

The Statement below was one of the first critical assessments of the transition policies in the post-communist Europe. Transition policies unique without precedence and they were launched between June 1989 and 1993 in 32 countries. Each country had a different approach and not all followed the same objective: to build free-market capitalism. This statement focused particularly on the Czechoslovak policies, which were most probably the most aspiring in reaching market capitalism by means of mass privatization. As you could see, our points, taken from the position of pure salaried academicians not involved in the political businesses, targeted the establishment of entrepreneurial, democratic and merit-based capitalism (α). In a negative sense, we were against the egalitarian, redistributive, imperial, corporatist, monopolistic, rent-seeking, non-competitive, state, one-party or socio-communist capitalism (ω). Our recommendations were rejected by most acting politicians. Their main argument was "these academics lack realism", which the time did not prove true, I may say. My surprising observation is that The Statement offered policy-recommendations, which could have fitted to much more transition countries than one. Transition policies required a lot of political and civil courage – and that were the scarcest inputs of the α -type of transition. Opportunism gradually dominated the closer the transition moved to the ω -types.

The question still remains: is an entrepreneurial capitalism (α) of the Schumpeter-Baumol type ever achievable? Is there a larger part of the population anywhere in the world who would wish it? Or is the communist capitalism of the Chinese style (ω) the natural final winner? What do you think?

ECONOMIC TRANSFORMATION: STRONG AND WEAK SIDE

A Statement of Independent Czech and Slovak Economists

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Introduction

The tolerance of the population to the continuing economic decline is rapidly decreasing. The feeling of uncertainty and fear about the future presents an opportunity for all kinds of Messiahs, who are willing to promise everything and deliver it immediately, once political power would be given to them. Growing is the danger of economic centralism that could develop into various forms of political totality.

In this difficult moment, we would like to emphasize, that we do not see any easier way, than the way of parliamentary democracy based on the

competition of political parties and on the transformation of the economy based on principles of open market economy and private property. Contrary to other observers, we believe, that the process of economic transformation is, on the whole successful, and should be accelerated and not decelerated. We agree with leftist critics that the transformation has some weaknesses which if allowed to continue could endanger the process. However, we believe that the weaknesses are quite different from those pointed out by the mentioned critics.

Basic Principles Are Correct

We are convinced that quick price liberalization was not incorrect. Gradual liberalization of prices would have continued to send in the long run distorted signals and hinder effective market coordination at the time, when the administrative regulation of the economy already collapsed. Restoration of central price regulation would be a step back and would contribute only to the decline in efficiency and to the acceleration of economic depression.

We are convinced that it was not incorrect to open the economy to international trade, to introduce internal convertibility and to devalue the currency and thus restore an equilibrium exchange rate. Support to exports through a realistic exchange rate is essential for stability and dynamism of a small open economy in the center of Europe, which in addition suffers from a lack of domestic demand. It is possible that the current exchange rate deviates from purchasing power parity rate. However, we are convinced that this deviation is much smaller than estimates presented by critics of devaluation. Nevertheless, an excessively undervalued currency could have some negative effects, the inequity between "rich" foreigners and "poor" locals being only a lesser evil. An expensive US\$ or DM could create an excessive protection barrier against competition of foreign goods and thus weaken foreign pressure to make domestic production more efficient and to improve quality of domestic goods and services

It is desirable that the domestic currency should gradually appreciate. However, a sudden revaluation would again distort market equilibrium and could force a return of an administrative system of foreign exchange rationing.

This would give bureaucrats back the right to decide about what should and what should not be exported and also about what sectors of the economy should develop faster than others. An inevitable consequence of such

measure would be further decline in efficiency, growth of foreign debt, and increased reluctance of foreign investors to enter the domestic market. The road to revaluation of the domestic currency requires continued commitment to liberalization and open markets and not their administrative regulation. Only an open market could generate signals, that would motivate rational decision-making of both domestic and foreign entrepreneurs.

The development during this year proves the above. From January 1, 1991, the domestic price level increased by about 50 percent, but the nominal exchange rate of the Koruna (Kcs) remained practically unchanged. This implies that the real exchange rate appreciated by about 33 percent. Adjusted to 1990 prices the current exchange rate is about 20Kcs/US\$. Due to the internal convertibility of Kcs, the exchange rate determines automatically the marginal benefits from exports and imports. Nobody would voluntarily trade in an open market in a less favorable exchange rate, however, most would be willing to trade in a more favorable one. This development disproves demagogic slogans about a sellout of national labor and assets to foreigners. In the middle of 1990 it was mentioned, that Czechoslovakia obtained one US\$ of imports for Kcs 18 of exports. However, this was the average and not the marginal ratio. This also implies that about half of foreign trade transaction took place at ratio better and the other half at a ratio worse than that. It is almost certain that the average exchange ratio calculated in 1990 prices is lower than KCS 18/US\$. The results of opening up to world trade, devaluation, internal convertibility, and reallocation in the composition of exports already brought about substantial efficiencies and savings and it is not a sellout of national assets to foreigners.

We are convinced that it has not been incorrect to use restrictive monetary and fiscal policies. This made it possible to stop beginning inflation within several months. High and accelerating inflation carries major economic and social costs.

Although the current aim to gradually relax restrictive policies may be appropriate, a sudden switch to excessive stimulation of aggregate demand at a time when enterprises have not yet been privatized and therefore have not changed their behavior would lead to price increases rather than to an increase in aggregate supply.

We are convinced that it is not incorrect to pay maximum attention and devote all energy of the Government to the privatization of the economy. Without fundamental changes in property rights, it would not be possible to

create a viable market economy. We don't believe that it would be possible to substantially rationalize the behavior of state enterprises. We don't believe that leasing of state property could effectively substitute for private property rights. We are deeply convinced that various forms of employee ownership would not have in most cases sufficient motivation effects. We are convinced that voucher privatization is a major step which could effectively sever the link between the state and those state enterprises, which are otherwise unable to function.

Finally, we are convinced that the Government is not incorrect in trying to avoid pitfalls of industrial policy based on "scientific" forecasts and "strategic planning". Western experience fails to confirm that indicative planning would guarantee success. The profession of so-called socioeconomic prognosticators has been almost completely discredited when it turned out that they were incapable to predict any significant economic change.

Transformation Should be Broadened

The current transformation strategy has several weaknesses. It is apparent that the Government realizes some of these but, under political pressure, continues in the wrong direction. The following part notes some of the more serious weaknesses.

We see the first serious weakness in the fact that the Government has not been paying sufficient attention to the development of small and medium enterprises. In Czechoslovakia, it is still not sufficiently recognized, that it is small and medium entrepreneurs, most starting from scratch, that are the engine of the future economy. This sector has been disadvantaged especially with respect to access to capital. The weakness of the banking sector continues to lead to preferences in credit allocation on the basis of collateral. While large state enterprises could offer substantial collateral, small entrepreneurs could offer only their personal property. Credit guarantee based on the future viability of the start-up enterprise is typically insufficient, and the focus of banks on large enterprises have been further enhanced by the state enterprise debt rescheduling rules.

We welcome that the Federal and State Governments finally realized the critical importance of accelerated development of small and medium enterprises and are coming up with new initiatives in this area. It remains to be seen how effectively would Government support not only conversion of state enterprises, but also the development of new businesses.

The second weakness, closely related to the first, is that two years after the velvet revolution in the whole of Czechoslovakia, small privatization created only about one tenth of the desirable number of small private enterprises.

Therefore, private sector has been unable to contribute significantly to GDP creation and to the creation of new jobs and thus has been unable to reduce the impact of the economic recession. For the same reason, the private sector has been unable to significantly contribute to the creation of a more competitive environment, which would curb attempts of monopolistic price increases and would also increase pressure on improved quality of goods and services. An integral part of small privatization should have been also the privatization of state housing, which in addition to enhancement of housing quality would reduce problems with liberalization of housing rents, increase labor mobility, improve public attitude toward private property, and foster mortgage financing. The acceleration and broadening of the scope of small privatization is essential.

The third weakness is the prohibition of secondary market in privatization vouchers. This slows down the process of concentration of capital, reduces the efficiency of the capital market, and in general, damages the credibility of privatization in the public eye.

This well-intentioned attempt to protect the inexperienced citizen is necessarily turning against him. Bureaucratically thinking politician is always convinced that he knows better what the citizen needs than the citizen himself. Such politician is eager to prove his importance by "protecting" the citizen.

Obstacles raised to market forces by administrative prohibition are not only ineffective, they are futile. It is obvious, that a secondary market in privatization coupons simply exists. Let's prevent escalation of administrative rules that would only slow down and make less effective the functioning of the secondary market and restrict competition of privatization investment funds. It is not the speculator that is "stealing" from the citizen, but those who prevent the development of the market. No political pronouncement or TV commercial would persuade doubting citizens that the value of their privatization coupons is higher than that of the registration stamp. It is not a calculation by a bureaucrat but only the market that sets the right price. It is well known that the market is an excellent "machine" to process information because in one complex system it uses the exchange of information and decisions of a large number of people. Many of them are

professionals, that in order not to make mistakes in their market decisions, analyze and estimate market development. Professional findings and intentions are then through the market and prices spread to others and thus increase the effectiveness of the decision-making process. Therefore, it is never restrictions, but on the contrary, a greater degree of market freedom, that guarantees effective transmission of information and establishes fair prices.

Foreign Capital Should Be Encouraged

The fourth weakness of the current policy is a timid attitude of politicians, Governments, and Parliaments toward foreign capital. On the one hand, it is understood that foreign capital participation would contribute the missing modern technology and management experience. On the other hand, one can hear reservations against big, but especially against small foreign capital, as if its objective would be only to rob the economy. This in principle socialist aversion toward foreign capital is then merged with nationalistic aversion. This is especially apparent with respect to German capital, capital from the most developed neighboring country, from which one would expect major involvement.

Foreign capital has a lot to offer not only to a business partner but to the whole society. With foreign capital we would obtain not only modern technology and management experience, but a number of other benefits.

Foreign capital would help to create a new working environment for Czechoslovak employees, would increase demand for local goods, would facilitate trade contacts abroad, and would contribute to the development of financial markets and institutions. Most important, its presence would force local entrepreneurs to work more efficiently. In addition, inflow of foreign capital could considerably improve the balance of payments and thus contribute to the revaluation of the local currency.

Notions, that foreign capital could buy out the entire domestic economy in one afternoon and that strong measures are needed to protect the domestic economy against it are entirely misplaced. The fact, that foreign capital inflow is not as strong as initially expected implies, that even with the current exchange rate, investments in the local economy are not substantially more attractive than investments elsewhere. High risk perceived by potential investors contributes to this greatly. And also, not all what is considered wealth in Czechoslovakia is seen as wealth by foreigners.

However, let's assume for a moment that foreign capital would indeed desire to buy out almost everything, and that there would be no restrictions. What would happen? Foreign investor would start buying local enterprises, property, land, and hire workers. How long would it take before say about 10 percent of national assets were transferred, negotiations completed, contract signed, and ownership rights actually transferred? It would not all happen within one year. But already during that year, foreign investors would start paying for the assets, so that a large inflow of foreign capital would bring about a major improvement in the balance of payments and appreciation of our currency. This process would continue until further foreign investments into our country would no longer be efficient.

Therefore, we believe that it is a major mistake to impose restrictions on foreign investment, as for example, excluding foreign capital from the first round of small privatization, excluding foreign capital from large privatization of selected enterprises (the so-called family jewels), excluding foreigners from land ownership, and especially limiting activities of foreign banks in Czechoslovakia. Today, at the time when foreign investment into former communist economies is small, capital incentives related to the FDI positive externalities and not restrictions on foreign investment are needed. For example, by temporary reduction of tax rates on the long-term capital investment.

Accelerated Development of Market Institutions is Needed

The fifth weakness of the current economic policy is the lack of support to the development of banking, tax, and legal institutions. Privatization, restitution, development of new businesses, bankruptcies, labor market mobility, liberalization of capital and labor markets, demonopolization, protection of fair competition, and new fiscal policy of the Government, all require a legal system that would ensure enforcement of property rights among market agents. Fundamental restructuring of economic resources requires to maintain the transaction cost of those changes as low as possible. Fundamental economic changes facing the Czechoslovak economy demand fundamental transformation of legal institutions, courts, and arbitration. To enable their accelerated development, it would be beneficial to privatize them, at least partially.

No doubt, Czechoslovakia has a good chance to return to the family of developed European countries. However, correct economic policy would

certainly matter in this process. Market economy has a number of fine nuances. What should not happen, however, is that economic policy of transformation and rules of the game be turned against the principles of market economy and thus further undermine the already insufficiently competitive environment of the Czechoslovak economy. The objective of this statement is to make it a basis for discussion of the strategy of economic transformation in Czechoslovakia. A discussion, which in the first place would emphasize a constructive economic argumentation, unhindered by political slogans and ideological attacks. The public is capable to determine on its own which of those alternatives reflects substance, reality, is sustainable, and on that basis would draw appropriate political decisions.

The statement is supported by the following 14 representatives of the economic profession:

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