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## The Czech transition: The importance of microeconomic fundamentals

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Research Paper No. 2009/17

## **The Czech Transition**

The Importance of Microeconomic Fundamentals

Jan Svejnar,<sup>1</sup> and Milica Uvalic<sup>2</sup>

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### **Abstract**

We examine the case of the Czech Republic, which has been frequently cited as one of the most successful cases of transition economies in Central and Eastern Europe (CEE). Despite the costs related to the break-up of Czechoslovakia in late 1992 and 1993, the immediate consequences were quickly absorbed and the country implemented the most important market-oriented reforms relatively successfully and faster than most other CEE countries. We first identify the initial conditions in the Czech Republic in 1989 and the development strategy adopted at the beginning of the transition. We then address the importance of international factors, including the role of trade opening, foreign direct investment, and external borrowing. We analyse the achievements and failures of the strategy with respect to both economic performance and progress with institutional reforms, as well as the reasons behind the resulting outcomes. This leads us to outline future challenges, including unfinished areas of reform. We conclude with lessons for other developing countries.

**Keywords:** transition economies, development policy, economic strategy

**JEL classification:** P2, P3, O10

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## Acronyms

|       |                                                        |
|-------|--------------------------------------------------------|
| BEEPS | business environment and enterprise performance survey |
| CEE   | Central and Eastern Europe                             |
| CMEA  | Council of Mutual Economic Assistance                  |
| EBRD  | European Bank for Reconstruction and Development       |
| EIU   | Economist Intelligence Unit                            |
| EMU   | European Monetary Union                                |
| FDI   | foreign direct investment                              |
| IMF   | International Monetary Fund                            |
| NNP   | net national product                                   |
| OECD  | Organization for Economic Cooperation and Development  |
| PPS   | purchasing power standards                             |

Tables and figure given at the end.

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## 1 Introduction

The Czech Republic has been frequently cited as one of the most successful cases of transition economies in Central and Eastern Europe (CEE). Despite the costs related to the break-up of Czechoslovakia in late 1992 and 1993, the immediate consequences were quickly absorbed and the country implemented the most important market-oriented reforms relatively successfully and faster than most other CEE countries. The aim of the present paper is to provide a better understanding of the Czech model of economic development during the postcommunist period, its main features, advantages and shortcomings, both *per se* and in order to draw policy implications for other developing countries.

The paper is structured as follows. The initial conditions in the Czech Republic in 1989 and the development strategy adopted at the beginning of the transition are addressed (section 2). The importance of international factors is also discussed, including the role of trade opening, foreign direct investment (FDI), and external borrowing (section 3). The main achievements and failures of the strategy are then analysed, regarding both economic performance and progress with institutional reforms, as well as the reasons behind the resulting outcomes (section 4). Finally, the present and future challenges are addressed, including areas of reform that remain crucial in the forthcoming period (section 5). The paper concludes with some lessons for other developing countries (section 6).

## 2 Development strategy

Czechoslovakia was among the first countries in CEE that decided radically to transform its economic and political system, implementing market-oriented economic reforms and introducing multiparty democracy. The ‘velvet’ revolution against the regime took place already in November 1989, while actual political and economic changes were implemented somewhat later. In June 1990, the noncommunist parties won the parliamentary elections, whereas the first package of economic reforms was launched in early 1991 (see below).

At the time of the revolution, the questions to be addressed were numerous and complex, as transition was a historically unprecedented process in terms of both the scope and speed of necessary changes. There were no blueprints of how to quickly transform a state-owned, centrally planned economy into a full-fledged market economy. Czechoslovakia was among the first countries to experiment with radical economic reforms, including the dismantlement of central planning, price and foreign trade liberalization, and privatization through an innovative model—the vouchers or ‘mass’ privatization—invented precisely in order to enable the quickest possible, but also most equitable, transfer of state-owned assets into private hands.

During a large part of the period considered, the development strategy pursued by the Czech government coincided to a great extent with the transition strategy. Although the European Bank for Reconstruction and Development (EBRD) in 1995 had made a sharp distinction between the concepts of ‘transition’ and ‘economic development’—transition being defined as the process of establishing open market economies, referring to institutional change, whereas development referred to the enhancement of living

standards—it is clear that transition to a market economy was largely motivated by the pursuit of economic development (see Kekic 1996).<sup>1</sup> In the Czech Republic, economic reforms needed for introducing a market economy, as the top priority of the government in the 1990s, were carried forward at the cost of sacrificing some objectives of economic development in the short run.

As in other transition countries, the main determinants of economic performance in the 1990s were a mixture of initial conditions, including the level of development, geographical location, the state of institutions and human capital, and government policies, although the relative weight of these factors varied widely across countries. We will consider the role of both initial conditions and the development strategy in the Czech Republic at the beginning and during the first decade of transition.

## **2.1 Initial conditions**

Having retained many features of the traditional centrally planned economic system, Czechoslovakia in 1989 was among the less reformed CEE economies, much less of a market economy than Poland, Hungary or Yugoslavia. It had the highest share of public sector output, as high as 97 per cent of net national product (NNP) in 1986 (Hlavacek and Mejstrik 1997: 3-7); only 1.2 per cent of the labourforce, 2 per cent of all registered assets and 4 per cent of GDP belonged to the private sector in 1989-90 (Svejnar 1995). The economy was highly concentrated, consisting of a number of monopolistic firms. Czechoslovakia was also one of the countries most dependent on trade with other socialist countries within the Council of Mutual Economic Assistance (CMEA), a complicated system of bilateral trade clearing agreements based on non-convertible currency.

Despite many features typical of the traditional centrally planned economy, the Czech Republic started its transition from fairly favourable initial conditions. Before the Second World War, Czechoslovakia was one of the fifteen most developed countries in the world (Pavlik 2003). It was a market economy with a fairly solid industrial structure, a feature shared only with Eastern Germany, as the rest of CEE was much less industrialized (see Lavigne 1999; Svejnar 1995).

Moreover, in 1989, the macroeconomic situation in Czechoslovakia was rather satisfactory. In comparison with some other communist countries which faced hyperinflation already in the late 1980s, Czechoslovakia had very low inflation and there were no major inflationary pressures. Shortages were not so frequent and the monetary overhang was smaller than in most other centrally planned economies. The budget deficit was also low. Contrary to most CEE countries (e.g., Poland and Hungary), Czechoslovakia had a very low foreign debt and external accounts were balanced. Although the growth rates were not high, the economy was growing and the standard of living was probably still higher than in the GDR (Lavigne 1999). The unemployment rate was very low, under 1 per cent in 1990 (see Table 1).

The country also benefited from a well-educated and highly skilled labourforce, due to historically placed emphasis on universal primary education, broad-based general and

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<sup>1</sup> Transition has been considered a major instrument of development strategy, since systemic changes in CEE were not the target but merely the path to sustainable growth (Kolodko 1999).

technical secondary education and a more narrowly based but high quality higher education (see Svejnar 1995: 3). While the communist regime decimated many areas of the humanities and social sciences, the primary, secondary and higher technical education was preserved at a high level of quality by OECD standards. As to physical capital, the Czech Republic was also in a somewhat better situation than the other countries, having been a worldwide leader in industry before the Second World War, although at the end of the 1980s it was clearly lagging behind western economies technologically (see Svejnar 1995: 3).

By its geographical location, the Czech Republic was and remains the western-most country of CEE, being located between Germany, Austria, Slovakia and Poland. It retains a very favourable geographical position, today being in the centre of the European Union (EU) and having EU countries as neighbours. The proximity to developed market economies has become particularly important after the country's entry into the EU in 2004.

Among the CEE countries Czechoslovakia also had a different political tradition, since before the Second World War it was the only country considered a democracy in the western sense (Lavigne 1999). The specific historical background helps explain the unparalleled popular patience and acceptance of the radical transition policies and their tough outcomes, brought about in part by the vision that transition will enable the country to regain the status of an advanced economy (Svejnar 1995: 5). This is why it was relatively easier to sell radical economic reforms than elsewhere in the region. In addition, the fact that Czechoslovakia had one of the most hardline communist regimes, with a very centralized economic and political system, probably made it easier to carry forward the necessary changes, in comparison with the more reformed and more decentralized countries like Poland or Yugoslavia.

Available comparisons of initial conditions in countries embarking on transition confirm the relatively favourable position held by the Czech Republic in the early 1990s. The frequently cited study by de Melo et al. (1997) indicates the Czech Republic as the second most developed country in 1989 (after Slovenia) and as the country that had less economic distortions than many other socialist countries. According to an index of initial conditions compiled by Kekic (1996), based on more differentiated indicators of the institutional characteristics of these countries in 1989 (including exports to the CMEA, external debt, energy intensity, economic structure, etc.), the Czech Republic had an index of 19 and thus was ahead of Poland, but lagging behind Hungary and Yugoslavia (see Kekic 1996). In a further assessment by EBRD, the Czech Republic was placed on the very top of all transition countries, having the highest index of initial conditions (see EBRD 2001: 19).

## **2.2 Transition strategy**

In the 1990s, the central focus of economic policies in the Czech Republic, as in other CEE countries, was the strategy for transition. The intentions to introduce a market economy were declared already in November 1989, while preparations for implementing radical economic reforms started soon after. A meeting was organized by the Czechoslovak government in the Kolodeje Castle on 2-4 February 1990. For that occasion, a strategy paper on transition was prepared (Svejnar 1989), which later substantially influenced the Czech government's economic policies. The goal of the

economic transformation was to move the Czechoslovak economy from a relatively inefficient, centrally planned system, marked by a lack of incentives and a distorted structure of prices and quantity allocations, to a more efficient, market-oriented system based on competitive forces. The proposed strategy was one of rapid legal, institutional, and economic measures (see Svejnar 1989).

The ‘Strategy of Economic Reform’ was adopted in September 1990, followed by the launch of a ‘big bang’ stabilization programme in January 1991 (see Lavigne 1999). The shock therapy model was chosen less out of necessity, since the macroeconomic indicators were good, than as the expression of the political victory of the new ideology.<sup>2</sup> In order to maintain macroeconomic stability while introducing a market economy, the macroeconomic strategy was based on restrictive monetary and fiscal policies as well as strict wage controls. The microeconomic strategy included price liberalization of most goods and opening up to international trade, thus inducing a more efficient allocation of resources based on world market prices. The government opted for a fixed exchange rate regime and, after major devaluations of the Czech crown in 1989 and 1990, the introduction of internal convertibility (see Svejnar 1995). Extensive tax reforms were also implemented.

Additional measures were to contribute to the dismantling of ‘state paternalism’ and the institutions of the communist system, including the reduction of state subsidies to enterprises, the breaking up of the large state-owned enterprises in order to reduce the degree of industrial concentration, and their subsequent privatization. Privatization consisted of small-scale privatization of enterprises through auctions, the restitution of property nationalized after 1948 to former owners, and privatization of large enterprises. The mass privatization programme implemented for privatizing large-scale enterprises was based on the distribution of vouchers to citizens at large, which could be exchanged for shares of enterprises or investment funds. The first wave of mass privatization was launched at the beginning of 1992. After the partition of the country, the Czech Republic launched the second wave of mass privatization, which began in April 1994 and was declared as completed by early 1995. Thus from a position of virtually complete state ownership in 1990, the Czech Republic had by early 1995 privatized about 80 per cent of all its assets, with over 4,300 out of about 6,000 large enterprises having been privatized in the two waves (Svejnar 1995: 13).

Important new institutions of a market economy were also created. A double-tier banking system was set up in 1991, with the separation of the central bank from commercial banks. The recapitalization of banks was undertaken through the establishment of a special institution, the Konsolidacni Banka, and the transfer of bad loans to the state. The Prague Stock Exchange was created in 1992, as one of the first stock exchanges in the region. A social safety net was also set up, introducing unemployment compensation and social security benefits, with the originally generous benefits becoming more modest over time—at the level of 65 per cent of the wage during the first six months and 60 per cent thereafter (see Lavigne 1999; Svejnar 2002).

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<sup>2</sup> As noted by Lavigne (1999), the big bang programme was to express an intellectual and political commitment to radically break away from the past, thus excluding any possibilities of policy reversals.

### **3 Role of international factors**

With respect to the domestic factors, primarily the key policy decisions of the Czech government supporting radical and rapid market-oriented reforms, the international factors—foreign trade, FDI, external borrowing—have played a relatively less important role, particularly in the early years of transition. The importance of trade and FDI has greatly increased primarily during the last ten years, as the Czech economy has become increasingly integrated with the EU and globally.

#### **3.1 Foreign trade**

Foreign trade has played a fundamental role for the Czech economy during the post-1989 period. Foreign trade liberalization implemented at the very beginning of the transition was important for both the reorientation from traditional CMEA trading partners towards the EU and for increasing competition on domestic markets. After a major decline in exports in 1990-91 primarily caused by the dismantling of the CMEA and the collapse of the Soviet market, exports of the Czech Republic have risen steadily. This was facilitated by the Association Agreement with the EU, signed by Czechoslovakia in 1991 which subsequently, after the split with Slovakia, was transformed into two separate agreements in October 1993. The Association Agreement enabled duty-free access for most industrial goods from the Czech Republic to EU markets, thus greatly facilitating the very quick reorientation of its foreign trade towards primarily EU countries. Whereas in the past, about two-thirds of Czechoslovakia's foreign trade has been carried out with CMEA countries (one-third with the USSR alone), by 1993 the share already dropped to 20 per cent (Svejnar 1995: 10).

During the 1990s, foreign trade became a modest engine of growth, when Germany had replaced Russia as the main trading partner. The composition of Czech foreign trade has radically changed. The share in exports of machinery and transport equipment has doubled since 1993, while raw materials and semi-finished products have shrunk in similar proportions.

Today, the Czech Republic is a small open economy in which international trade is an important component, in 2005 exports and imports of goods and services representing 72 per cent and 70 per cent of GDP respectively (CERGE-EI 2006: 25). Due to increasing exports, from 2005 onwards the trade deficit has been turned into a surplus, for the first time since 1993. The recent high growth of the Czech economy was in part fuelled by increasing exports, which can at least partly be attributed to the positive effects of FDI and the EU accession, with the latter increasing the motivation for the further inflow of FDI.

#### **3.2 Foreign direct investment**

FDI has played an extremely important role in the Czech Republic, although with a delay relative to some countries such as Hungary. FDI inflows became significant primarily after 1997, in part as a response by the government to the economic crisis (see below). To some extent, this was due to the privatization of three major big banks and Transgas. Although in 2003 and 2004 FDI was much lower than in the previous years, it again picked up in 2005, when the Czech government sold its 51 per cent stake in the major telecommunication company to Spain's Telefonica. In 2005, the Czech Republic

has attracted the highest FDI per capita (US\$989) among all 28 transition economies, with the only exception of Hungary (EBRD 2006). The Czech economy today continues to rank high in terms of FDI attractiveness and was ranked number one in the *World Competitiveness Yearbook* (WCY) 2006 (see CERGE-EI 2006). The upward trend can be explained by the improving legal and institutional system, investment incentives, convenient location in the centre of Europe, and relatively low labour cost and corporate income tax (see CERGE-EI 2006: 29-30).

Despite the early delays in attracting major FDI, the Czech Republic is now among the highest recipients of total FDI among all transition countries. During the whole 1989-2005 period, the cumulative net FDI inflows into the Czech Republic have amounted to almost US\$52 billion, the second highest in the region (after Poland) (EBRD 2006). Moreover, cumulative FDI per capita in 1989-2005 has been over US\$5,000 (EBRD 2006), the highest among all 28 transition countries.

### **3.4 External borrowing**

The Czech Republic has been rather atypical in comparison to many other CEE countries, as external borrowing has played a limited role. Contrary to many transition countries that had to rely on stand-by arrangements with the International Monetary Fund (IMF) and negotiated write-offs of substantial parts of their external debt (e.g., Poland), the Czech Republic was not a highly indebted country: in 1990, its foreign debt was as low as 17 per cent of GDP. Although foreign debt in the meantime has gradually increased to over 40 per cent of GDP by 2006, it is still relatively low compared with that of Hungary or Bulgaria.

The Czech Republic concluded only one stand-by agreement with the IMF on 17 March 1993, and the agreement expired on 16 March 1994. The amount approved was 177,000 million SDR, while the amount drawn was only 70,000 million SDR. The amount was reimbursed before expiry in 1994, and the Czech government declined to use the last tranche. Since then there have only been regular discussions with the IMF under the Article IV Consultation missions.

Unlike in many other countries, the IMF and other international financial institutions have had little influence over the Czech government's policies. Although the 1991 Czech stabilization programme was very close to standard IMF packages, it was adopted independently of the IMF by a government which came to power democratically and which claimed full responsibility for its policies (see Lavigne 1999).

## **4 Assessment of the strategy: achievements and failures**

The first years of the Czech economic transition seemed to be a great success, both regarding macroeconomic stabilization and transition-related economic reforms. The Czech Republic was among the low inflation transition economies, and together with Slovakia and Hungary, it had the lowest inflation rate among all the CEE countries. After the liberalization of most prices, inflation jumped to 52 per cent in 1991, but was brought down to 11 per cent in 1992. Inflation was again relatively high in 1993 (21 per cent) but was reduced to 10 per cent in 1994 and remained fairly low thereafter (see Table 1). Contrary to most other CEE countries, the Czech Republic registered low

budget deficits in 1991-92, even a surplus in 1993, and has kept the deficit relatively low during the coming years (see Table 1).

As other CEE countries, however, the Czech Republic also experienced a very sharp decline of GDP during 1990-92, which stopped in 1993 and turned into a modest growth in 1994. The recession of the early 1990s was considered the necessary cost of the radical transformation of the economic system, which was to lead to faster growth and economic development in the future. Industrial production had declined even more than GDP. The early depression was caused by various factors, including tight macroeconomic policies, the credit crunch stemming from the reduction of state subsidies and rise in real interest rates, disorganization among suppliers, producers and consumers after the abolishment of central planning, the switch from controlled to uncontrolled monopolistic structures, difficulties of sectoral shifts in the presence of labour market imperfections, and the dissolution of the CMEA (Svejnar 2002). In the case of the Czech Republic, it is considered that around two-thirds of the GDP decline had been due to the effect of domestic policies, and one-third to external factors, primarily the abolition of the CMEA (see Svejnar 1995).

By the mid-1990s, the Czech Republic also seemed to have implemented rather successfully major institutional reforms, as suggested by the EBRD indicators on progress in transition (see EBRD 1995). In mid-1995, the Czech Republic ranked first among all transition countries regarding the private sector share of GDP (70 per cent), as the mass privatization programme had enabled a very quick transfer of previously state-owned enterprises to the private sector. Economic reforms had been virtually completed regarding large and small-scale privatization, trade and foreign exchange liberalization, and legal reforms, as in all these areas the country had been evaluated by the highest score '4'. Delays were reported in completing enterprise restructuring and governance, competition policy, banking reforms, and securities markets and non-bank financial institutions, but these areas of reform were still evaluated with a relatively high score of '3', suggesting that the Czech economy had made substantial progress also in these areas of reform (see EBRD 1995).<sup>3</sup>

Though the 1991 macroeconomic stabilization programme consisted of measures typical of the shock therapy, the Czech government also implemented a more gradualist strategy in a few other areas. The government was reluctant to close large loss-making state-owned firms and tolerated significant inter-enterprise debt, which prevented massive lay-offs (see Dyba and Svejnar 1995). Such a policy option, together with the absorption of many workers that remained without jobs by the services sector and the small-scale sector, meant that unemployment remained very low during much of the 1990s. By 1994 the Czech economy had gone through a slower and less complete labour adjustment than the Polish and Hungarian economies (Svejnar 1995: 7). In sharp contrast with most other transition countries, the unemployment rate increased from only 0.7 per cent in 1990 to around 4 per cent in 1993, and remained below 5 per cent thereafter. Only in 1998-99, as a consequence of the 1997 economic crisis, did the unemployment rate jump to 5.8 per cent and 8.5 per cent, respectively (see Table 1).

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<sup>3</sup> Interestingly, these indicators were subsequently revised downwards. Thus in the December 2007 electronic version of the EBRD transition indicators, two indicators for the Czech Republic in 1995 have been brought down to a 2+: competition policy, and securities markets and non-bank financial institutions.

Inequality in the Czech Republic has also fared better than in most other countries in the region (see Svejnar 2002). While all communist countries had highly egalitarian income distributions, in the early 1990s the Czech Republic had a lower Gini coefficient (23) than all the other 14 transition countries considered, except the Slovak Republic. By 1996-98, though the Czech Republic had seen its Gini coefficient increase to 26, it was still comparatively lower than in most other CEE countries; only Hungary at that time had a lower Gini coefficient than the Czech Republic (see Svejnar 2002: 19-20). Unlike many other transition economies, the Czech Republic has been relatively free of industrial disputes, despite the strong fall in wages in the early 1990s (see Dyba and Svejnar 1995: 45).

However, what was considered as the most liberalized and market-oriented transition economy entered a deep economic crisis in 1997-98. The Czech Republic was the only one among the five CEE countries that experienced a severe recession also in the second half of the 1990s. The 'Czech economic miracle' of the early 1990 had been based on excessively optimistic rhetoric of the Klaus government, since many reforms were not completed at all. The 1997-98 economic crisis showed that even a very consistent systemic transformation of the economy in a country with favourable starting conditions can fail, if it is not accompanied by the establishment of an adequate legal and institutional framework; that even a very well designed macroeconomic stabilization programme may not lead to sustainable macroeconomic stability if necessary changes at the microeconomic level are not implemented (Pavlik 2003). Instead of being a success story, the Czech Republic became a cautionary tale about the importance of development of proper economic institutions (CERGE-EI 2006: 67).

The roots of the 1997 economic crisis were manifold (see CERGE-EI 1997, 2006; Svejnar 2002; Lizal and Svejnar 2002; Pavlik 2003). The microeconomic ingredients for success of the transition strategy were missing. The weak legal framework and institutional development led to insufficient restructuring of the enterprise and financial sectors, as well as non-repayment of loans and hence accumulation of non-performing loan portfolios in the semi-privatized banks. Despite its relative speed, mass privatization resulted in dispersed ownership of shares and poor corporate governance. The weak legal system, with little protection of minority shareholders and other measures that would assure good corporate governance, often permitted managers or majority shareholders to appropriate profits and assets of the firms, thus also preventing the restructuring of many privatized firms (see Svejnar 2002). The capital market also could not cope with the huge number of illiquid shares immediately after privatization, and the expectations of establishing a fully functioning stock market within a short period of time did not materialize. Instead, insider trading, price manipulations, fraud in the investment funds, and abuses of minority shareholder rights prevailed (CERGE-EI 2006: 34).

Poor corporate governance also resulted from the ownership structure after privatization, since the most important state-owned banks often had important stakes in privatized enterprises, as they were the parent institutions of the largest investment privatization funds. Thus investment privatization funds were frequently controlled by semi-privatized banks in which the state still had an important stake (see Uvalic 2002; Estrin, Nuti and Uvalic 2000). Econometric evidence indicates that large poorly performing (loss making) firms had access to as much or more investment funds as the better performing firms and that smaller firms did not have easy access to capital (Lizal and Svejnar 2002). In view of the mounting non-performing loan problem, the banks

under the influence of the Czech National Bank gradually restricted new credit, thus triggering off economic slowdown.

By 1997, the Czech Republic was also confronted with growing macroeconomic imbalances. With the fixed exchange rate regime and domestic inflation exceeding inflation in western Europe, the Czech crown became overvalued and contributed to a substantial increase in the trade and current account deficit. Speculative attacks on the Czech crown occurred and forced the Czech National Bank to give up defending the currency in May 1997. The Czech National Bank adopted a floating exchange rate and implemented a more restrictive monetary policy, while the government adopted more restrictive fiscal policies (CERGE-EI 2006: 67). The previously soft budget policies that the banks pursued even vis à vis many of the privatized firms were replaced by hard budget constraints which, together with higher interest rates set by the Czech Central Bank, made the situation of many unreformed firms difficult.

A key remedy, stemming from the economic crisis, was privatization of the semi-privatized, state-owned banks. The banking crises required a huge government bailout, the size of which is estimated at 10-20 per cent of GDP (depending on the methods applied); if not under the state umbrella, banks' net worth at that point would have been negative (Tuma 2006). Given the size of the bailout and the similarity of experiences in other CEE economies, the government decided to turn to foreign strategic investors to complete the privatization of banks. As a result of privatization of the four largest banks between 1997 and 2001, entry of foreign banks, liquidations, and mergers, by 2005 institutions with majority foreign ownership accounted for 96 per cent of total assets of the banking sector. The development of the Czech capital market, however, has been rather non-standard due to the way privatization was conducted. Despite new regulations introduced in 1998 and adoption of EU legislation, the weak enforcement of rules and the non-transparency of the market have remained and the situation has been improving only gradually. The number of liquid shares has remained very low and new issues have not been forthcoming, since companies have not been willing to open up to the public (see CERGE-EI 2006: 34). More effective financial sector supervision has been enforced only in 2006, through the establishment of an integrated agency within the Czech National Bank. Overall, as in Germany and some other European economies, firms in the Czech Republic (and other CEE countries) remain reliant on bank credit and internal funds for investment.

The main achievement of the economic strategy adopted by the Czech Republic during the postcommunist transition is that it succeeded in implementing very quickly certain key market-related economic reforms, including small- and large-scale privatization and price and trade liberalization, cushioning, at the same time, the social impact of economic restructuring. There have also been important policy failures, however. Czech policymakers have grossly neglected the need to establish an adequate legal framework which would ensure efficient corporate governance of firms and banks, thus neglecting the importance of key microeconomic changes (Svejnar 2002). The Czech government deliberately opted for a model with very little regulation and weak legal norms, which led to a number of undesired outcomes.

Probably the main overall cost of these policy failures has been a relatively slower process of growth and catching up with the more developed countries, compared with other leading transition economies (see Figure 1). Throughout the 1990s the Czech Republic has had relatively slower growth rates than most other CEE countries.

Moreover, whereas the deep recession of the early 1990s was inevitable, the same cannot be said about the recession in 1997-98. Because of slower initial recovery and the crisis in 1997-98, the performance of the Czech economy has been below its potential. During the first decade of transition, the economic strategy in the Czech Republic did bring considerable institutional change, but it did not deliver some of the objectives of economic development. Economic recovery came with a delay and it took more than a decade to reach the 1989 level of GDP. Although over the 1989-2006 period the Czech Republic has almost tripled its GDP per capita in nominal terms (from less than US\$5,000 in 1989 to almost US\$14,000 in 2006, see Table 1), it was only in mid-2001 that the real GDP surpassed its 1989 level (EBRD 2002). The aspiration of quickly moving the Czech economy towards the ranks of advanced economies has thus not been fulfilled.

The post-crisis decade since 1998 constituted a successful development decade, characterized by strong FDI inflow, robust economic growth, rising wages, declining unemployment rate and an entry into the European Union in 2004. Still, it is primarily after 2004 that Czech GDP growth rates have become comparable to those of the other new EU members states and substantially higher than in the old members states. This has enabled faster convergence of the Czech GDP per capita towards the EU average: from about 40 per cent at the beginning of the transition, by 2006 its GDP per capita in PPS (purchasing power standards) corresponded to 79 per cent of the EU-27 average, similar to that of Malta and Portugal (Eurostat News Release of 17 December 2007). Despite such remarkable results in catching up, the Czech Republic has not changed its relative position within the group of postcommunist countries. In terms of GDP per capita, it remains the second most developed country among the ten new EU member states from central and southeast Europe, right after Slovenia (therefore similar to its position in 1989). In the 2007-08 UNDP *Human Development Report*, where countries are ranked according to the human development index (HDI) (based on life expectancy at birth, education enrolment and GDP per capita), the Czech Republic ranked 32d, therefore again ahead of all the other new EU member states, except Slovenia (see [www.hdr.undp.org](http://www.hdr.undp.org)).

As elsewhere in CEE, the relative parts played by initial conditions, government policies and external shocks responsible for the successes and failures of the Czech model of economic development are difficult to disentangle (Uvalic and Nuti 2003). While favourable initial conditions have undoubtedly helped, many of the outcomes, such as the low unemployment rate, rapid privatization and continuous popular support for the transition, have been brought about by judicious government policies (Svejnar 1995). This conclusion can actually be extended and considered valid for the whole 15-year transition period, as government policies have had the most important role for both the successes and failures of the Czech transition.

Godoy and Stiglitz (2007) give a broad survey of empirical literature on transition and its variable outcomes, considering the role of initial conditions, policies, and institutions. One of the striking results of their own regressions, undertaken for a longer period of analysis than the earlier studies, is that privatization speed has a negative effect on growth, thus lending cautious support to gradualism versus shock therapy (Godoy and Stiglitz 2007: 101). This result is consistent with what seems to have happened in the Czech Republic. Rapid privatization had a disruptive effect on the economy and was associated with asset stripping, which undermined subsequent and more meaningful reform efforts. Without good laws on corporate governance, and in the

absence of financial institutions and macroeconomic policies that make resources available at reasonable terms for wealth creation, incentives were in place for asset stripping rather than wealth creation. Shock therapy created conditions that were adverse to the creation of institutions that would themselves in the long run be conducive to growth (Godoy and Stiglitz 2007: 102-6).

## **5 Present and future challenges**

During the Czech Republic's negotiations with the EU, the most important economic criteria for accession had been fulfilled, as confirmed by the successful conclusion of the accession negotiations and its entry into the European Union in 2004. The Czech Republic today is considered a functioning market (or 'post-transition') economy. Consequently, the economic strategy of the Czech government in recent years has clearly been different than the one pursued in the 1990s.

After the country's entry into the EU in May 2004, the government has published a blueprint for reform, the 'Economic Growth Strategy' adopted in 2005, with a large number of detailed proposals regarding further integration of the country with the EU economy (see OECD 2006). In our view, the two most important challenges ahead are membership in the European Monetary Union (EMU), and maintaining competitiveness of the Czech economy in today's increasingly competitive environment.

### **5.1 EMU membership**

One of the most important challenges concerns the future entry of the Czech Republic into the EMU. The Czech Republic already fulfils most, if not all, of the Maastricht criteria required for EMU membership. Both the inflation rate and long-term interests rates in 2006-07 were well below the reference values (see EIU 2007). There was an upward blimp in inflation in late 2007-08, but this is expected to be a temporary phenomenon affecting all of Europe as a result of rising resource prices. Although public debt has rapidly increased in recent years, from only 13 per cent of GDP in 1999 to over 30 per cent of GDP in 2006, it remains well below the Maastricht limit of 60 per cent. The Czech Republic will also need to decide when to enter the ERM II (though the meaning of this criterion is controversial; see EIU 2007).

Until recently, the main problem was the budget deficit, which in recent years frequently stood above the set 3 per cent of GDP. Because of relatively fast economic growth, the 2007 deficit was below the 3 per cent limit and is expected to remain below 3 per cent in the future. The fiscal targets and envisaged ceilings are spelled out in the convergence programme and determined by a gradual adjustment path to meet the 3 per cent public deficit limit, as envisaged by the EU Stability and Growth Pact. However, successful long-term growth will require the implementation of more radical reforms. Although the government substantially decreased general government expenditure during the last fifteen years, from 54 per cent of GDP in 1990 to 42 per cent in 2006 (see Table 1), further changes in fiscal policy are needed which cannot be accomplished without substantial reforms of the social security, healthcare and pensions system (see OECD 2006).

Although the Czech Republic prepared a Strategy of Accession to the Eurozone in 2003, not much has been done to realize this goal. The Czech Republic had earlier been targeting euro adoption in 2010, but the current Czech president and most of the members of the Board of the Czech National Bank are against the adoption of euro, at least in the near future. As a result, the government has not set a target date for entry into the ERM II nor the EMU.

## **5.2 Maintaining competitiveness**

Accession of the Czech Republic to the EU has contributed to further expansion of export-driven manufacturing, backed by substantial FDI (see OECD 2006). Foreign-owned manufacturing firms are dominant today in the Czech Republic: it was estimated that in 2004, they produced 65 per cent of sales, employed 45 per cent of employees, and represented almost 80 per cent of total exports (CERGE-EI 2006). Multinational firms are responsible for the majority of Czech exports and have thus become the main engine of growth.

The Czech Republic retains the advantage of excellent location and proximity to the more developed EU countries. Lower transportation costs in comparison with some other EU members from CEE (e.g. Poland) imply that Czech firms can more easily be subcontractors to firms from the more developed EU countries. How to take advantage of the currently favourable situation and make it sustainable in the long run? How to keep the multinationals from moving further east, to Moldova or Ukraine, or, more realistically, complement the outflow of earlier FDI with a new inflow?

As the Czech Republic develops further, the diversion of labour-intensive, lower value-added manufacturing is likely to occur (Manktelow 2007). The Czech Republic would hope to compensate such trends by attracting more investment in higher value-added production and research and development. But enterprises operating in the Czech Republic and other CEE countries are increasingly struggling to find qualified labour, so this type of investment is at risk as a result of shortages of skilled labour. Germany's Bosch has indefinitely suspended a plan to open a new centre for automotive engines in the Czech Republic owing to concerns over staffing (Manktelow 2007: 10). Labour shortages seem to coexist parallel with the still high rates of regional unemployment, essentially due to educational mismatches. A study of IT employment in 2006 found that only one-fifth of undergraduate degrees and less than one-half of postgraduate programmes met firms' quality requirements. Thus the education system is failing to provide the necessary labour skills (see Manktelow 2007: 8).

The business environment and enterprise performance survey (BEEPS) on transition economies implemented in 2002 by the EBRD and the World Bank also confirm that there is a clear tendency for firms to increase the share of skilled employees in total employment, a common feature across regions for both manufacturing and services (see Commander 2007: 123). Firms from countries with better systems of education are competing in IT, marketing and other important areas.

One of the key factors for maintaining the favourable position of the Czech economy is therefore to invest more in human capital and R&D (see Svejnar 2007). In order to reduce skills mismatches, investment in education is clearly vital. The Czech Republic already fares well regarding some of the main indicators of the knowledge-based economy. R&D expenditure in 2005 was 1.42 per cent of GDP, therefore not much

lower than the EU-27 average of 1.84 per cent and substantially higher than in all the other new EU member states from CEE and the Baltics, where this indicator is usually well below 1 per cent (in all except Slovenia, where 1.22 per cent of GDP is spent on R&D; see Eurostat News Release, 12 January 2007). R&D expenditure financed by the business sector in the Czech Republic represents already 52.8 per cent of the total, therefore close to the 54.9 per cent for the EU-27 average, which is again substantially higher than in all the other new EU member states, except Slovenia (Eurostat, *ibid.*). Indicators on ICT in Czech enterprises are also encouraging. In 2007, 95 per cent of all enterprises had access to internet, therefore a larger percentage than the EU-27 average of 94 per cent; 77 per cent of firms had broadband connection, just as many as the average in the EU-27; and 71 per cent of enterprises had a website, in comparison with 65 per cent on average in the EU-27 (Eurostat News Release, 10 December 2007).

Nevertheless, a key policy failure is that the system of education has not really been substantially reformed (see Mateju 2004). The Czech Republic boasts one of the highest upper secondary school completion rates in the OECD (see CERGE-EI 2006: 45), but indicators regarding university education confirm low quality and low enrolment rates. According to the OECD indicators *Education at Glance*, the Czech Republic still belongs to those countries with the lowest enrolment rates to tertiary education, essentially due to extremely tough competition for admission. There is resistance to implementing a new model of financing, based on tuition fees and loans which would enable more young people to obtain a university education. An additional problem is the increasing inequality in access to tertiary education (see Mateju, Rehakova and Simonova 2003).

The Czech government has not yet presented any consistent policy agenda to address these issues. A lack of university reform imperils the ability of the country to compete, losing out particularly to countries that have reformed their universities and put them to the very centre of the human-resources development and innovation process (Mateju 2004). The still limited offer of educational opportunities and insufficient expansion of the tertiary sector of education, which is incapable of satisfying the growing demand for workers with higher education, can be a major threat to competitiveness and growth of the Czech economy in the future.

## **6 Policy implications**

From a centralized and closed economy, albeit a solid industrial and rather developed base, the Czech Republic turned out to be one of the fastest reformers among all transition countries. The Czech transition strategy was a rather unique combination of successful macroeconomic stabilization, fast transformation of the economic system, and minimization of the social impact of changes, which elsewhere has been much more dramatic.

Some main lessons to be learnt from the 18-year experience of economic reforms in the Czech Republic, which may be useful for other developing countries, are briefly outlined below.

- i) *Soft budget constraints*: The need to wean current and former state-owned firms from subsidies, whether direct or through the banking sector, is an

imperative of a successful policy package. The Czech case indicates that privatization *per se* does not necessarily lead to superior performance and that privatized firms may still rely on subsidies without adequate restructuring. Semi-privatized banks may function as providers of loans to poorly performing firms, while restricting credit to small- and medium-sized firms.

- ii) *Legal and institutional framework*: The lack of proper legal regulations and institutions that ensure the enforcement of laws can seriously undermine far-reaching and radical economic reforms. This implies that reforms of the judiciary should also be one of the top priorities on the reform agenda.
- iii) *Macroeconomic policies*: Macroeconomic stability is an important condition for long-term growth. The cases of the Czech Republic and other CEEs show that inflation can be contained in the presence of robust economic growth. At the same time, excessively restrictive monetary policies can be detrimental and can impede fast catching up with the more advanced countries.
- iv) *Openness*: A model based on openness to trade and FDI can have very positive overall effects, not only for the faster integration of a country into wider regional markets, but also because of their broader positive effects on the domestic economy, through increased competition, inflow of capital and knowhow, and spillover effects.
- v) *EU norms*: The adoption of the EU legislative framework is preferable at an early stage. In the Czech Republic, the convergence criteria were initially an important incentive for implementing necessary legislative changes. By late 1990s, however, although the Maastricht Treaty offered clear guidelines, the Czech Republic did not exploit this opportunity but postponed some of the changes to much later. This is an important lesson for the countries aspiring to join the EU, such as the candidate and potential candidate countries in the western Balkans.
- vi) *Education and skills*: Radical reforms of the system of education are also vital. The lack of an adequately qualified workforce could represent a major barrier for increasing competitiveness of the Czech Republic in the future.

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Table 1  
Selected macroeconomic indicators for the Czech Republic

|                   | 1989                              | 1990    | 1991    | 1992     | 1993    | 1994     | 1995     | 1996     | 1997     | 1998     | 1999     | 2000     | 2001     | 2002     | 2003     | 2004     | 2005     | 2006     | 2007     |
|-------------------|-----------------------------------|---------|---------|----------|---------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|
|                   | (Percentage change in real terms) |         |         |          |         |          |          |          |          |          |          |          |          |          |          |          |          |          |          |
| GDP               | 1.4                               | -1.2    | -11.6   | -0.5     | 0.1     | 2.2      | 5.9      | 4.2      | -0.7     | -0.8     | 1.3      | 3.6      | 2.5      | 1.9      | 3.6      | 4.6      | 6.5      | 6.4      | 5.5      |
| Exports           | na                                | na      | -6.0    | 9.5      | 15.8    | 1.7      | 16.7     | 5.5      | 8.4      | 10.4     | 5.4      | 16.5     | 11.2     | 2.1      | 7.2      | 20.7     | 11.8     | 15.9     | na       |
| Imports           | na                                | na      | -32.8   | 29.7     | 23.7    | 14.7     | 21.2     | 12.1     | 6.9      | 8.3      | 4.9      | 16.3     | 12.8     | 5.0      | 8.0      | 17.9     | 5.0      | 15.2     | na       |
|                   | (In % of labourforce)             |         |         |          |         |          |          |          |          |          |          |          |          |          |          |          |          |          |          |
| Unemployment      | na                                | 0.7     | 4.1     | 2.6      | 4.3     | 4.3      | 4.0      | 3.9      | 4.2      | 5.8      | 8.5      | 8.8      | 8.0      | 7.0      | 7.5      | 8.2      | 7.9      | 7.1      | na       |
|                   | (Annual average)                  |         |         |          |         |          |          |          |          |          |          |          |          |          |          |          |          |          |          |
| Consumer prices   | 1.4                               | 9.7     | 52.0    | 11.1     | 20.8    | 9.9      | 9.6      | 8.9      | 8.4      | 10.6     | 2.1      | 4.0      | 4.7      | 1.8      | 0.2      | 2.8      | 1.9      | 2.5      | 2.7      |
|                   | (In % of GDP)                     |         |         |          |         |          |          |          |          |          |          |          |          |          |          |          |          |          |          |
| Gov't balance     | na                                | -0.2    | -1.9    | -3.1     | 2.6     | -1.2     | -1.1     | -3.3     | -3.8     | -5.0     | -3.7     | -3.7     | -5.7     | -6.8     | -6.6     | -2.9     | -3.5     | -2.9     | -4.0     |
| Gov't expenditure | na                                | 54.5    | 51.6    | 49.6     | 41.2    | 43.8     | 40.5     | 42.6     | 43.2     | 43.2     | 42.3     | 41.8     | 44.5     | 46.3     | 47.3     | 43.8     | 43.6     | 42.3     | na       |
| Gov't debt        | na                                | na      | na      | na       | 18.8    | 17.6     | 14.4     | 12.3     | 12.2     | 12.9     | 13.4     | 18.2     | 25.9     | 28.5     | 30.1     | 30.7     | 30.4     | 30.6     | na       |
|                   | (In millions of US dollars)       |         |         |          |         |          |          |          |          |          |          |          |          |          |          |          |          |          |          |
| Current account   | na                                | na      | na      | na       | 455.8   | -786.8   | -1.369.1 | -4.127.1 | -3.621.5 | -1.308.1 | -1.464.2 | -2.687.9 | -3.271.8 | -4.263.7 | -5.785.3 | -5.751.3 | -1.940.0 | -4.585.0 | -6.468.0 |
| Trade balance     | na                                | -600.0  | -500.0  | -1.901.6 | -525.3  | -1.381.2 | -3.677.9 | -5.705.5 | -4.938.0 | -2.646.9 | -1.900.8 | -3.093.1 | -3.077.0 | -2.239.4 | -2.519.1 | -529.6   | 2.522.3  | 2.979.3  | 3.367.0  |
| FDI, net          | na                                | na      | na      | 982.9    | 563.3   | 748.9    | 2.525.6  | 1.280.3  | 1.258.6  | 3.574.6  | 6.219.7  | 4.941.7  | 5.474.2  | 8.281.6  | 1.813.6  | 3.940.5  | 11.630.0 | 4.666.5  | 5.200.0  |
|                   | (In % of GDP)                     |         |         |          |         |          |          |          |          |          |          |          |          |          |          |          |          |          |          |
| Current account   | na                                | na      | na      | na       | 1.3     | -1.9     | -2.5     | -6.7     | -6.3     | -2.1     | -2.4     | -4.7     | -5.3     | -5.7     | -6.3     | -5.2     | -1.5     | -3.2     | -3.9     |
| External debt     | 11.4                              | 17.1    | 26.3    | 23.8     | 24.3    | 26.0     | 31.1     | 34.2     | 37.8     | 38.9     | 38.0     | 38.1     | 36.2     | 35.8     | 38.2     | 41.3     | 37.1     | 40.9     | na       |
|                   | (In US dollars)                   |         |         |          |         |          |          |          |          |          |          |          |          |          |          |          |          |          |          |
| GDP per capita    | 4.880.1                           | 3.376.0 | 2.480.7 | 2.891.8  | 3.385.8 | 3.977.2  | 5.362.4  | 6.016.3  | 5.545.1  | 6.008.5  | 5.832.9  | 5.520.5  | 6.059.1  | 7.377.6  | 8.947.0  | 10.726.0 | 12.216.9 | 13.896.1 | na       |

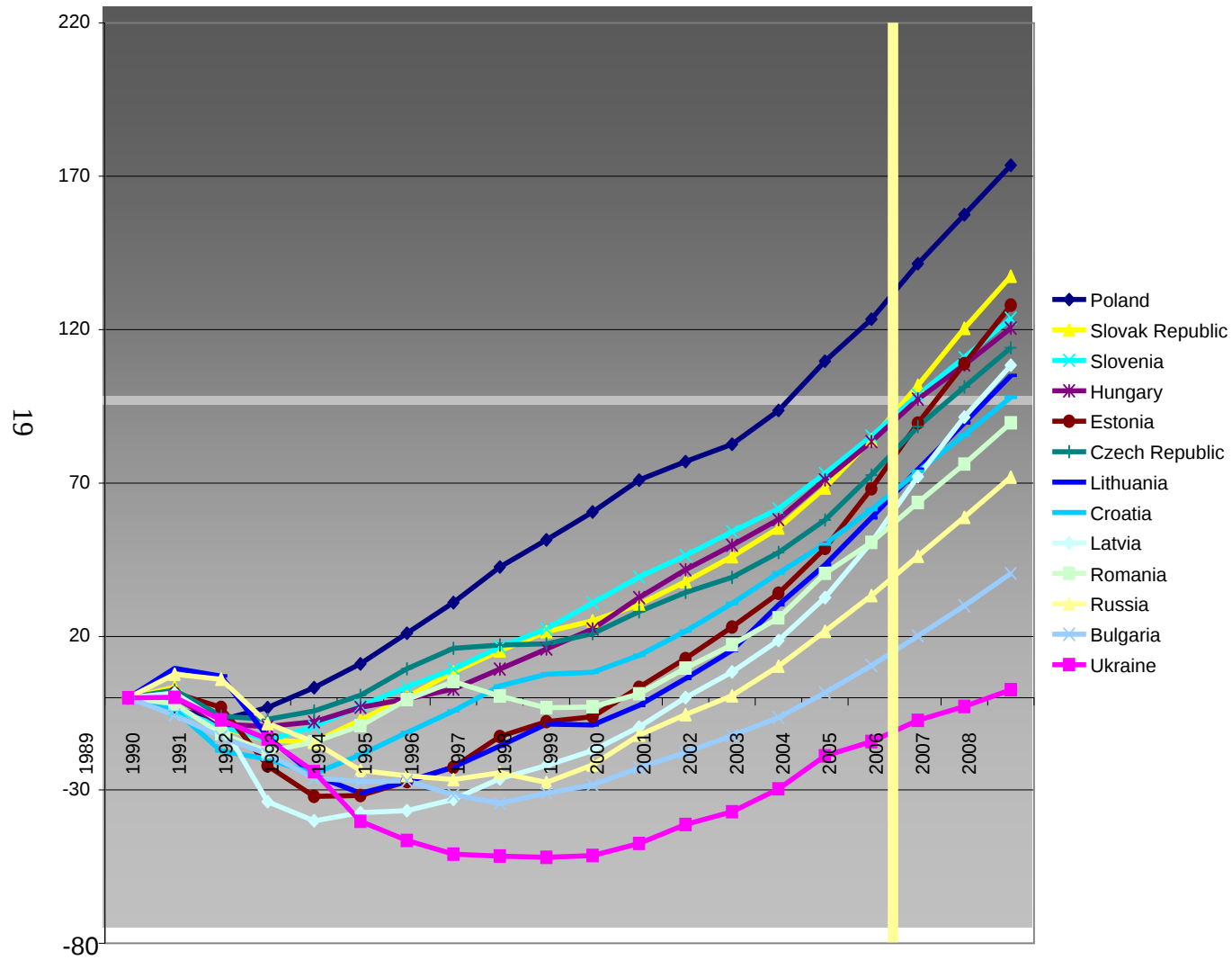
Source: EBRD (2007: macroeconomic indicators, electronic version available on-line).

Table 2  
EBRD transition indicators, Czech Republic

|      | Large-scale<br>privatization | Small-scale<br>privatization | Enterpr.<br>restructuring | Price<br>liberalization | Trade & Forex<br>system | Competition<br>policy | Banking reform &<br>interest rate<br>liberalization | Securities markets<br>& non-bank financial<br>institutions | Overall<br>infrastructure<br>reform |
|------|------------------------------|------------------------------|---------------------------|-------------------------|-------------------------|-----------------------|-----------------------------------------------------|------------------------------------------------------------|-------------------------------------|
| 1989 | 1.00                         | 1.00                         | 1.00                      | 1.00                    | 1.00                    | 1.00                  | 1.00                                                | 1.00                                                       | 1.00                                |
| 1990 | 1.00                         | 1.00                         | 1.00                      | 1.00                    | 1.00                    | 1.00                  | 1.00                                                | 1.00                                                       | 1.00                                |
| 1991 | 1.00                         | 3.00                         | 2.00                      | 4.00                    | 3.00                    | 2.00                  | 2.00                                                | 1.00                                                       | 1.00                                |
| 1992 | 2.00                         | 4.00                         | 2.00                      | 4.00                    | 4.00                    | 2.00                  | 3.00                                                | 1.00                                                       | 1.67                                |
| 1993 | 3.00                         | 4.00                         | 3.00                      | 4.00                    | 4.00                    | 2.67                  | 3.00                                                | 2.00                                                       | 2.00                                |
| 1994 | 4.00                         | 4.00                         | 3.00                      | 4.00                    | 4.00                    | 2.67                  | 3.00                                                | 2.67                                                       | 2.33                                |
| 1995 | 4.00                         | 4.00                         | 3.00                      | 4.00                    | 4.00                    | 2.67                  | 3.00                                                | 2.67                                                       | 2.33                                |
| 1996 | 4.00                         | 4.33                         | 3.00                      | 4.00                    | 4.33                    | 2.67                  | 3.00                                                | 2.67                                                       | 2.33                                |
| 1997 | 4.00                         | 4.33                         | 3.00                      | 4.33                    | 4.33                    | 2.67                  | 3.00                                                | 2.67                                                       | 2.67                                |
| 1998 | 4.00                         | 4.33                         | 3.00                      | 4.33                    | 4.33                    | 2.67                  | 3.00                                                | 3.00                                                       | 2.67                                |
| 1999 | 4.00                         | 4.33                         | 3.00                      | 4.33                    | 4.33                    | 2.67                  | 3.33                                                | 3.00                                                       | 3.00                                |
| 2000 | 4.00                         | 4.33                         | 3.33                      | 4.33                    | 4.33                    | 2.67                  | 3.33                                                | 3.00                                                       | 3.00                                |
| 2001 | 4.00                         | 4.33                         | 3.33                      | 4.33                    | 4.33                    | 2.67                  | 3.67                                                | 3.00                                                       | 3.00                                |
| 2002 | 4.00                         | 4.33                         | 3.33                      | 4.33                    | 4.33                    | 3.00                  | 3.67                                                | 3.00                                                       | 3.00                                |
| 2003 | 4.00                         | 4.33                         | 3.33                      | 4.33                    | 4.33                    | 3.00                  | 3.67                                                | 3.00                                                       | 3.33                                |
| 2004 | 4.00                         | 4.33                         | 3.33                      | 4.33                    | 4.33                    | 3.00                  | 3.67                                                | 3.33                                                       | 3.33                                |
| 2005 | 4.00                         | 4.33                         | 3.33                      | 4.33                    | 4.33                    | 3.00                  | 4.00                                                | 3.67                                                       | 3.33                                |
| 2006 | 4.00                         | 4.33                         | 3.33                      | 4.33                    | 4.33                    | 3.00                  | 4.00                                                | 3.67                                                       | 3.33                                |
| 2007 | 4.00                         | 4.33                         | 3.33                      | 4.33                    | 4.33                    | 3.00                  | 4.00                                                | 3.67                                                       | 3.33                                |

Source: EBRD (n.d., transition indicators; electronic version available on-line).

Figure 1  
Real GDP growth index in transition countries (in PPP), 1989-2008 (1989=100)



Source: Svejnar (2007).