TEN YEARS ON

Some Lessons from the Transition

delivered by
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Ladies and Gentlemen,

I am greatly honored to be invited to deliver this year’s Per Jacobsson Lecture. I would like to take this occasion to offer you some reflections on ten years of experience with the transformation of the former centrally planned economies into free market economies. Some may wonder whether the lessons from such a transition are still relevant today. As I will presently explain, I believe that the transition process is still incomplete. And the latest World Economic Outlook clearly shows that there are still large differences among individual transition economies. Some have already traveled a long way toward a modern market economy, while others still have a lot of work to do. The countries whose transition is less advanced certainly can and should benefit from the lessons and mistakes of the more advanced transition economies.

I will try to take a broad view of the issues of transition, and not focus only on the experience of the Czech Republic. But I must admit that my thinking about the issues of transition is most strongly influenced by the experiences of my own country, where I had the privilege, as governor of the Central Bank, and for a short time as Prime Minister as well, to pass the whole of the last decade in helping to implement major steps in the reformation of our economy.

Early in the 1990s, as their Communist regimes collapsed, all the states of the former COMECON faced the same challenge: to learn how to do business, how to communicate, trade, and co-operate with the advanced Western world. This was a huge challenge. It required adjusting to an entirely new world; building new institutional frameworks from scratch; privatizing the economy; embarking on a far-reaching restructuring to remove accumulated distortions and deformations; and strengthening ties with the markets of the West. It also required paying off the debts of the past and acquiring enough capital to pay for the needed modernization of companies, in ways that would not burden future generations with excessive debt. Perhaps the most important and most difficult task was to
change, fundamentally, the mentality of the people, so that their criterion of success would no longer be how well they meet the plan, but what profits their companies generate and how well they succeed in competing with their rivals.

Everyone knew that this could not be done overnight. But many seemed to share the naïve idea that all these changes would be achieved in a matter of several years at most. Some politicians were reluctant to admit publicly that the transition from a deformed command economy to a modern market economy might be a long and painful process. It is true that the self-confident optimism displayed by many politicians was helpful, in the beginning, in mobilizing broad support for the economic reforms. But later it led to disappointment and disenchantment when the reforms did not deliver the promised benefits as quickly as expected. Far wiser were the words of Winston Churchill on becoming Prime Minister: he promised the British people “blood, toil, tears and sweat” – and by doing so helped win the war.

Arguing after ten years of transition that most of our failures and difficulties are still rooted in the past may sound like a worn-out alibi. I do not want to belittle the problems caused by our own lack of experience, knowledge, or foresight. Many problems were also caused by unscrupulous persons who abused this period of rapid political and economic change to dishonestly amass unprecedented fortune and influence. But I would argue that even these problems are part of the legacy of totalitarian regimes.

What was this legacy, and how did it affect the economic transformation? I would like to describe some of the important ways.

I. The Legacy and Starting Conditions: an Objective Factor of the Transformation

Today, it is all too easy to forget the actual state of the economies that the new democracies of Central and Eastern Europe inherited ten years ago. Such forgetfulness can cause us to exaggerate the importance of the subjective errors that were made in the course
of the transformation. Sometimes it can also cause the previous regime to be idealized in certain strata of society. This is why I consider it essential to remind ourselves constantly how greatly the problems and deformations inherited from the previous regime contributed to the difficulties of transition.

First of all, it must be kept in mind that ten years ago the transition economies were mostly or completely nationalized. To illustrate: in the Czechoslovakia of the 1980s, state enterprises accounted for more than 87 percent of national income, co-operatives accounted for ten percent, and only slightly more than two percent was produced by small individually owned businesses. In 1949 there were some 2,000,000 private farmers in Czechoslovakia. At the end of the 1980s there were only about 10,000. Sure, there were differences. In Hungary and Poland, and also in the former East Germany, small private businesses and enterprises were not so rare. But Czechoslovakia was under the control of a rigid ideology that forbade any form of “exploitation of man by man,” which was a euphemism for the existence of a private sector. As a result of this almost total nationalization of the economy, a program of mass privatization was needed to move quickly to a market economy. It was simultaneously necessary to create an adequate institutional framework for this newly appearing private sector. In the clear light of hindsight, it is apparent that the second task was more demanding than the first.

The second and equally serious legacy was the inherited deformations and distortions of the real economy. These deformations took different forms. Let me mention the most important:

The first deformation was the economy’s exclusive geographic orientation toward eastern markets. For example, 70 percent of Czechoslovakia’s foreign trade was with the countries of COMECON. After the collapse of COMECON, this heavy dependence had severe consequences for many Czech companies. Czechoslovakia’s situation may be compared with that of Finland after the collapse of the former Soviet Union at the beginning of the 1990s. Finland’s problems were quite serious even though Finland was much less dependent on Soviet markets than were the COMECON countries.
Deformations in the structure of production and trade were aggravated by the policy of economic self-sufficiency. An example will illustrate this deformation. The former Czechoslovakia produced almost 1000 kg of steel per capita, making it the top steel producer by that measure. There was just one problem: Czechoslovakia had no comparative advantage in steel production. Also, Czechoslovak industry produced a wide range of all possible products, and built new production facilities aimed at supplying Soviet markets, though these were gradually collapsing. Such a wide range of products did not allow the development of desirable specialization, nor did it allow industry to focus enough on improving quality and technology to the levels achieved by their Western competitors.

Last but not least, the deformations of the real economy were intensified by excessive concentration resulting from the deliberate creation of big enterprises and monopoly structures. Large enterprises had become the rule because they corresponded best to the needs of a centrally planned economy, but these colossuses created problems during the transition because dismantling them frequently caused sensitive social problems.

The political changes that took place in 1989 made it possible to determine the true extent of the distortions and deformations inherent in centrally planned economies and the true magnitude of the implicit, hidden indebtedness. As to external debt, the starting conditions of individual countries were widely different at first glance. At one end of the spectrum were the heavily indebted economies of Poland and Hungary, the latter paying off the debts of the “goulash Communism” of János Kádár. At the other end was Romania, which had inherited from Ceausescu a zero financial obligation toward other countries, but his reduction of Romania’s external debt to nearly zero had been achieved at the heavy cost of a pauperized society and economy. From this it is evident that officially reported external debt cannot be considered the only relevant indicator of favorable or unfavorable conditions for transformation. Far more important was the growth of internal debt. An important goal of ruling Communist parties was to avoid social unrest by providing an acceptable living standard. But as the productive capacities of the Communist economies were eroded by their inherent inefficiencies, a decent living standard could only be achieved by mortgaging
the future, i.e. by living on hidden debt. This hidden debt mostly took the form of environmental devastation and neglect of environmental investment, and of deteriorating infrastructure. There were other ways to keep people happy with the limited resources generated by inefficient economies, including artificial employment, free health care and free education. State companies supported this artificial employment through their guaranteed access to bank credits, and more generally by maintaining operation regardless of profitability. It is not surprising that the consequences of the longstanding allocation of resources based on political priorities instead of on profitability sources, and of the low efficiency of the credits, continued to haunt reformers during the 1990s, as massive amounts of bad loans began to surface.

Many of the economic problems of transition stem from human factors. Two basic kinds of problems are involved. The first is that the structure of education and the mix of skills in a command economy do not match the needs of a market economy. The second is the ways in which living under socialism shaped people’s qualities, mentality, and morals.

At first glance, the former Czechoslovakia had a reasonably qualified workforce. The number of university graduates quadrupled from 1960, and the number of persons with a secondary education diploma tripled. But the workforce did not possess as wide a range of knowledge and skills as is required by a modern market economy, and this deficiency was most acutely felt during the first years of the transition.

It was even more difficult to overcome habits associated with planned economies. Instead of focusing their efforts on increasing efficiency and profits, workers and managers gave priority to achieving compliance with plans and ensuring easy plans and norms for the future. The behavior of economic agents was still being influenced by the practices native to a socialist economy, including excessive leveling of wages, whose structure did not always reflect skills and effort; a guaranteed right to work; automatic (though modest) claims for social benefits; guaranteed provision for old age; and affordable but heavily subsidized housing. These were not exactly the skills and habits needed to succeed in the intense competition in the increasingly global economy of the 1990s. I must not forget to
mention another fact which is that the behavior of people was also influenced by a relatively extensive, peculiarly socialist shadow economy. This came into existence not so much as a means of tax avoidance and evasion, but rather in response to the numerous supply shortages created by the rigid state economy. This shadow economy often operated using inputs from state companies, where they did not enjoy the same degree of protection as private property. Public property was thus used to generate private profits. This activity was frequently tolerated, serving as yet another means of keeping people happy. Unfortunately this system did not breed a strong respect for property rights.

One way or another, all of the countries striving to make the transition to a standard market economy have had to cope with the problems outlined above. In addition, the past decade saw the emergence of yet another serious problem. The economies of the new democracies were confronted with the environment of a rapidly moving globalization involving widespread liberalization of flows of goods and capital, which is to say the conditions of an increasingly tough competition. Of course, all countries had to accept these changes and adapt to them. But the transition economies were at a special disadvantage. Their “delayed start” had given them much less time to adjust, and they were forced to proceed with integration into the global economy and international financial system quickly, regardless of the risks connected with such rapid integration.

Naturally each of the individual transition economies had its share of unique special features, but it was the mass of common problems they had inherited that shaped the generally accepted strategy of economic reform.

It is beyond the scope of this presentation to discuss in detail the approaches of individual transition economies in implementing these reforms. But it could be instructive to discuss in more detail the subjective errors, misperceptions, and mistakes in implementation that combined with the inherited distortions and deformations to hinder and complicate the transformation process.
II. Mistakes and Errors – a Subjective Factor of the Transformation

The unique initial conditions in the transition economies of Central and Eastern Europe and the former Soviet Union called for an approach fundamentally different from the adjustment approaches applied in Latin America, Asia, and elsewhere. In these countries there was no need to rebuild, from scratch, a private sector, create a market-compatible institutional environment, or correct the serious inherited deformations and distortions of the real economy. It is likely that some of the errors made during transition stem from the underestimation of these particular difficulties. In addition, analysts from the advanced countries and from international institutions sometimes provided standardized policy recommendations that failed to take sufficient account of important special conditions affecting transition countries. And sometimes the inexperienced authorities of newly independent transition countries gratefully accepted this flawed advice. Understandably there was sometimes a sort of competition among the newly independent transition countries that encouraged a belief that their own approach to reform was the best or only approach. Misplaced national pride thus sometimes interfered with learning from the experience of other transition countries.

One widespread and very damaging mistake was the misconception that the systemic measures that could actually be implemented “overnight” – such as liberalization of prices and foreign trade, moving to a more realistic exchange rate, or creating market institutions on paper – would mean completion, then and there, of all the necessary institutional and structural reforms. Many analysts now agree that the present difficulties of some transition economies whose economic performance has been unexpectedly slow to catch up, stem from their initial misunderstanding of the importance of institutions in a market economy.

In the advanced market economies, the institutions, legal framework, and formal and informal norms and ethics are the product of continuous and gradual development over decades. But economic transformation required the transition economies to abolish their existing institutions, laws, and norms, and replace them with completely new ones. The
state inescapably has an important role to play in the development of new institutions, but in fact it often failed in that role. There is little or no profit in debating, at this late date, whether this failure was a predictable consequence of the actions of old administrative structures that were unwilling or unable to grasp the nature of the institutions needed in a free market economy, or whether it resulted from the naïve idea that the market alone would magically mold these institutions in its own image. It is even possible that the neglect of institutional reforms resulted from purposeful behavior on the part of groups whose natural resistance to regulation, developed under the system of directive control, persisted due to their association of free market economics with opposition to any official regulation or control.

Underestimation of the importance of the institutional framework was common during privatization. Many countries, the Czech Republic prominently among them, were trying to achieve rapid privatization. At the time the only form of domestic private capital, the money savings of households, in the aggregate covered only a small percentage of the book value of the state property to be privatized. In addition, many of these enterprises were in a condition that made them unattractive to foreign investors, while the companies that might have been attractive were usually considered too important to be sold to foreigners. Under these conditions, distributing ownership of the state’s assets, free of charge, to the domestic population seemed the only way of completing the privatization rapidly, after exhausting the possibilities of other privatization methods, including an extensive restitution to their former owners of property nationalized in the early days of the Communist regime.

Many economists still criticize this privatization approach, saying that it did not bring in the capital needed for restructuring and that the scattering of ownership did not improve, but rather worsened, the corporate governance of the privatized companies. The authors of the privatization scenario were aware of these problems. They knew that many of the new owners resulting from this scheme would probably only be temporary owners, who more often than not would prefer to consume the dividends of ownership rather than reinvest them to enhance their companies’ development. But faced with a choice between continuing the command economy for a long time or privatizing fast, they chose the lesser
of two evils. In a situation where the state held most of the country’s productive assets, the people did not have the needed money, and foreign buyers were not exactly flooding the country, the standard privatization methods could not be applied. Looking back, it does not appear that the choice was fundamentally wrong, though the clear light of hindsight does reveal that some of the risks of rapid privatization were underestimated.

A serious mistake, in my view, was the neglect of the regulatory framework needed for the privatized economy to function smoothly. The unconventional method of voucher privatization, which had some claim to justification, was accompanied by an unconventionally conceived institutional environment in which voucher privatization and the subsequent activities of the new owners was to take place. The specific inadequacies of this institutional environment included insufficient regulation of the capital market, minimal protection for minority shareholders, and most important the lack of transparency of the various financial operations by means of which the assets of the privatized firms were siphoned into the private accounts of new owners. Another very frequent error connected with privatization was the embracing of false, nationalistic ideas. In the Czech Republic, as in several other countries, the processes of privatization and transformation were hindered by polemics about unsaleable “family silver,” or irrational insistence that our very own national way of privatization should be applied to a number of important assets.

The behavior of the new owners who preferred consumption to improving the operation of their companies contributed to another serious problem of the transition, namely the growth of external imbalances. True, there were also many inherited contributing factors: the widespread shortages of the command system had created an overhang of money supply over domestic supplies of available goods, and an exaggerated demand for goods not previously available. In addition, current account deficits are to some extent a natural phenomenon of both emerging market countries and transition countries, due to the exigencies of a more expeditious restructuring. Many countries had relatively low external debts and could therefore finance the new consumption partly with easily available external resources. But the Czech Republic’s reliance on foreign savings soon became excessive even by emerging market standards. In 1996, the inflows of foreign,
mostly short-term capital that covered the trade deficit reached a peak at 16 percent of GDP, and the gross external debt of the Czech Republic, founded only four years earlier in 1993, had tripled.

The vigor of the response of the authorities of individual countries to a worsening external imbalance is affected, among other things, by the domestic political cycle. The approach of elections does not usually favor the implementation of necessary but unpopular restrictions. But whenever political calculations have prevailed over the objective needs of the economy, the day of reckoning has only been postponed. An example of a country which undertook a politically difficult but economically necessary adjustment is Hungary. Early in 1995, Hungary was generally viewed by the financial markets as a candidate for a crisis similar to Mexico’s. But a strong stabilization package, adopted by a government determined to maintain stringent fiscal and monetary policies, averted the crisis, and since then Hungary has enjoyed the benefits of rapid growth. But in my own country in 1996 and early 1997, what was economically necessary was not politically feasible, and the result was the crisis of May 1997.

Here let me touch briefly on the role of central banks in addressing macroeconomic imbalances. In the advanced market economies, central bank independence has grown as the political authorities and the public have gradually become aware of the advantages for the whole economy of low inflation and stable growth. It is the recognition of these advantages that has made national central banks increasingly independent of the national political cycle and the momentary political constellation.

In general, transition economies formally embraced most of the European legal framework’s elements defining the position of central banks. But the principle of central bank independence embodied in that framework has not yet been fully accepted by the public and especially by politicians. When macroeconomic imbalances accumulated, central banks often had the unpopular task of announcing the bad news. If in addition a central bank responded with an appropriate tightening of monetary policy, it fell into even greater disfavor, being blamed for the slowing of growth, increasing unemployment, and
social unrest. The reaction of governments or representative bodies was to try to get them under control. This political pressure has been a fact of life for the central banks of most countries in our region. I see this as a symptom of the immaturity of the transition economies, a symptom which fortunately may soon disappear as these countries become members of the European Union.

As to the financial sector, it may be said that probably all transition economies have had one or more serious financial crises. These crises were a result of subjective but often unavoidable mistakes and errors. I would like to emphasize the word “unavoidable” because it is the financial sector that undergoes the greatest changes in the course of an economic transition. The transformation of a centrally planned financial sector (with its full subordination to the state plan, and possessing one state monobank, one insurance company, etc.) to a market economy financial sector was a complete systemic overhaul requiring the development of a totally new financial infrastructure. Institutions of kinds never seen before (e.g., capital markets) had to be created, and the functioning of those that already existed had to be fundamentally changed. The financial sectors of post-Communist countries continue to be criticized, but it should not be forgotten that the task of creating from scratch a strong, efficient, globally competitive financial sector operating in a suitable legal environment was a lot to expect in only ten years. The many subjective mistakes made along the way could hardly have been avoided.

As might be expected, financial sector problems tend to be concentrated in banks. Banks were practically the only financial institution that existed to collect savings. Therefore, in the absence of a well-developed capital market or other sources of financing, banks had major responsibilities for the success of the economic transition. Aside from the legacies of the past – nonperforming loans that had been granted under political pressure in aid of dubious projects – there were other reasons why the costs of the transition were bound to fall on the banking sector. Some of the banks’ problems stemmed from the obvious inexperience of the managers and shareholders of banks and their supervising agencies. Even more arose from the difficulty of the banks’ tasks – they had to invest in an unstable environment and provide credit to unknown firms and projects which could not be evaluated
because they had no history. And of course there were cases where the problems of a bank resulted from schemes to defraud clients or from corrupt lending decisions – behavior for which there is no excuse.

III. Results

What, then, were the results of transition where highly unfavorable starting conditions were combined with many subjective mistakes and errors?

There have been many studies of the quantitative characteristics of developments in individual transition economies. Of course, economics cannot do without quantitative analysis. But there is the risk that excessively mechanical interpretation of quantitative data may not fully capture either their informative value or their limitations. Achieving a five-percent inflation rate may represent success for one country and total failure for another. Growth data alone may not say all that can be said about the improvement of living standards. And so on. Such limitations must be kept in mind while interpreting dry statistical data.

I will limit myself to a single very frequently used indicator of the success of any economy: the behavior of gross domestic product. (Slide). The chart, depicting GDP growth rates in six transition economies, shows that the decline in GDP at the beginning of the 1990s was a general phenomenon. During the subsequent recovery, only Poland attained a GDP level that exceeded its 1989 level. Based only on these data, the 1990s might appear to be a decade of failure for transition. This conclusion would seem to be confirmed by the fact that instead of approaching the economic level of the more advanced Western countries, the transition countries seem to be lagging further and further behind.

But a radical economic transformation is precisely the kind of situation where calculated GDP is not necessarily the ideal indicator of a country’s social well-being and the quality of life. For example, the amount of electricity being produced in the Czech Republic
is presently about the same as in 1990, but its production is now much sounder from the environmental standpoint, and the general improvement of the environment is visible on every hand. Data show that emissions of sulfur dioxide were cut by more than two-thirds in the past decade, while emissions of particulate solids are down to one-tenth of their former volume. As far as I know, similar changes have also been accomplished in Hungary and Poland. And it is a little known fact that during the last decade, average life expectancy in the Czech Republic increased by more than three years, while increasing also in Poland, Slovenia, Slovakia, and Hungary.

A mechanical look at GDP data also fails to reveal that the production structures developed under central planning were responding to other agendas and priorities than the benefit of the consumer. As a result, GDP data alone cannot take account of the inferior quality of the goods produced under that system. Also relevant here are the ideas of János Kornai, famed for his analysis of shortages in a nationalized economy. Those widespread shortages entailed additional costs, such as time spent in searching for goods, but the elimination of these costs is not reflected in the official GDP data. All these considerations undermine the informative value of a mechanical comparison of the volumes of products recorded before and after the political changes of ten years ago.

It will be seen that evaluating the results of transition is quite a complex task, because transition has many aspects not all of which are captured by official economic data. If I were asked to answer briefly the question whether I consider that the transformation of the economy of the Czech Republic and other economies at a similar stage of their transition has been successful, my reply would be an emphatic “Yes!” It is true that the difficulties and problems were much greater than we could have imagined a decade ago. It is true that we made a lot of mistakes. But I think that all will agree that the countries of Central and Eastern Europe that have made the most progress in adapting themselves to the conditions of a free market economy are today incomparably better off than the countries that have postponed these reforms.
Each of these countries has had its share of problems, its episodes of imbalances and setbacks, but the generally positive direction of the trend is beyond question. In the last ten years, the pitiful economic conditions that prevailed in the closing days of real socialism have become a distant memory, and the most advanced transition countries are serious candidates for membership in the European Union. Their maturity is attested by the extent to which they satisfy the well-known Copenhagen criteria, which in addition to the political requirement “that the candidate State has achieved stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities,” also emphasize “the existence of a functioning market economy, as well as the capacity to cope with competitive pressure and market forces within the Union.”

Today there is not time for me to discuss, in more detail, how this requirement is being met. Let me just mention two facts. First, the volume of trade between the Czech Republic and Germany is about the same as between Germany and Sweden. And second, the volume of trade between the transition economies and the European Union is growing two or three times faster than the total volume of trade in the whole of Europe. This evidence of increasing economic integration with Western Europe is an important signal that the transition must be regarded as essentially successful.

IV. Conclusion

In conclusion, let me quote from a speech that the former President of the Deutsche Bundesbank, Mr. Hans Tietmayer, presented about a year ago in Prague: “There exists no theoretical model of optimal transformation. In general, it will not be possible to avoid future mistakes. The transformation of an economic system is after all one of the most complex economic tasks, mainly because neither the business sector nor the politicians could prepare for a radical historical change ten years ago.”

What I find important in this quotation is his stress on the idea that the time allowed for seeking ways to complete the remaining transition tasks, and for making mistakes, has
not yet come to an end. It was not possible, ten years ago, to design and implement the optimal procedure. How could it have been, when even today we still do not know everything about the best transformation strategy, and many issues are still the subject of intense discussion? All this makes me very cautious about drawing general conclusions and lessons from the transition process so far.

But one fact cannot be questioned. Transformation was always inescapable, a consequence of the forty or more years of experimenting with what we called “the socialist planned economy,” what others called “the centrally planned economy.” The Germans probably had the most apt expression for it – “Kommando Wirtschaft.” Had there never been this deviation from the principles of a democratic society and free market economy, we never would have had to deal here with the problems of transformation, and the economies of Central and Eastern Europe would probably not have differed much from the neighboring economies located to the West.

In the event, however, development in the Western and Eastern parts of Europe diametrically diverged. In Western Europe, living standards were improving rapidly, economies were gradually becoming more integrated, and barriers to the free movement of people, goods, services, and capital were gradually disappearing. This trend has culminated in the present with the introduction of a common European currency. Contrast this with Eastern Europe where even the integration of economies was proceeding in compliance with directives. This is why the ten years of transition has also become the period of disengagement from dictated political and economic ties. This process has not everywhere been peaceful and free of violence, and I am grateful that the 1993 breakup of the former Czechoslovakia was conducted in a civilized manner, earning it the title of “the velvet divorce.”

The return to the standard principles of a democratic market economy – and this is the principal goal of transition – was often painful, accompanied by many mistakes and errors. From some mistakes we can learn; others are unrepeatable and untransferable in nature. The main historical lesson is that the real root cause of all the problems was the
deviation from the normal, an attempt to make human nature conform to an artificial, philosophical model, an experiment that survived in our part of Europe for over forty years. The best way to avoid the mistakes and errors of transformation is therefore never to repeat a similar experiment.