in the Czech part – Občanské fórum – Civic Forum
  - very broad group of ideas – united against the communist regime
- 1991 split of the Civic Forum
  - the leading role of Václav Klaus
  - Civic Democratic Party (ODS)

# Elections of 1992

- regular elections
- different attitudes to the transformation in the Czech and Slovak parts
  - in the CR support for continuous quick transformation
    - ODS and their right wing coalition win
      - Klaus prime minister
    - in the SR support for slower pace of the reforms and for more independent Slovak part – left wing populist government
- ⇒ 1993 split of Czechoslovakia

# Elections of 1996

- regular elections
- right wing coalition wins but forms only minority government (99 X 101)
  - later on 101 X 99 – very weak position
  - Klaus prime minister
- growing tensions inside the government
  - financial scandals
  - currency crisis in 1997
- ⇒ government toppled – autumn 1997
- ⇒ clerk government till early elections in the middle of 1998

# Elections of 1998

- Social Democrats (ČSSD) win
  - left wing party
  - Zeman the prime minister
  - unable to form coalition government ⇒ minority government with silent support of the ODS
  - ⇒ weak position of the government

# Elections of 2002

- ČSSD win
  - weak coalition (101x99)  $\Rightarrow$  centre-left
  - many crises but survived till 2006 elections
- Klaus president since 2002
- generally – stable democracy for the whole period
- but feeble governments since 1996

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## C. General aspects of the transformation

- reform vs. transformation
  - reform just partial – eg. tax reform
  - transformation – change of the whole system of functioning
    - from centrally planned economy to market economy
  - ⇒ change everything – economic policy, liberalize economy, legal system, behaviour of people, ...
- ⇒ very difficult and complicated tasks

# Shock therapy X gradual way

- shock therapy
  - = quickly to the market economy with restrictive economic policy
  - worries of getting stuck between the systems
  - political capital
    - support for the reforms after the political change
    - willingness to suffer
  - against pressure groups that are weak at the beginning
  - disbelief in the state and its ability to govern
  - coming to terms with the past
  - costs connected to economic decline and stabilization at the beginning of the process

# gradual way

- never clear strategy
  - only slower pace of reforms (Hungary, China)
  - worries about the costs connected with the shock therapy
  - in their way – slower pace = lower costs of the transformation

# in practice

- first proposal of the Czech government
  - slower pace of reforms
  - active structural policy
  - ‘standard’ privatisation
  - slower pace of opening the economy – worries about the stability of the companies

- vs. Federal government (Klaus) 4/1990
  - quickly
  - denationalisation and quick privatisation
  - price liberalization, deregulation
  - devaluation and internal convertibility of the crown
- ⇒ final „Strategy“ approved by the parliament in 9/1990
  - more to the Federal proposal

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  - 1990-1993 basic steps
  - 1994-1996 economic growth
  - 1997-1999 recession
  - 2000 - ... recovery and growth

# D. Chronological development - 1990

- adopting the transformation scenario
- institutional changes
  - changing of the legal system
    - private enterprise allowed ⇒ people could start their own business
    - joint stock companies, ...

# end of food price subventions

- during the past regime – taxes strongly varied
  - if it was negative it meant subventions  $\Rightarrow$  negative turnover tax
    - companies had to keep their prices fixed to get this subvention
- in the mid-1990 this regime for foodstuff was abandoned
  - the whole amount of subvention was divided to all inhabitants  $\Rightarrow$  people were given 140 crowns (5 % of then average income) every month as direct subventions
  - at the same time prices of foodstuff increased
- later in the year prices of energies and petrol that had been subsidized increased too

# Devaluation

- the exchange rate was unrealistic (and there were a few different exchange rates in fact)
- ⇒ government opted for devaluation
  - there were 3 during the year and the crown significantly weakened
    - very difficult decision
- ⇒ the crown was undervalued ⇒ „transformation pillow (cushion, buffer)“
  - time for Czech producers to adapt to new conditions and competitors from abroad

# NOTE: Balance of payments – highly important

- all transactions with abroad !
- structure:
  - current account CA (trade, services: „out – in“)
  - financial account FA (all form of capital: „out – in“)
  - changes in currency reserves
  - the sum of previous is zero (by definition !)
- it means for example
  - „change in reserves“ is the balancing item
  - deficit in the CA can be covered by inflow of capital or outflow of reserves
  - you can have together deficit in the CA and outflow of capital only as long as you have reserves
- if imbalances  $\Rightarrow$  changes in the exchange rate

# Exchange rate regime

- government with the central bank decided for fix exchange rate regime (basket of 5 currencies)
- ⇒ „transformation anchor“
  - one stable variable which all the market subjects can count with
    - economists afraid of devaluation-inflation spiral – devaluation  
↑ cost of imports in the fix regime = ↑ prices ⇒ pressure on devaluation ...
  - but at the same time obligation for the central bank to keep this value of the crown stable and intervene on the markets to keep it (sell and buy any amount at this value“
  - we borrowed more than a billion of dollars to support the exchange rate

# Restitutions

- return of property stolen during the communist regime to its previous owners
- difficult process – economist against due to worries of slowing down the privatisation process
- who to return to?
  - the communist coup in February 1948 set as the milestone and only for physical persons
- Czechoslovakia the only country in the region that returned physical property

# Economic policy

- both fiscal and monetary policies restrictive
- monetary policy – increase of the interest rate and interest quotas
- fiscal policy more restrictive too

# 1991

- the real transformation started 1<sup>st</sup> of January 1991
- all crucial steps happened on that day
  - price liberalization, opening to international trade, internal convertibility
- difficult to estimate the following development

# Price liberalization

- prices as the signal for all market subjects ⇒ necessary to relax
  - unpopular but necessary measure
- most of the prices 85 % were liberalized at the beginning of the year ⇒ prices shot up by 40 % during the month but the increase calmed down consequently
- ⇒ ⇒ 2. transformation pillow – „wage pillow“
  - decrease of real wages because increase of prices higher to increase of wages – population accepted
  - ⇒ again time for the companies to adapt to the new situation

# Internal convertibility

- in the past people could obtain hard currency only with permission (very difficult to get) or on the black market
  - companies could not import from the West because they could not get hard currency for importing
- ⇒ changed with 1 January ⇒ internal convertibility
  - household - limits for buying hard currency but all people could get these limits (roughly 1000 crowns per person)
  - companies
    - they could get money for importing goods from abroad
    - but at the same time they had obligation to sell all currency gained from the exports to the central bank ⇒ could not have foreign currency account

# WHY?

- very important step in the process!
- economist were afraid about inflation pressures after the prices liberalization in the monopolistic environment
  - ⇒ increased competition – open borders and allowing imports to keep domestic companies under pressure
- also they were afraid about the stability of the exchange rate – it was the anchor of the whole system !
  - need enough of reserves = hard currency
  - ⇒ limits and only internal convertibility
  - + import surcharge

# Other measures

- liberalization of the trade
  - discussion – worries of the position of the domestic companies
- January – start of „small privatisation“
  - auctions of shops, restaurants, small companies – mostly in services
- building safety net
  - one of the reasons for support of the process among inhabitants

# Economic policy

- restrictive against  $\uparrow$  of prices
- monetary policy
  - the central bank independent
  - unawareness of the market functioning and economic policy (as everybody)
- fiscal policy restrictive too
  - limited subventions to companies
  - only a small deficit

# Wage regulations

- worries of inflation – wage spiral
  - $\uparrow$  of prices  $\Rightarrow$  pressure on  $\uparrow$  of wages  $\Rightarrow$  it means  $\uparrow$  of costs companies  $\Rightarrow$  increase their prices  $\Rightarrow$  pressure on growth of wages ...
- to stop it soon at the beginning
  - there were limits (additional taxes) on the growth of wages in all companies that was above increase of profits

- dismantling of the COMECON and other factors in the international trade with the East
  - strong impact on the countries
- X association agreement with then European Community

# 1992

- elections – in the CR support for reforms
- continuous changes in the law system – amendment of
  - Trade law
  - Business code ...
- continuous restitutions ...

# Mass privatisation

- very difficult process – remember the proportion of the state in the economy
- all of the methods pros and cons – no silver bullet !
- always – everywhere troubles (in our case limited)
- disputes - quickly or after „restructuring“
  - government decided for quick form – disbelieve in the ability of state clerks
  - important difference between Czechoslovakia and, for instance, the UK – thousands of companies vs. 30
- important aspect – lack of domestic savings
- till now critical views of the process

# privatisation - process

- all of the managers of the selected companies (around 1000 in the CR) had to submit privatisation proposals
- anybody else could  $\Rightarrow$  competition among the proposals
- proposals different methods
  - direct sales, sales to managers, auctions, transfer to towns and villages, sale abroad, voucher privatisation, ...
- Ministries selected the winning proposal

# Voucher (coupon) privatisation

- started in the second half of the year
- all of the inhabitants over 18 years of age were allowed to take part – to get coupons to invest
  - against supply of „shares“ of the companies
- people decided for companies – applied their coupons
  - people's demand  $>$  supply – coupons returned and  $\uparrow$  of prices – so for every coupon you could get a smaller part of the company
  - $S > D$  ... accepted the offer and  $\downarrow$  of the price ...
  - $\Rightarrow$  market mechanism determined the price
- all together 5 times – then roughly balanced – people used their coupons and large parts of the companies were sold

# Economic policy

- fiscal policy
  - still restrictive – very small deficit
- monetary policy
  - targeting M2
  - relaxing and later in the year again restrictive
- wage regulations
  - second half of the year

# 1993

- 1.1. splitting of the country
  - single currencies after a few weeks
  - custom union – no tariffs between the countries
- tax reform – introducing VAT
  - government tasks – declining taxes and the amount of public finance
- end of small privatisation and second wave of the mass (voucher privatisation)
  - establishing of the Prague stock exchange

# economic policy

- monetary policy
  - restrictive – to support the new currency
  - still fixed system – problem for monetary policy
    - but small fluctuation zone +/- 0,5 % and in the basket only 2 currencies – dollar and DM
- fiscal policy
  - balanced public budget – exception in the region
- wage regulations – 2<sup>nd</sup> half of the year
- changes in the social policy – unemployment benefits, sick benefits, ...

# 1994-1996 economic growth

- 1994
  - fiscal policy
    - formally balanced budget but structural deficit
    - decline in the tax load
  - monetary policy
    - inflow of foreign capital  $\Rightarrow$  appreciation pressures  $\Rightarrow$  the CB had to intervene
  - ability to pay debts at the IMF
  - imbalances in the economy -  $\uparrow$  wages  $>$   $\uparrow$  productivity

# 1995

- successful transformation
  - the CR member of the OECD – as the first of the ex-CPE countries
  - and investment grading
- external convertibility – export and import of capital – (every transaction bar a few exceptions – foreigners could not buy real estate here)

- economy strong  $\uparrow$ 
  - overheating –  $D > S \Rightarrow$  deficit in the current account
  - strong inflow of foreign capital
- fixed nominal exchange rate and inflation (10 %) higher to abroad  $\Rightarrow$  appreciation of the real exchange rate
- fiscal policy stable
  - decline in tax rates

# 1996

- elections – minority government – weak position
- application for the EU
- growing imbalance
  - deficit in the current account
    - disputes
- $\uparrow$  of wages  $>$   $\uparrow$  prices  $\Rightarrow$  disappearing of the wage pillow

# monetary policy

- troubles
- inflow of money from abroad
  - higher interest rates
  - stable growing economy (OECD, ...)
  - stock exchange
  - positive outlook
- $\Rightarrow$   $\uparrow$  of money in circulation  $\Rightarrow$  inflation pressures
  - if the CB  $\uparrow$  interest rates  $\Rightarrow$   $\uparrow$  of the capital from abroad
  - if the CB  $\downarrow$  interest rates  $\Rightarrow$  monetary expansion  $\Rightarrow$  inflation
  - $\Rightarrow$  dilemma for monetary policy

- CB
  - increase in the fluctuation zone of the crown ( +/- 7,5 %)
    - to increase risks for investors
  - in the middle of the year  $\uparrow$  of interest rates  $\Rightarrow$  restrictive policy
    - to balance the deficit in the current account – but the connection weak

- optimistic atmosphere but criticism:
  - imbalances
  - problems with institutions – law system, enforceability of the law, bureaucracy, corruption, ...
  - finishing privatisation
    - problematic ownership structure
  - price liberalization, ...
  - slow restructuring

# 1997-1999: recession

- slowdown of the economy
- ↑ imbalance – the current account
- deficit of the public finance:
  - the budget set for growing economy
- twin deficit
- ⇒ government for fiscal restrictions
  - government „parcel“ of restrictive measures – strokes in expenditures
  - to increase trust in the economy and economic policy

# currency crises

- growing disbelieve in CZK
- May attack on the currency
  - devaluation negative for investment from abroad
  - speculative capital
- the CB had to
  - sell dollar reserves to keep the exchange rate in the zone
    - cost of 3 billion dollars
  - increase interest rates to lure capital
- in the end crown had to devalue ⇒ floating
- but the decline only modest (in comparison for example with the Asian countries)

# after crises

- the government issued another restrictive parcel
- monetary policy quite restrictive too
  - the CB afraid of another attack
  - at the end of the year change of the monetary policy system to „inflation targeting“
    - obligation of the central bank to keep inflation in a target zone
    - at once ambitious target (without consultation with the government)
- currency crises  $\Leftrightarrow$  economic crises
- autumn – government toppled

# 1998-

- 1998 elections – social democrats
- economic policy restrictive
  - monetary policy – the central bank undershot its (ambitious) target (in most of the following years)
    - problems with knowledge of the transmission mechanism, world prices, delays ...
  - fiscal policy relatively restrictive too at the beginning
    - in the following years the policy more relaxed – fiscal impulse and deficits of the public finance

# privatisation

- commercial banks (finally) sold as well as some other large companies in the following years
  - foreign owner essential for better functioning of the banks
  - and social democrats needed sources for its fiscal expansion

# 2000 -

- since 2000 economic growth
- problems with fiscal balance
- continuous privatisation
- pressure on harmonization with the EU
- 2004 admitted to the EU