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**GOVERNING THE TRANSITION TO A MARKET ECONOMY**



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**GOVERNING THE TRANSITION TO A MARKET ECONOMY**

by

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# GOVERNING THE TRANSITION TO A MARKET ECONOMY

"Transition is a bridge, therefore do not dwell upon it"<sup>1</sup>

## INTRODUCTION

After an initial burst of euphoria, transition economics, as the most recent child of our discipline, seems to follow the tradition of the mainstream: it is indeed becoming a dismal science. While political economists have multiplied the attacks against "cook-book-capitalism"<sup>2</sup> mainstream advisers in Central and Eastern Europe and academic research institutions alike have suddenly discovered the role of "institutions" to explain, why things have developed so much worse than expected.<sup>3</sup> For some this has focused the debate on specific reform deficiencies (Begg and Portes, 1992; Buch and Schmieding, 1992; Schmieding, 1993a). This, if anything, amplifies the role of government in the transition, while in no way contradicting the consensus around a broad set of initial reforms. However, the rescue found with institutional economics has led a number of economists to eschew any comprehensive reform plan. In the light of historical evidence for the slowness of institutional evolution (North, 1990; 1992) a gradual reform strategy is perceived to be naturally first best, and governments are advised to take a conservative and cautious trial and error approach to economic policy in the transition (Murrell, 1991; 1992; Etzioni, 1991).<sup>4</sup>

It is indeed ironic that neo-classical prescriptions are now being criticised not so much for involving too much market and too little state, but for neglecting government failures and societal inertia in prescribing the appropriate medicine for emerging market economies (EMEs) (see for instance Csaba, 1992a). While it is one thing to interpret the output falls in transition economies as a process of necessary and to a certain degree unavoidable "creative destruction" (Gomulka,

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<sup>1</sup> Chinese saying, quoted in Benacek (1992, p. 31).

<sup>2</sup> See Neuber (1993) for a very good summary. Also Killick and Stevens (1992); Przeworski (1991); Roland (1992).

<sup>3</sup> This author is no exception. See Raiser (1992).

<sup>4</sup> Such considerations are based on the presumption of inherent inflexibility in human behaviour and hence rising transactions costs if the rules governing economic exchange should be suddenly replaced. This is empirically untenable (Neuber, 1993) and further confuses the aims and constraints of economic transition. But even second best arguments for gradualism, taking into account political opposition and administrative bottlenecks, founder if the credibility of economic reforms is recognised as a necessary condition for sustainability and success (Funke, 1993).

1991), it is quite another to rely on the dynamism of the Schumpeterian entrepreneur alone to generate economic recovery (Murrell, 1991; 1992). This line of argument seems to forget that the very nature of the transformation crisis resides with the limited scope and role of capitalist private enterprises. The call for a reduction of entry barriers for small businesses is welcome (e.g. McDermott and Mejstrik, 1992), but it doesn't relieve the problem of what to do with the legacy of inefficient, giant state owned enterprises (SOEs).<sup>5</sup> Seen in this light the advocacy of trial and error as an economic policy programme sounds worryingly like another round of one step forward, two steps back reforms, which so characteristically failed in the period before the revolutions of 1989.<sup>6</sup>

Janos Kornai has perceptively analysed the reasons for industrial inefficiency in planned economies. His concept of soft budget constraints is central to any explanation of the current transformation process in Central and Eastern Europe (see Raiser, 1992; Kornai, 1993). It stresses the fundamental role of incentives for managers and workers in SOEs to behave according to market signals. Its premise is that, although concerted efforts should go into the rapid privatisation of the large scale industrial sector, the process of creating new property rights is necessarily slow (see also Csaba, 1992b). This means that governments in EMEs face a major task in monitoring the behaviour of SOEs until privatisation and creating incentive structures conducive to minimal friction in industrial adjustment. From this perspective we can endorse those contributions from the institutional economics literature that focus on how to reduce transactions costs during the transition (e.g. Buch, 1993; Heinrich, 1993) and how to fill the institutional void left under the ruins of the centrally planned economy (Schmieding, 1993b). The fundamental conclusion is that the state must organise its own retreat.<sup>7</sup>

This paper seeks empirical evidence to support the above contention. Thereby it capitalises on emerging differences in the reform strategies of the three countries already well into the second stage of economic transformation. Specifically, the Czech experience of low unemployment and remarkable price stability in contrast to both Poland and Hungary raises the question, whether this may be attributed to government policy, its late start in the transition process, or whether

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<sup>5</sup> For all creative destruction, most of these firms are still alive. Slow decay would thus be a better descriptive term.

<sup>6</sup> For a discussion of the reasons for failure see the extensive publications by Kornai (1980; 1986; 1992a). Also Brusz (1992).

<sup>7</sup> This may place a heavy weight on the commitment of policy makers as they have to cut through the variety of conflicting interests within the public sector.

exogenous factors and initial conditions are more important. On the other hand, the Hungarian reform path seems to be closest to the gradualist recommendations (Hare and Revesz, 1992). But Hungary also has pioneered the experience with strict bankruptcy enforcement and a number of other institutional reforms. It is thus of interest to relate its policy design to its economic performance, especially over 1992. The underlying aim of the comparison is to address the interrelated questions of whether microeconomic adjustment in the enterprise sector has taken place in each respective country and at what macroeconomic cost.

The following section briefly reviews economic developments in Czechoslovakia and Hungary until the end of 1992.<sup>8</sup> This leads to the formulation of three opposing hypotheses that may account for the observed differences in those two countries in particular. The third and fourth section investigate these hypotheses by first attempting an explanation for the Czech "miracle" of low inflation and low unemployment and then contrasting financial developments in Czechoslovakia to those in Hungary. The role of government policy is stressed although exogenous factors are found to play some role. The fifth section concludes in drawing the lessons from the Czech and Hungarian cases and outlining the ways in which governments can positively influence incentive structures in the transition to a market economy.

## **II. An Overview of Economic Reforms in Czechoslovakia and Hungary**

### *a) Czechoslovakia*

The Czechoslovak communists fell last in Central Europe. After the "velvet revolution" of November 1989, the new democratic federal government elected in June 1990 took six months to formulate a comprehensive reform plan. When it came into effect in January 1991, its key elements resembled the shock approach of Poland's Balcerowicz Plan introduced exactly one year earlier.<sup>9</sup> The plan included liberalisation of 85 per cent of prices (95 per cent in June 1991), inland convertibility combined with a 50 per cent upfront devaluation, complete abolition of import quotas and the introduction of a temporary 10 per cent import surcharge, as well as drastic cuts in budgetary expenditures, involving most

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<sup>8</sup> This implies that we treat Czechoslovakia as one country for most parts of our analysis. However, the different experiences of Slovakia and the Czech Republic shall be addressed, too. An overview of Polish reforms until mid-1992 can be found in Raiser (1992).

<sup>9</sup> The policy making environment and the economic discussions preceding the January reform are vividly narrated in Myant (1992).

consumer subsidies, and tight monetary policy as part of a macroeconomic stabilisation package (Borenzstein et al., 1992). Although conservative macroeconomic management preceding the reforms made for lower disequilibria both domestically and in the balance of payments<sup>10</sup> the government additionally relied on two nominal anchors to prevent the initial price jump from ushering in an inflationary spiral. The exchange rate was fixed against a basket of Western currencies and an incomes policy designed as part of a collective agreement, providing for a 12 per cent fall in real wages over 1991.

The Czechoslovak stabilisation programme must be judged an unmitigated success. Consumer prices rose 40 per cent from January to March 1991, but after that the inflation rate was down to less than 1 per cent per month, translating into a trend rate of 10- 12 per cent per annum. In spite of some administrative price corrections in January 1992 and the introduction of VAT in January 1993, consumer price inflation has been kept down and should not exceed 15 per cent even this year (PlanEcon, 1993). This stabilisation success contrasts markedly with Poland, where an inertial inflationary floor has persisted into the third year of reform.

Nonetheless, Czechoslovakia has not avoided a deep industrial recession at the start of the transition. GDP fell by 16 per cent in 1991 and another 5-7 per cent in 1992. For 1993 recovery is expected in the Czech Republic, although the disruption of trade with Slovakia may cause GDP to remain flat for another year, while Slovakia may slip even deeper into recession. Of particular interest is the fact, that unlike in the rest of Central Europe, the output fall in the Czech Republic has not been followed by large unemployment (see Section 3).

On the structural side, Czechoslovakia swiftly moved to small scale privatisation, involving some 25 000 economic units, mainly in services and commerce. Large scale privatisation was prepared in 1991 and was initiated in the second half of 1992 under the "voucher" scheme (Heinrich, 1993). Each citizen was given 1000 voucher points that were to be allocated in several rounds of public auctions. Shares of a total of 1500 enterprises in the first round (Dyba and Svejnar, 1992) could be bought directly or through a so-called investment funds. Although administrative bottlenecks and political barriers connected to the separation of the Czech and Slovak Republics have delayed the

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<sup>10</sup> Czechoslovakia was estimated to enter the transition with a much smaller monetary overhang than, for instance, Poland, shortages were limited, and the country's foreign debt stood at merely 15 per cent of GDP in 1989 (Borenzstein et al. (1992).

completion of the first phase of mass privatisation,<sup>11</sup> by the end of 1993, the share of the private sector in industrial production could reach over 35 per cent. This is a remarkable achievement, if one takes into account that 98 per cent of industrial output emanated from firms in state ownership prior to 1990.

Czechoslovakia has also accomplished a number of important institutional reforms. In 1990 a two-tiered banking system was introduced (Buch and Schmieding, 1992). Although the banks remained initially specialised and inherited portfolios that were largely sectorily concentrated, the intention of moving towards a universal banking system was clearly stated, with the involvement of banks in the voucher privatisation scheme. For the 1993 fiscal year capital adequacy ratios of 6.25 per cent have been declared for the old banks, new entrants after 1991 have to comply with the international standard of an 8 per cent capital-asset ratio. Moreover, the government has founded the Consolidation Bank, charged with converting bad debts of the banking sector into low interest bearing government bonds. Additionally, from April 1992, the central government was required to cover its deficits by open market operations, rather than borrowing directly from the Central Bank. All this implies a substantial deepening of the capital market, which could indeed be observed (Buch, 1993). Finally, after being postponed in October 1992, a bankruptcy law has come into effect on April 22nd 1993. It involves a three months grace period for enterprises in financial difficulties and came after several months of efforts to clear inter-enterprise arrears under the auspices of the National Property Fund. The effectiveness of this institutional framework shall concern us in Section 4.

#### *b) Hungary*

In contrast to Czechoslovakia, by the late 1980s Hungary had had two decades of experience with economic reforms. Since the introduction of the New Economic Mechanism in 1968 Hungarian economic policy was geared towards gradually expanding the role of market incentives in the allocation of resources. Prior to 1990 this was attempted mainly through a set of institutional reforms, involving inter alia the abolishment of compulsory output targets for SOEs, profit incentives for managers and workers, decentralisation of decision making to the enterprise level, and in 1987-88 banking and tax reform (Hiemenz et al., 1992). Foreign trade was also gradually liberalised. By the mid 1980s, the share of market transactions not subjected to price controls had reached 40 per cent, by

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<sup>11</sup> Bidding has been closed in December 1992, but shareholders and investment funds are in possession of their assets only since June 1993.



1990 this had been gradually expanded to 90 per cent of all products (Falk and Funke, 1993).

In spite of these measures, Hungarian economic performance failed to outpace that of its much more conservative Northern neighbour. Hungarians may have been acquainted much earlier with market mechanisms and the competitiveness of Hungary's industry may have been tested against Western competitors to a greater extent, but the pre-1990 governments continued to be prone to discretionary paternalistic interventions, which preserved soft budget constraints for enterprises, leading to a perverse incentive structure in the economy (Kornai, 1986; Kornai and Matits, 1987). Thus, GDP growth stagnated throughout the 1980s, averaging 1.8 per cent in 1982-88, while inflation gradually increased to reach 29 per cent in 1990. Additionally, the attempt to placate a disgruntled population and compensate for falling domestic savings led the Hungarian government to double its foreign debt between 1985 and 1990, when its gross value stood at 21.2 billion US \$, corresponding to a 45.5 per cent debt service ratio relative to exports (in convertible currencies) ratio, an extremely high figure both by comparison to other centrally planned economies (CPEs) and some of the highly indebted developing countries (DCs) (Oblath, 1993). The failure of piecemeal reforms prepared the ground for the toppling of Kadar from the Communist leadership in May 1988 and the beginning of economic transformation (Csaba, 1992b).

The Hungarian transformation so far, in a way, has been as eclectic as its reforms were earlier. Price liberalisation was continued at a somewhat accelerated pace, import liberalisation gradually reached 90 per cent of product categories, only 10 per cent remaining subject to licensing (Csaba, 1992b). Inland convertibility was, however, partially reversed in 1989, and only in 1992 were exchange controls fully lifted (Falk and Funke, 1993). In the area of macroeconomic policy, the monetary stance has been much less tight than in Poland or Czechoslovakia, while budget deficits overshot the original targets both in 1991 and 1992. As a result, inflation had risen to over 30 per cent in 1991. In 1992 inflation was reduced to 23 per cent.

Significant institutional changes were introduced with the banking reform in 1987 and a bankruptcy law in 1988. However banking regulations were tightened only at the end of 1991 and the New Bankruptcy Law enacted with a four year lag in January 1992. Privatisation policy has shifted emphasis several times (Mihalyi, 1993). In 1990, the process of "spontaneous privatisation" by SOE managers was halted and responsibility for the transfer of ownership rights

was located with the State Property Agency (SPA). The underlying aim was to sell state assets to the highest bidder. The slowness of this process - until the end of 1992 only 18 per cent of large scale SOEs were privatised through this method (EBRD, 1993) - and fears about a dominance of foreign capital yet again opened the door for some privatisation from below, involving management and worker buy-outs (Heinrich, 1993).

In spite of the less disruptive character of its transformation, the Hungarian economy has not escaped the deep recession besieging Central and Eastern Europe. GDP fell approximately 3.5 per cent in 1990, dropped by 12 per cent in 1991 and declined another 4-5 per cent in 1992 (EBRD, 1993). Unemployment hit the 13 per cent mark in the first quarter of 1993, while industrial production began a slow recovery from the third quarter of 1992. Nonetheless, pressing difficulties in the financial sphere, that prevent interest rates to fall, and a budgetary situation, that is close to getting out of control,<sup>12</sup> may mean that Hungary has to brace itself for yet another year of decline (GKI, 1992).

### *c) Three Opposing Hypotheses*

In a recent paper this author has pointed at four stylised facts characterising transition economies (Raiser, 1992). These were persistent moderate inflation after an initial price jump, unprecedented output falls, particularly in the state-owned industrial sector, rising budget deficits during the course of transition, and rising unemployment with a significant lag behind output falls (Table 1). Seen in relation to this broad canvas the above overview poses two puzzles. First, while the cumulative output decline has been similar (close to 20 per cent) in Poland, Hungary, and Czechoslovakia, in the latter inflation rates have not exceeded 15 per cent per annum, if one excludes the initial price shock, it has maintained fiscal balance, and unemployment rates have actually declined in the second year of transition (Burda, 1993). Why and/or how has Czechoslovakia, or at least the Czech Republic, avoided three of the four stylised facts mentioned in this paragraph? Second, why has Hungary's early start with gradual liberalisation and the establishment of some crucial market institutions three years before Czechoslovakia not lessened the costs of transition in the former country (see Köves, 1992). While a lot has been made recently of the Hungarian "gradualist success story" (Hare and Revesz, 1992; Szekely and Newberry, 1993) this seems hard to square with the evidence presented here.

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<sup>12</sup>The deficit reached 8 per cent of GDP in 1992 and could well reach the 10 per cent mark in 1993 (Budapest Bank, 1993).

Table 1 - Selected Macroeconomic Indicators, Czech Republic, Hungary, Poland, Slovak Republic, 1990-92

	1990	1991	1992 (estimates)
<i>Gross domestic production (percentage change)</i>			
Czech Republic )			
}	-0.4	-15	-7.1
Slovak Republic )			
Hungary	-4	-12	-5
Poland	-11.6	-7.0	0.5- +2
<i>Industrial Production (percentage change)</i>			
Czech Republic )			
}	-3.5	-24.7	-13.8
Slovak Republic )			
Hungary	-9.2	-18.1	-9.8
Poland	-26.1	-11.9	+4
<i>Unemployment (per cent of labour force)</i>			
Czech Republic )		4.1	2.6
}	1.0	6.6	5.1
Slovak Republic )		11.8	10.4
Hungary	2.5	8.0	12.3
Poland	6.1	11.8	14.0
<i>Fiscal Balance (per cent of GDP)</i>			
Czech Republic )			
}	0.1	-2.0	-3.3
Slovak Republic )			
Hungary	0.8	-3.2	-8.1
Poland	0.7	-6.5	-6.1
<i>Inflation (per cent increase in consumer prices)</i>			
Czech Republic )			
}	10.8	58.7	10.9
Slovak Republic )			
Hungary	29	34	23
Poland	585	70	43

Source: EBRD (1993), Statistické Prehledy (1993).

We suggest three opposing hypotheses that may account for these two puzzles. First, differences in economic performance in transition economies may be due to varying initial conditions. These would include exogenous factors such as geographical location, historical traditions and other "natural endowments", but also macroeconomic conditions at the start of transition, the extent of previous liberalisation and commercialisation of economic exchange, and structural differences related to the division of labour within the CMEA. Specifically, unemployment may be smaller, where a safety valve for redundant labour exists in a neighbouring country, where the inflow of tourism helps the rapid development of a service economy, and where the structural distortions prior to transition were less. Price stability could be due to a previous track-record of prudent macroeconomic management that helps to reduce inflationary expectations and avoids the problem of price inertia (Dornbusch and Fischer, 1991).

Second, it may be argued that relatively low unemployment rates in the Czech Republic are an indication that the worst is still to come for the Czech economy (Kopint Datorg, 1993; *The Economist*, 1993).<sup>13</sup> Supporters of this view impute a sense of inevitability to the recessions in all transition economies, including the vicious circle of rising unemployment, a deteriorating fiscal situation, due to increasing social welfare outlays, increasing inflation, and the slow emergence of private sector jobs. Once the Czech and Slovak Republics have enacted bankruptcy legislation and once privatisation has been completed, it is argued, SOEs will be forced to reduce hidden unemployment. Implicitly, this view would also expect to find evidence for soft budget constraints for SOEs in Czechoslovakia that enabled them to hold on to their workforce either by consuming their assets or running up debts with the expectation of a future bail-out. Hence, low and constant inflation rates may hide loose financial discipline and an underlying instability in the economy.<sup>14</sup>

Third, differences in government policy and in the general approach to economic reforms may determine the costs of adjustment to market conditions to a significant degree (Raiser, 1993a). This view relates low unemployment rates in the Czech Republic to specific policy measures that have helped to keep real

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<sup>13</sup>In Slovakia unemployment is already close to the Hungarian or Polish level. This hypothesis would presumably see a much worse fate still in keeping for the Slovak economy.

<sup>14</sup>Such an argument is made by Raiser (1992) for Polish industry in 1990-91. We shall compare developments in Poland and Czechoslovakia in the following section.

wages down and favoured the creation of new jobs. Price stability is similarly attributed to a monetary policy targeted at hardening budget constraints for SOEs and direct credit controls that have helped to overcome financial legacies and substituted efficiently for a market-based incentive structure. Hence, this hypothesis lays particular stress on the behavioural changes within the state-owned industrial sector. Only if SOEs react to changes in relative prices can structural change take place at all. Moreover, this hypothesis calls attention to the credibility and internal consistency of the newly created institutional incentive structures, in order to account for diverging reform experiences.

In the following two sections these hypotheses shall be investigated. We start in Section 3 by considering the exogenous factors that may account for the Czech "miracle" of low inflation and low unemployment during its transition so far. Then the case for a lack of enterprise adjustment in Czechoslovakia is taken up and rejected by looking at the development of real wages and labour productivity in particular in contrast to Poland and Hungary. The role of government policy thus emerges as the most important element of relatively successful reforms in Czechoslovakia. This finding is strengthened by contrasting the incentive structures in Hungary's financial market reforms to those in Czechoslovakia in Section 4.

### **III. A Tentative Explanation of the Czech Miracle**

#### ***a) Exogenous Factors and Initial Conditions***

Czechoslovakia entered the transition with the lowest foreign debt of the three Vishegrad countries. This reduced the need to finance interest payments by running trade surpluses. On the other hand, Hungary's initially precarious level of foreign reserves did not allow for the use of the exchange rate as a nominal anchor in price stabilisation (Fry and Nuti, 1992). In fact, however, the Hungarian real effective exchange rate substantially appreciated over the period of 1990-92, bringing the Forint quite close to its purchasing power parity level (PlanEcon, 1993). The large inflow of direct foreign investment and a surge in convertible currency exports have prevented balance of payments difficulties, related to the inherited foreign debt. The rise in Hungarian inflation up to 1991 cannot thus be attributed to its lack of a nominal exchange rate anchor.

The small monetary overhang in Czechoslovakia is often quoted as a factor that portended a less drastic stabilisation effort in Czechoslovakia at the start of transition (Borenzstein et al., 1992). While this may be true, it did in fact not lead to a less restrictive monetary policy to stem the inflationary pressures

resulting from price liberalisation (see Section 4). Hungary similarly had no monetary overhang by the late 1980s, mainly due to the gradual liberalisation of 40 per cent of prices that it had achieved as early as 1987. However, the country opted for a less disruptive monetary policy. Hence, rather than declining as in Czechoslovakia, Hungary's inflation rates since the start of transition were rising until 1991. The same result obtains for a comparison of fiscal policies in both countries. Both entered the transition with balanced budgets. Hungary introduced important fiscal reforms, such as the replacement of turnover taxation with VAT, as early as 1988, but its fiscal deficits have been constantly on the increase since 1990. Hence price stability continues to be endangered. Czechoslovakia, on the other hand, has been true to its tradition of fiscal balance. In conclusion, the initial macroeconomic conditions in Czechoslovakia and Hungary were not that unfavourable to the latter country. If Hungary still battles with inflationary tendencies, then this must be related to its macroeconomic policy design above all.

Let us now turn to the issue of unemployment and go through the exogenous factors that may have limited unemployment in the Czech Republic both in contrast to Slovakia and Hungary. First, one has to take into account the high level of industrial development in Bohemia and Moravia even before world war II. The Czech lands had a national income probably exceeding that of Austria in 1945 and measured in terms of purchasing power parities the Czech Republic's GDP surpassed that of Hungary by 23 per cent in 1992 (PlanEcon, 1993). Before embarking on the Stalinist development path, stressing heavy concentrated industrial compounds at the expense of small and medium scale enterprises, an industrial structure existed in the Czech Republic that engrained entrepreneurial expertise in the minds of its population (Audretsch, 1992; McDermott and Mejstrik, 1992). Especially the rapid development of small scale businesses after the initiation of privatisation may have been favoured by this tradition.

If this argument is taken to imply that a capitalist history may help to shorten the transition back from socialism, then it should not be limited to the Czech Republic. Indeed, Hungary's experience with private enterprises and "moonlighting" activities since 1968 should have provided a much better training ground and storage facility for the knowledge of how to do business, than a tradition reaching 40 years back!

Second, the inflow of tourism and large amounts of foreign investment capital are prime reasons behind a strong private sector dynamic in the Czech Republic. The private sector's share in GDP almost doubled from 10.6 per cent in 1991 to

19.5 per cent in 1992 (PlanEcon, 1993). Prague's unique attraction to foreign visitors continues to create a labour shortage in the Czech capital. In 1992 the Czech Republic boasted a 800 million US \$ surplus in services (PlanEcon, 1993), mainly from tourism. Direct foreign investment by the second half of 1992 had reached a quarterly rate of 420 million US \$. This stands in stark contrast to the Slovak experience of rather lukewarm foreign interests and certainly accounts for the larger number of vacancies in the Czech lands (Burda, 1993). However, Hungary is still the most successful attractor of foreign investments in the region. Neither this nor Budapest's reputable tourist attractions have limited unemployment there.<sup>15</sup> This would again point to a different adjustment pattern in the industrial sectors of Czechoslovakia and Hungary as a prime reason for diverging unemployment rates.

Third, the Czech Republic's geographical location on the border to Germany may have provided easy access to Western markets and a safety valve for redundant workers, that have crossed into Saxonia and Bavaria by the thousands. Unfortunately, we could not find any data that would indicate the importance of the latter phenomenon.<sup>16</sup> Hence, the following argument follows merely by conjecture. The contribution of cross-border migration to low unemployment in the Czech Republic is supported by evidence from Slovakia and Hungary, pointing at wide regional differences in unemployment. Indeed, close to the Austrian border unemployment in Hungary was below 10 per cent and similarly the area around Bratislava in the Slovak Republic has maintained relatively low unemployment rates (Burda, 1993; PlanEcon, 1993).<sup>17</sup> As Burda (1993) shows the vacancy-unemployment ratio displayed a large variance in the Czech republic, too. However, it was still higher in Northern Moravia than in Bratislava, inspite of a significantly longer geographical distance to the border with Western Europe. This fact is congruent with the finding of PlanEcon (1993) that unemployment pockets of 20-25 per cent are singularly absent in the Czech Republic. Unless we assume a much larger propensity to migrate among the Czech population, geographical proximity alone cannot explain such large unemployment differences as we observe. The same holds true for access to

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<sup>15</sup> Hungary's surplus in tourism was 590 million US \$ in 1992 (NBH, 1992).

<sup>16</sup> Inofficial estimates given to the author by the Ministry of Finance are in the range of 20 000 regular pendlers. This is less than 1% of the active labour force.

<sup>17</sup> Interestingly, Polish unemployment was highest in the Lower Silesia region bordering East Germany (PlanEcon, 1993). It is possible that high unemployment in East Germany provided less opportunities for cross-migration, or that Polish labour market policies made it easier to work illegally abroad and be registered as unemployed at home.

Western markets. The aggregate trade data does not indicate that Czech exports to Western Europe have grown considerably faster than Hungary's. According to PlanEcon (1993) Hungary's exports on a customs basis rose by 10.5 per cent in 1992, equivalent to roughly 2 per cent in real terms. Czech exports in 1992 declined overall by 1.8 per cent, although this possibly reflects some speculation about a devaluation of the Czech crown towards the end of 1992. Germany's share of total Hungarian exports was 25.5 per cent in 1991, while it took roughly 22 per cent of Czech shipments in 1992 (PlanEcon, 1993). Even if Eastern Hungary and Slovakia have been geographically disadvantaged, if we take Czechoslovakia as a whole, unemployment was still only half the Hungarian level in 1992. This strongly suggests that policy differences at a national level were the main factor influencing economic performance during transition so far.

As a final argument supporting the first hypothesis, we turn to structural differences that could explain a higher level of transitional unemployment in those areas burdened with the most inefficient industrial "dinosaurs" (Siebert, 1991). It is unfortunately extremely difficult to make any informed guesses about the extent of structural distortions in any of the CPEs prior to the start of transition. In the most comprehensive attempt to date Hare and Hughes (1992) find that the share of output in industries with negative value added at world prices, calculated using the domestic resource cost methodology, was 34.8 per cent in Czechoslovakia and 34.6 per cent in Hungary.<sup>18</sup> This does not give any a priori indication of higher structural distortions in either of the two countries. What other indicators could one use?

One crucial aspect of industrial inefficiency in CPEs economies was the level of energy intensity in production. With the rise in the price of Russian oil exports to world market levels, after the collapse of the CMEA, the heavy industrial sector should have been particularly affected. As Borenzstein et al. (1992) note, in Czechoslovakia this sector counts for a relatively large proportion of industrial output. Moreover, Slovakia as the arms forgery of the Warsaw Pact was probably most severely hit by the decline in demand for military equipment. In trying to make sense of differences in unemployment in the Czech and Slovak Republics several observers have alluded to this structural disadvantage of the latter country (Borenzstein et al., 1992; *The Economist*, 1993; PlanEcon, 1993).

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<sup>18</sup> These figures include adjustments for output quality and are based on input-output data from 1986 and 1987, and on 1988 and 1989 prices for Hungary and Czechoslovakia respectively.



A different way to look at the same problem is to compare Hungary's and Czechoslovakia's trade dependence on the CMEA. Interestingly, Hungary managed to reduce the share of exports going to the Soviet market alone from 35 per cent in 1985 to 18.7 per cent in 1990 (Csaba, 1993). In the same year as much as 40 per cent of Czechoslovakia's exports were still destined to the Soviet Union (Griffith-Jones, 1992). Thus, it would seem that, if anything, structural factors should have made for more unemployment in the Czech and Slovak Republics than in Hungary.

The relevance of structural factors in determining unemployment differences is further weakened, if one takes into account that the decline in industrial output and employment was virtually the same in the Czech and Slovak Republics both in 1991 and in 1992. We conclude at this stage that Hungary's position in terms of industrial structure, access to foreign capital, geographical proximity to Western labour markets, and macroeconomic conditions was not substantially worse than that of Czechoslovakia. Unemployment differences between the Czech and Slovak Republics may have to do with exogenous factors in so far as foreign capital inflows helped the creation of new jobs and Slovaks were disadvantaged in their access to cross-border employment opportunities.

***b) Is the Worst Still to Come?***

In an analysis of enterprise behaviour in 1990 and 1991 Krovak et al. (1992) strongly support the hypothesis of limited behavioural adjustment in Czechoslovak industry. Their findings are based on six aggregate indicators of enterprise behaviour, including revenues, profit rates, unemployment, enterprise indebtedness, bank credits to the enterprise sector, and enterprise deposits. The case for delayed behavioural adjustment rests on one particular observation, namely the close positive correlation of enterprise deposits and enterprise indebtedness. For Krovak et al. (1992) SOE managers used short term credits from the state banking sector for the purpose of decapitalising their firms prior to privatisation. The obtained funds were presumably transferred onto bank accounts under another name, while raising the debt/asset ratio of the firm would lower its market value.<sup>19</sup> This contention is further supported by the evidence of a lag of unemployment behind the fall in revenues and profits, and a negative correlation between profits and deposits.

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<sup>19</sup> Krovak et al. fail to provide any disaggregated data by firm. Hence, it is quite possible that the increase in deposits comes from those firms that are profitable, while indebtedness, including involuntary trade credits builds up in the inefficient enterprises.

The analysis of Krovak et al. seems to provide a reason for the phenomenon of a lack of structural change in 1991 identified by Borenzstein et al. (1992) and Hare and Hughes (1992), stemming from end-game strategies by SOE managers (see also Schmieding, 1991; 1993b). If Krovak et al. are right, the pattern of industrial adjustment in Czechoslovakia reflects the prevalence of soft budget constraints and perverse incentives in the industrial sector. This is precisely what this author has argued with respect to Poland (Raiser, 1992). A comparison of enterprise behaviour may thus help to decide the matter.

Indeed, macroeconomic developments in Czechoslovakia over 1991 mirror quite closely developments in Poland after the initiation of the Balcerowicz programme exactly one year earlier. While the budget recorded an initial surplus of 10 per cent of GDP in the first half of the year (8 per cent in Poland, see Raiser, 1992), the overall deficit at the end of the year had reached 2 per cent of GDP (Borenzstein et al., 1992). Unemployment in Poland at the end of 1990 was 6 per cent, while it was 6.6 per cent in Czechoslovakia in December 1991. Moreover, in Hungary unemployment was only 8 per cent by the end of 1991 and the fiscal deficit limited to 3.2 per cent of GDP. Both figures rose dramatically in 1992, when bankruptcy legislation may have increased pressures for structural adjustment. All indication was that further profitability declines, a deepening recession, rapidly rising unemployment, and an emerging fiscal crisis would haunt Czechoslovakia, too, in 1992. But the ghost has not appeared.

In the following we concentrate on one particular indicator of enterprise behaviour namely the relationship of real wages to labour productivity to explain this aspect of the Czech "miracle". As Estrin, Schaffer and Singh (1992) argue this may indicate whether cost minimisation was followed by SOEs. Other indicators, such as profitability figures, are less reliable and in any case unavailable for Czechoslovakia. Our approach has the additional benefit that the surprising explosion of real wages in Poland has often been cited as one crucial indication of loose financial discipline in the enterprise sector (Pinto et al., 1992; Raiser, 1992). The results obtained here hence also prepare the ground for the discussion in Section 4.

An analysis of the available data (for sources see Graphs 1, 2, 3) leads to the following observations:

- 1) On a sectoral level a correlation of a nominal wage index with labour productivity for 17 branches of Czechoslovak industry yielded a significant positive coefficient. This confirms results of a firm-based survey conducted by

Estrin, Gelb and Singh (1993), who found a substantial adjustment process under way in Czechoslovak industrial firms over 1992.

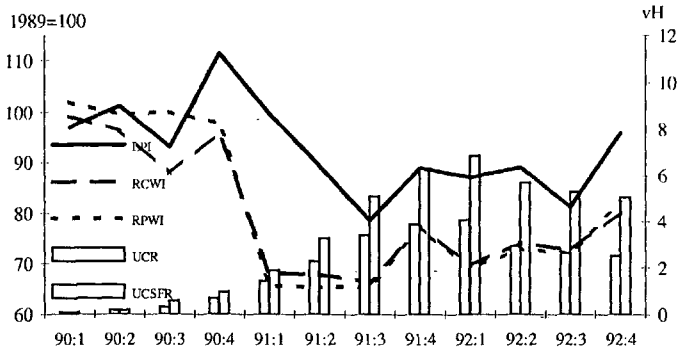
2) The fall in industrial production in Czechoslovakia was halted in the second half of 1992 (PlanEcon, 1993). This compares to a constant pace of labour shedding of around 10-12 per cent per annum, so that the industrial sector was able to maintain labour productivity during the first half of 1992 and even substantially increase it in the last quarter of that year (Graph 1). This recovery in labour productivity could signify an important turn-around for the still predominantly state-owned industrial sector, reducing the period of transitional recession in Czechoslovakia to less than two years. The contrast is provided by Poland where employment fell at a roughly similar pace following the start of transition in 1990, but a second collapse in output at the beginning of 1991 meant that labour productivity was still declining until the end of the second year of transition (Graph 2).

3) There was an acceleration of nominal wage increases in Czechoslovakia during 1992. Deflated by the CPI real wages have risen by around 7 per cent. However at the end of 1991 real wages were 26 per cent below their average level in 1990. By contrast, in Poland real consumer wages fell rather less during the first half of 1990 (i.e. the first year of transition) and had regained 90 per cent of their 1989 level by year end. When real product wages are considered the contrast is even more striking. As producer prices rose much less in Poland than consumer prices (see also Estrin, Schaffer and Singh, 1992), the real product wage actually rose above its 1989 average by December 1990.<sup>20</sup> Polish enterprises not only gave in to workers' wage demands more easily but they also suffered from the fact that even a limited decline in consumers' standard of living would correspond to a massive rise in unit labour costs.

4) The most striking difference between Czechoslovakia and Poland, however, results from combining the observations about labour productivity and real product wages. While in Czechoslovakia there is an almost perfect correlation for the industrial sector as a whole, real product wages in Poland exhibit a temporary peak at the turn of each year. More seriously, the real product wage

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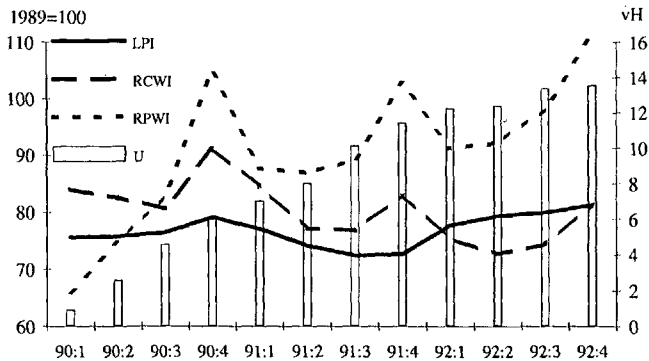
<sup>20</sup>The phenomenon of the rising "wedge" between producer and consumer prices may have a number of explanations. It is driven by the larger share of non-tradeables, notable services, in the CPI. Hence exchange rate overvaluation in Poland, and to some degree in Hungary is one candidate. Relative to its PPP level the Czech Koruna by contrast is still strongly undervalued (PlanEcon, 1993).

Graph 1 - Labour productivity, Real wages and unemployment in the Czech Republic<sup>a</sup>

<sup>a</sup> 90:1 - 91:4 Labour productivity data - CSFR.

Sources: RWI: Real Average Wage Index, Czech Industry (PlanEcon, 1993); LPI: Labour productivity Index (International Financial Statistics, 1993; PlanEcon, 1993), UCR, Czech unemployment rate (PlanEcon, 1993); UCSFR: Czechoslovakian unemployment rate (Statistické Přehledy, 1993).

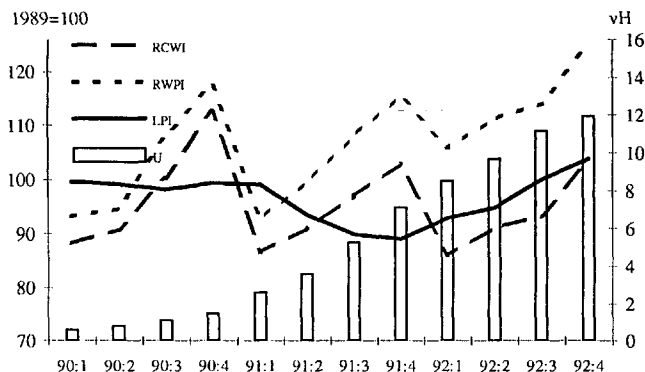
Graph 2 - Labour productivity, Real wages and Unemployment in Poland



Sources: LPI: Labour productivity Index in Industry (PlanEcon, 1993), RWI: Real Average Wage Index (PlanEcon, 1993), U, unemployment (PlanEcon, 1993).

line stays above the labour productivity line from the second quarter of 1990 onwards. In Czechoslovakia, on the other hand, real product wages have stayed below labour productivity throughout the transition. As the strong recovery of labour productivity after September 1992 suggests, recent wage rises are unlikely to fundamentally change this pattern.

Graph 3 - Labour productivity, Real wages and Unemployment in Hungary



Sources: RCWI, RPWI: Average monthly nominal industrial wage (PlanEcon, 1993; Statztikai havi kozlemenyek, 1991), deflated by CPI, PPI (International Financial Statistics, 1993); LPI: Labour productivity index (PlanEcon, 1993; Statztikai havi kozlemenyek, 1991); U: Unemployment, (Kopint-Datorg, 1992, PlanEcon, 1993).

5) When Czechoslovakia and Poland are compared to Hungary, we first of all note a much smaller decline in labour productivity in the latter case. This corresponds to a much greater reduction in industrial employment, by 10 per cent in 1990 and 18 per cent in 1991. Thus, Hungarian enterprises surprisingly did not exhibit a similar reluctance to shed labour, as their Polish and Czechoslovak counterparts. However, this adjustment in employment was unfortunately not translated into stronger wage moderation. Real consumer wages have fluctuated between 85 and 100 per cent of the 1989 average, while the growing "wedge" between producer and consumer prices has meant that unit labour costs were substantially higher in 1992 than three year earlier.

How can these four observations be combined into a consistent picture and does it support or contradict the hypothesis of a lack of structural change in Czechoslovakia as the root cause for lower unemployment? First, we can state

that the level of unemployment seems to be related to the development of unit labour costs in transition and not so much to structural adjustment per se. The contrast between Hungary and Czechoslovakia is most illuminative in this respect. While in both countries the industrial sector seems to have undergone important adjustments (see also Estrin, Gelb and Singh, 1993), in Hungary this was done primarily by laying people off, while Czechoslovak firms coped with overmanning by reducing real wages in addition to increasing redundancies. This casts substantial doubt on the pessimism of some authors concerning the flexibility of factor prices during transition. However, if factor prices are flexible and price elasticities of factor demand high, as in the Czechoslovak case, there is no reason why structural adjustment needs to be costly. With real wages in particular displaying little rigidity in the Czechoslovak case, the inevitability of unemployment, once bankruptcy regulations are enforced, may similarly be doubted. Hence our analysis raises the question by what policy measures the Czechoslovak government may have encouraged real wage flexibility and thereby limited unemployment (see next subsection).<sup>21</sup>

Second, given the roughly similar pace of labour shedding in industry in Poland and Czechoslovakia higher unemployment in the former case seems to indicate that obtaining a new job after having been made redundant was substantially more difficult. This again points in the direction of active labour market policies as a way to limit unemployment. Somewhat puzzling in this respect is the well-established belief that recovery in Poland is firmly private sector based (e.g. *The Economist*, 23.01.1993). This should have increased the pace of job creation. We can only give two speculative answers that may be related to statistical differences in the two countries. First, as Burda (1993) notes, a certain degree of moonlighting is permitted in Poland, hence, the increase in private sector employment to over 50 per cent of the Polish labour force should include some "working unemployed", too. Second, many private activities in transition economies continue to go unrecorded. While there is no a priori reason to expect this phenomenon to be more important in Czechoslovakia, the relatively strict labour market policies, there, may increase the supply of labour to the shadow economy. A lower reservation wage could imply that private activities grow even faster than statistically observed and that the Czech recovery may rival that of Poland.

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<sup>21</sup> Of course, ultimately the costs of structural adjustment should be measured by GDP declines. In this respect Hungary seems to have fared very slightly better than even the Czech Republic. However, the substantial statistical uncertainty surrounding GDP figures leaves open the possibility that this ranking could easily be reversed.

Third, the development of unit labour costs would seem to have an influence on the length of recession during the transition, too. This is supported by the fact that industrial recovery in Poland and to a lesser degree in Hungary gained momentum only during 1992. Czechoslovakia entered the transition process later, but emerged from recession at the same time. The possibility that a substantial part of the growth in the Czech service sector is underreported, raised in our previous point, supports this conclusion.

The evidence presented so far leads us to reject the hypothesis of a lack of behavioural adjustment in Czechoslovak industry at least as a cause for low unemployment. We must now attempt to find support for the third hypothesis, namely that government policies are one major reason behind lower unemployment and inflation in Czechoslovakia. The next subsection consequently looks at labour market policies and relates those to the development of real wages in Czechoslovakia.

### *c) Governing the Labour Market in Czechoslovakia*

Labour market policies in Czechoslovakia have been characterised by a considerable degree of direct interventions, inspite of the neo-liberal credo of the Czechoslovak government and its successor in the Czech Republic.

With the letter of General Agreement signed by the government and the Czech and Slovak Confederation of Trade Unions (CSKOS) on January 28th 1991 the door was open to a substantial cut in real wages. In fact, the planned decrease of 12 per cent was almost doubled in the course of the year. Moreover, an initial full indexation clause for minimum wages, set at 60 per cent of the average January 1991 wage level, was unilaterally abolished by the government in June 1991. This raises the question of why trade unions did not stage more powerful protests against this blatant and imposed reduction in workers' living standards. One could think of four reasons. First, workers' preferences for job security in the face of economic uncertainty may have outweighed wage aspirations. Low unemployment was a goal they were willing to support with sacrifices. Second, the CSKOS could not really be considered a political force of the "Solidarity" caliber. It had only been founded in 1990, had no tradition of fighting for workers' rights, and most of its officers were new to their jobs. This fostered an atmosphere of almost unconditional support for the government's reform strategy amongst the population. Third, the absence of multi-party coalitions in the Czechoslovak government gave a degree of discretion and power to the reformers in government, first and foremost the finance minister Vaclav Klaus, that probably surpassed even that of Leszek Balcerowicz during the early stages

of Poland's reform. Fourth, the government enhanced its credibility by pursuing an active retraining and employment policy. More importantly, maybe, the government strictly adhered to its balanced budget target (see below) and thereby honoured its side of the commitment to price stability in the economy.<sup>22</sup>

The Czechoslovak government has adhered to its policy of wage controls until the end of 1992. Excesses above the norm were taxed at a 500 per cent rate (Myant, 1992). Unlike in Poland, where access to credit has allowed even unprofitable firms to exceed the wage norms (Pinto et al., 1992),<sup>23</sup> excess wage taxes have never become an important item in the federal budget (EBRD, 1993). This, of course, is related to the extremely tight monetary stance followed in Czechoslovakia since the beginning of reforms, which is the topic of the next section. But the Czech government has recently reconfirmed that it does not shy back from direct interventions in the labour market in addition to macroeconomic policies. After the abolishment of wage taxes in January 1993 led to a rapid increase in real wages, penalties for nominal wage increases that exceed revenues in the preceding quarter by 15 per cent have been reintroduced in July (CBU, 1993).

The second aspect of labour market policies in Czechoslovakia is the rather strict eligibility criteria for unemployment benefit and the active retraining and employment policy pursued by the Czech government in particular. In comparing unemployment benefits across Central Europe, Burda (1993) finds that only 38 per cent of all unemployed were covered by Czechoslovak regulations, against 78 per cent in Hungary and 73 per cent in Poland. Moonlighting is not permitted as in Poland, and new entrants into the labour force are strictly excluded. Multiplying the coverage ratio by the net present value of the benefit package in terms of average weekly earnings, one gets an index of the unattractiveness of unemployment. Czechoslovakia scores best with 522 points, compared to 1240 for Poland and a startling 3388 in Hungary. Clearly, Czechoslovakia intervened successfully to minimise friction in the labour market, while Hungary's generosity probably contributed to the costly adjustment path over rising unemployment. Finally, active employment measures are found by Burda (1993) to have contributed considerably to the high vacancy-unemployment ratio in Czechoslovakia. Significantly, these

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<sup>22</sup>The importance of sticking to one's promises is stressed by Aspe (1992) in his assessment of the Mexican "Pacto" as an important element of stabilisation success in that country.

<sup>23</sup>Raiser (1992) notes that delayed payment of excess wage taxes accounted for a large and rising proportion of fiscal deficits in Poland over 1991-92.



policies were initiated earlier in the Czech Republic than in Slovakia. Over 1991 157000 jobs were created by local authorities in the Czech lands against only 24000 in Slovakia. Figures published by the OECD employment outlook (OECD, 1993) indicate that public measures to subsidise employment, particularly in the private sector reached 2.3 per cent of the labour force. The Czech Republic has invested 0.19 per cent of GDP in the mobilisation of labour supply against 0.07 per cent and 0.15 per cent in Poland and Hungary respectively. This again confirms our underlying argument that active labour market policies are one prime reason behind lower unemployment in the Czech Republic.

#### IV. FISCAL AND MONETARY POLICIES IN TRANSITION: The Evolution of Financial Discipline in Czechoslovakia and Hungary

##### a) *Enterprise Adjustment and Fiscal Consolidation*

There are two sides to the problem of enterprise adjustment in economic transition. If the enterprise sector fails to adjust to market conditions after the start of full-blooded liberalisation this will necessarily entail either rising unemployment and bankruptcies or a deepening financial and fiscal crisis related to the prevalence of soft budget constraints that may temporarily shield the state owned industrial sector. If the contrast between Czechoslovakia, Poland and Hungary is to be tenable we should observe diverging developments in their financial sectors and budgetary performance, too. For Poland the extent of its financial mess has been sketched in Raiser (1992). This section looks at the evidence for soft budget constraints in Czechoslovakia and Hungary and addresses the interrelations between industrial adjustment and macroeconomic policies. Thereby we also try to account for the remaining inflation differential between the two countries.

Let us start with the interrelation between enterprise adjustment and fiscal consolidation during transition. There are two issues to be considered. On the one hand, net transfers from the budget may be one way in which SOEs can avoid the necessary adjustment. If an enterprise is able to cover its loss by claiming subsidies from the government, then it may be able to hold on to its labour force, while paying higher wages at the same time. As Hardy (1992) shows theoretically, the government has an incentive to provide such subsidies, if the social costs of unemployment are considered to be too high. SOE managers are thus involved in a double bargaining game with workers and the government, in which the formers' strength may determine the amount of money

to be gained from the latter.<sup>24</sup> On the other hand, the adjustment path chosen by industry has a fundamental impact on the fiscal situation, even if subsidies are largely absent. Thus, in order to lower the social costs of unemployment the government may feel compelled to introduce a social safety net, which could weigh heavily on the expenditures side of the budget. At the same time, higher wages in SOEs reduce their overall profitability and may thus lead to an erosion of the traditional tax base in transition economies.

Table 2 - Czech and Slovak Federal Republics; General Government Accounts<sup>1, 2</sup>

	1988	1989	1990	1991	1992 Estimate	1993 Projection	
						Czech Republic	Slovak Republic
	<i>(In per cent of GDP)</i>						
<b>Revenue</b>	58.0	62.1	60.2	52.2	49.5	47.0	47.2
of which:							
Turnover taxes <sup>3</sup>	15.8	17.7	18.0	13.0	12.3	0.0	0.0
VAT and excise taxes	0.0	0.0	0.0	0.0	0.0	15.0	15.1
Taxes on profits	16.7	10.9	12.2	14.1	11.5	10.0	9.7
Taxes on personal income	6.9	6.9	6.7	6.3	7.6	2.0	1.3
Payroll tax and social security contributions	6.6	12.6	12.0	11.3	10.5	14.0	15.2
Taxes on foreign trade	2.1	3.1	2.7	0.3	1.7	1.0	1.2
<b>Expenditure</b>	59.5	64.5	60.1	54.2	52.8	47.0	47.2
of which:							
Consumption expenditures	24.0	23.2	22.7	20.7	18.8	n.a.	n.a.
Transfers to households	12.3	13.7	13.7	16.6	16.2	n.a.	n.a.
Transfers to enterprises <sup>4</sup>	17.3	19.8	15.7	7.3	5.1	n.a.	n.a.
Capital expenditures	4.6	1.6	2.1	4.3	5.1	n.a.	n.a.
<b>Balance</b>	-1.5	-2.4	0.1	-2.0	-3.3	0	0
<b>Memorandum item:</b>							
Subsidies <sup>5</sup>	13.0	16.1	12.9	7.3	5.2	n.a.	n.a.

<sup>1</sup> Includes the state and local budgets, and extra-budgetary funds, but does not include the funds of ministries and subsidised organisations. Data for 1988 are not strictly comparable with those of later years. - <sup>2</sup> Data for 1992 are based on state budgets and are not comparable with earlier years. - <sup>3</sup> Does not include net disbursements for negative turnover taxes, which are counted as expenditures in this presentation. - <sup>4</sup> Includes subsidies through negative turnover taxes. - <sup>5</sup> Based on national budget definitions, which not necessarily consistent with the definitions used in the general government accounts.

Source: EBRD (1993).

<sup>24</sup> Germany's current policy in the East comes close to this scenario, where unsustainable initial wage increases have caused employment to fall by over 50 per cent, and social unrest, including hunger strikes by workers, pushes the government to maintain employment by subsidies in those firms it has so far been unable to sell.

These two interrelated issues can be vividly illustrated by a comparison of Czechoslovakia and Hungary. As Tables 2 and 3 show both countries have substantially reduced subsidies to the enterprise sector; Czechoslovakia from a startling 20 per cent of GDP in 1989 to only 5.1 per cent in 1992, Hungary from 8.1 per cent in 1988 to an estimated 2.7 per cent in 1992. Governments in both countries have been firm in their determination to stop the support of SOEs out of the general government accounts.<sup>25</sup> The reduction of enterprise profit and turnover taxes on the revenue side is similarly accentuated in Czechoslovakia and Hungary. The sum of both items reached 31.5 per cent of GDP in 1988 in the former and 30.2 per cent in the latter. By 1992, this figure had fallen to 23.8 per cent in Czechoslovakia and a mere 17.2 per cent in Hungary. Overall, early tax reforms in Hungary seem to have enabled the government to maintain its revenue share in GDP around 52-54 per cent.<sup>26</sup> Czechoslovakia suffered a decline by 8.5 percentage points between 1988 and 1992. One would have expected that this would pose a severe burden on Czechoslovak fiscal policies. However, the budget remained roughly balanced.<sup>27</sup> In Hungary, by contrast the fiscal deficit exploded in 1992. The major reason, is the dramatic rise in the social security budget (see also Kornai 1992b), leading to an overall increase in the state expenditure quota in GDP to over 60 per cent. Rising unemployment is thus one of the main reasons behind fiscal problems in Hungary. In spite of institutional reforms on the fiscal side, inconsistent government policies have increased budgetary problems. In Czechoslovakia low unemployment meant less need for a generous social security system. Moreover, the recent introduction of VAT in January 1993 has posed no threat at all to fiscal stability (CBU, 1993). Stringent expenditure management remains the key to fiscal consolidation, and a necessary condition for successful institutional reforms.

The alternative to direct transfers from the budget for loss making enterprises, was to rely on subsidies from the financial system. This is all the more relevant

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<sup>25</sup> This, of course, still leaves open the possibility of subsidies through the financial system to which we turn further below.

<sup>26</sup> Perversely, this has been done by increasing the reliance on payroll taxes, hence making wage labour an extremely unattractive form of employment (EBRD, 1993). This may have further increased the redundancies and pushed employees into illegal or case by case contract work, while also increasing the number of claimants on unemployment insurance. See below.

<sup>27</sup> The 3.3 per cent deficit in relation to GDP given in Table 2 as an estimate for 1992 is probably much too high. Indeed, both PlanEcon (1993) and CBU (1993) report a balanced budget for the year.

Table 3 - Hungary: Consolidated Central Government Accounts<sup>1</sup>

	1988	1989	1990	1991	1992 Estimate	1993 Budget
	<i>(In per cent of GDP)</i>					
<b>Revenue</b>	54.8	53.8	52.8	52.9	52.4	54.6
Enterprise income/profit tax	8.2	8.1	7.2	5.7	2.8	2.8
Household income tax	0.3	1.6	2.9	5.9	5.9	6.5
Payroll tax	14.4	15.7	15.5	16.2	17.8	17.4
Property tax	0.1	0.0	0.1	0.0	0.1	0.2
Turnover tax, VAT, and excises <sup>2</sup>	22.0	17.4	16.6	14.3	14.4	15.4
Customs duties	3.0	2.8	3.1	2.7	3.8	2.7
Other revenues	6.7	8.1	7.5	8.0	7.5	9.5
<b>Expenditure</b>	55.1	54.5	52.0	56.1	60.5	60.6
Current expenditure	51.3	51.4	50.1	53.1	57.0	57.0
of which:						
subsidies to producers	8.1	5.4	3.9	3.1	2.7	2.3
subsidies to consumers	4.9	6.6	5.4	4.3	0.7	0.8
Capital expenditure	3.8	3.1	1.9	3.0	3.5	3.6
<b>Overall balance</b>	-0.2	-0.7	0.8	-3.2	-8.1	-6.0

<sup>1</sup> Consolidated accounts of the State and extra-budgetary funds (essentially the Social Insurance Fund, the Solidarity Fund, the Employment Fund, and the now defunct Housing Fund). State budget figures quoted in the Hungarian press may differ from figures in this table as the former usually refer to the state excluding extra-budgetary funds. - <sup>2</sup> Including the differential producer price turnover tax (DPTT), which applied to imports from CMEA until 1991. The DPTT totalled 3.2 per cent of GDP in 1988, 2.3 per cent in 1989, 2.7 per cent in 1990 and 0.5 per cent in 1991.

Source: EBRD (1993).

to the issue of SOE adjustment, as capital markets in transition economies are generally underdeveloped and the banking system typically has remained in majority state ownership for some time. Two problems are particularly pertinent to this issue. First, there is a debate whether monetary policies in transition economies have been too tight and thereby have exacerbated output falls (Calvo and Coricelli, 1992), or whether expansionary monetary policies merely fuel additional wage increases and ultimately leave the real economy unaffected, while raising inflation rates (Hrnčir, 1992; Raiser, 1992; Schmieding, 1993b). Second, even tight monetary policies may be ineffective in limiting the access of SOEs to liquidity, as deficient capital markets allow for the expansion of monetary substitutes in the form of payment default and the spread of loose financial discipline (Bofinger, 1992; Raiser, 1992; Kornai, 1993). Differing monetary policies and diverging approaches to capital market reform are thus the other two areas where we contrast the Czechoslovak to the Hungarian experience, in order to find support for our contention that Czechoslovakia successfully avoided large scale unemployment and high inflation during transformation due to credible and well targeted government interventions.

## b) *The Role of Credit*

As mentioned in Section 3, neither Czechoslovakia nor Hungary entered the transition with a substantial disequilibrium in the money market, which was pervasive in most CPEs in the form of the "monetary overhang". Monetary policy immediately after price liberalisation could thus be conducted without the danger of a sudden spending spree following the decumulation of forced savings.

Arguably more important than monetary aggregates is the distribution of credit among the various sectors of the economy. Under central planning, credit to the enterprise sector responded passively to the need for liquidity, while the household money circuit was entirely disconnected from enterprise finance. Monetary policy during transition thus had to be aware of the legacy of close contacts between bank managers and the directors of SOEs, that might perpetuate the allocation of capital on demand, with no consideration of expected returns (Raiser, 1993a). Thus in addition to tightening the provision of credit to the economy overall, in order to stem inflationary pressures, institutional reforms to improve the efficiency of capital allocation were paramount to a successful transition on the monetary side.

Table 4 - Monetary Survey, Czechoslovakia, 1991-1992, changes in per cent over previous end-year figures

Money	1991				1992			
	1	1-2	1-3	1-4	1	1-2	1-3	1-4
M1	-3.5	-1.1	9.7	28.7	-4.1	1.7	6.9	15.8
Quasi Money	4.5	13.1	15.4	25.7	8.9	13.0	19.4	25.5
Currency	-1.1	3.4	9.5	20.0	-3.5	7.5	12.1	12.2
Demand deposits	-4.2	-2.6	9.9	31.8	-4.6	-0.1	5.2	16.9
enterprises	-1.9	3.2	27.6	69.5	-9.7	-2.3	6.2	25.6
of which:								
SOEs	-22.0	-22.8	-4.5	44.5	-39.5	-42.1	-43.0	-25.4
households	-8.8	-11.0	-11.6	-8.9	0.7	2.5	2.1	3.5
T+S deposits	5.1	9.6	9.7	20.8	6.6	8.0	11.6	17.9
enterprises	43.8	87.6	32.4	30.5	94.9	135.8	171.5	218.9
of which:								
SOEs	-30.4	-31.8	-53.8	-54.6	98.4	199.9	170.3	234.5
households	4.4	7.7	11.2	25.9	3.9	5.6	6.7	14.6
For cur. dep.	-1.1	42.1	62.2	66.9	23.1	41.8	65.9	70.9
enterprises	-22.2	18.8	26.1	10.0	10.6	31.3	55.1	32.3
of which:								
SOEs	-	-	-	-	-	-	-	-
households	37.7	84.7	128.6	171.4	31.9	49.6	74.1	99.6
Producer price index	40.9	49.1	49.4	53.5	1.7	2.9	6.3	10.7
Consumer price index	47.6	53.2	52.5	54.8	2.9	5.7	7.2	9.2

Source: Own calculations based on: SBCZ (1992).

As Table 4 reveals monetary policy in Czechoslovakia has been extremely tight in 1991, while it was slightly expansionary in 1992. The contraction in 1991 was considerably greater than anticipated, as the projected yearly inflation of 30 per cent was exceeded by over 20 percentage points. Real M1 fell by roughly 25 per cent in 1991, reflecting both a fall in currency in circulation and in demand deposits. Time and savings deposits also fell dramatically, indicating a decline in savings, which is explained by the substantial deterioration of money incomes of the population. Interestingly, however, total liabilities of the banking sector to enterprises increased. This would seem congruent with the contention by Krovak et al. (1992) that the rise of SOE deposits reflects purposeful decapitalisation in the light of increasing enterprise indebtedness. However, a look at Table 5 refutes that argument. In fact, total credit of the banking sector to SOEs rose by merely 5.7 per cent over 1991 as a whole, a decline of almost 50 per cent in real terms.<sup>28</sup> The rise in SOE demand deposits rather reflects their precaution in the face of considerable economic uncertainty. It seems that SOEs in Czechoslovakia almost overreacted to the limited access to bank credits by breasting themselves for any unexpected further decline in their liquidity. This lies behind the drastic fall in real wages during 1991 and reflects the fact that monetary policies were credible and perceived to have shifted permanently. We argue that this is the main reason for the remarkable price stability achieved almost immediately after the initial price shock of January 1991, and maintained ever since. The general caution in Czechoslovakia's monetary sector is finally reflected in the unwillingness of banks to extend medium and long term credits. The ratio of short term to medium plus long term assets in their portfolios rose dramatically from 27.5 per cent in March 1990 to 48.2 per cent one year later and 64.6 per cent by March 1992.

In spite of a much looser monetary stance over 1992, SOEs continued to face extremely tight liquidity conditions. Table 5 exposes the further decline in credits to SOEs, by 13.2 per cent over the year in nominal terms. On the other hand, the private sector benefited greatly from the real increase in total domestic credit by 3 per cent. Its share in total assets of the banking sector rose from 5.7 per cent in December 1991 to 26.4 per cent at the end of 1992. Hence the share of the private sector in total credit for the first time exceeded its share in industrial production and GDP. With the goal of price stability achieved in 1991,

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<sup>28</sup> Of course, SOEs could still have avoided an adjustment to tighter liquidity by simply defaulting on outstanding payments. We look at this possibility in the next subsection.

Table 5 - Credit Survey, Czechoslovakia, 1991-92, changes in per cent over previous end-year figures

	1991				1992			
	1	1-2	1-3	1-4	1	1-2	1-3	1-4
Domestic credit	2.5	4.2	8.6	17.0 (18.7)*	-1.6	3.2	9.6	13.7
Net credit to gov.	-30.1	-84.1	-78.6	-32.1	-63.6	-39.7	-7.1	33.2
Net credit to prop. funds (absolute figures in bn. Ksc)	-0.9	-4.2	-11.7	-22.9 (13.7)*	1.9	-0.8	-10.3	-23.8
Credit to: Enterprises of which:	5.9	14.1	19.9	25.8 (20.3)	2.2	7.1	12.6	16.1
SOEs	-16.2	8.8	11.3	5.7	-2.7	-7.7	-10.5	-13.2
private	25.1	279.1	531.0	894.0	94.3	179.9	306.2	432.6
Households	2.4	3.2	6.2	10.8	1.6	0.9	13.5	19.8
Short term credit < 1 year	24.4	43.7	55.6	60.0	3.3	3.4	4.4	8.2
SOEs	22.9	38.2	47.6	51.0	-0.1	-5.3	-9.2	-10.9
private	85.5	724	1107	1608	21.2	64.2	140.6	225.0
Medium + LT	-31.9	-2.2	-1.1	-7.9	4.4	7.1	15.9	20.6
SOEs	-34.5	-4.9	-5.9	-15.8	-5.1	-9.7	-11.7	-15.2
private	2.9	116.4	320	633	156.5	271.3	447	609.3
CPI	40.9	49.1	49.4	53.5	1.7	2.9	6.3	10.7
PPI	47.6	53.2	52.5	54.8	2.9	5.7	7.2	9.2

\* Including 30 bn. Ksc bond issues to write-off bad debts in enterprise sector.

Memo Items:

1) Shares in Total Credit

12 1990 SOEs	84%	Private	0.6%	Cooperative	15%	
12 1991	79%		5.7%		14%	Foreign enterprises
12 1992	60%		26.4		11%	3%.

2) Short Term Credit/Medium + Long Term

03.90	27.5	03.92	64.6	12.92	58.4
03.91	48.2	06.92	64.9		
12.91	63.1	09.92	61.3		

Source: Own calculations based on: SBCZ (1992).

the Czechoslovak authorities could allow themselves to loosen up the tight monetary reign. But crucially, this did not lead to a resumption of perverse credit allocation to inefficient SOEs as in Poland at the end of 1990. Parallely, the banking sector could afford to increase the share of long term loans again, while there was a remarkable shift in the deposit structure towards longer term liabilities. It is important in this respect to note that SOEs in particular drew heavily on their accumulated demand deposits to finance wage increases over 1992. Hence, unlike in Poland wage increases in SOEs did not follow on the

heals of a rise in credits, but simply reflected an internal shift of enterprise resources.

Monetary developments in Hungary over 1990-92 followed a decrease in real money supply in both 1988 and 1989. Broad money fell by 12 per cent in 1988 and another 5 per cent in 1989 in real terms. During 1990-92 monetary policy was moderately restrictive. Broad money rose almost in line with consumer price inflation over 1990-91 and increased by 7 per cent in real terms in 1992 (Table 6).

Table 6 - Monetary Survey Hungary, 1990-92 - percentage increase, quarterly -

	1990			1991				1992			
	2	2-3	2-4	1	1-2	1-3	1-4	1	1-2	1-3	1-4
M2	3.9	7.9	24.1	-0.1	5.1	10.5	28.7	-0.1	6.6	15.3	28
Currency	0.1	0.05	11.8	-3.8	5.7	11.9	23.8	-6.9	0	10.0	
Enterprise deposits	10.3	17.5	43.3	-1.4	0.1	1.6	16.5	0.1	11.4	14.8	
Household deposits	3.0	7.3	20.7	0.05	5.3	13.3	36.1	1.8	3.5	17.0	
Net dom. credit	1.6	4.2	9.6	7.4	12.4	12.6	22.9	-0.2	3.6	6.3	
Debt of comm. sector	6.5	14.4	26.1	3.1	9.4	12.1	20.2	-3.2	-1.7	0.3	
Deposits of comm. sector	11.4	19.6	43.4	-1.5	2.9	4.1	21.6	1.6	8.1	12.6	
Net debt	2.4	10.4	12.5	7.7	15.7	19.1	18.8	-7.8	-11.4	-11.9	
Net. gov.* debt	0.1	-0.3	0.1	1.3	14.8	15.9	16.8	0.1	6.2	9.5	18.5
Net savings of households								7.5	21.6	34.9	37.4
Consumer price index Jan 1990=100	12.2	20.2	26.7	16.9	24.9	28.3	33.7	8.0	11.7	15.6	21.8
Producer price index	3.8	11.6	27.2	14.2	16.2	18.5	19.7	3.5	6.4	9.8	13.1

\* Inclusive of housing loans from 1991 on.

Source: NBH (1992).

For reasons that we come back to below, the monetary contraction in 1988-89 did not initiate structural change in Hungarian industry (see also Estrin et al., 1992). It was thus of interest to see, whether the change of government to a democratically elected coalition in June 1990 would at least alter the allocation of credit away from the support of ailing SOEs. Unfortunately the statistics for Hungary do not distinguish between state owned and private firms. Table 6 nonetheless reveals that the real bank debt of the commercial sector, stayed constant in 1990 and fell significantly in 1991, if one uses the consumer price deflator. However, it still rose about as rapidly as producer prices in that year. The latter figure measures the access to liquidity of the enterprise sector more



accurately. Thus we do not detect any strong restriction of bank lending to enterprises during 1990-91. We conjecture on the basis of the small absolute importance of the private sector that the bulk of bank loans was used to keep SOEs afloat in times of a severe profitability crisis. The remarkable behaviour of real wages in Hungary would support this contention. Only with the introduction of bankruptcy legislation in 1992 did the situation change. Real bank lending to the corporate sector fell by roughly 20 per cent. This severe credit restriction is expected to have greatly increased financial discipline.<sup>29</sup>

These observations raise two important issues, that shall serve to contrast Hungarian monetary policy to that of Czechoslovakia.

First, the contraction of credit to enterprises was limited in Hungary until 1992. In this sense, the country provides an empirical counterfactual to Calvo and Coricelli's (1992) credit crunch explanation for the recession in transition economies. Indeed, real credit in terms of producer prices fell by 28 per cent in Czechoslovakia in 1991, while it stayed constant in Hungary. Industrial output at the end of 1991 was 25 per cent below the 1990 figure in Czechoslovakia, while the decline over 1991 was 18 per cent in Hungary. The initially less disruptive character of Hungary's credit policies only slightly alleviated the industrial recession, because much of the money went into financing the service of bad debts. Much of the difference in monetary policies in Hungary and Czechoslovakia over 1990-91 simply was due to good money chasing bad money in the former case. In this situation the government was challenged to provide appropriate incentives to prevent creditor passivity (see Begg and Portes, 1992). Only Czechoslovakia took this challenge seriously.

Second, the situation in Hungary in 1992 is a textbook case of crowding out of the commercial sector by rising government debt. Its large increase since the second quarter of 1991 has provided an attractive outlet for funds that have accumulated in the banking sector. Moreover, the government seemed the only creditworthy entity left in Hungary, after the extent of the financial crisis had become clear.<sup>30</sup> In Czechoslovakia, on the other hand, the increase in broad

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<sup>29</sup> Note however, that as Szanyi (1992) argues, the uncertainty, connected to the large number of liquidations, similarly affects the access of profitable firms to bank loans. With real lending rates falling much slower than real deposit rates, investment-led recovery may yet be far away (see also Budapest Bank, 1993).

<sup>30</sup> The banking sector's dependence on government paper on their asset side gives a perverse twist to the government's monetary policy in the future. If it attempts to increase the demand for money by lowering the yield on its treasury bills, thereby also reducing its own debt service, this reduces revenues for the banks, which will therefore seek to recoup the

money in 1992 was accompanied by renewed lending to the enterprise sector, benefiting private firms above all.

### *c) Governing the Capital Market in Transition*

The discussion of general monetary developments in Czechoslovakia and Hungary has left open the question of how a perverse allocation of credit was largely avoided in Czechoslovakia and why problems persisted in Hungary, despite its early start with institutional reforms in the capital market. We start with the Hungarian case as it exposes the nature of the problem.

In 1987 a two-tiered banking system was introduced in Hungary. The state monobank was split into three commercial banks that inherited portfolios, divided roughly along sectoral lines (Abel and Bonin 1992). The National Bank of Hungary was established as the central monetary authority with control over interest rates and charged with the refinancing of the banking sector. Although the banking reform allowed the establishment of new commercial banks, the three largest banks, the Hungarian Credit Bank (HCB), the Commercial and Credit Bank (CC), and the Budapest Bank (BB) still accounted for 87 per cent of all enterprise deposits and 76 per cent of all assets in the commercial sector in 1990 (Abel and Bonin, 1992). Hence competition was virtually absent from the beginning. Moreover, ownership of the three largest commercial banks was distributed among the government and SOEs.

In this situation of pervasive cross ownership, the political pressures on the banks both from the government and from enterprise managers were high. Until 1990 both were essentially concerned with avoiding any social costs of the transition to a market economy and thus, in order to prevent bankruptcies, bank lending to ailing enterprises continued. Non-performing assets in the banking sector grew from 2.8 billion HUF in 1987 to 43.3 billion HUF in 1990, of which roughly 90 per cent were due to the HCB, the CC, and the BB alone (Buch and Schmieding, 1992; Szanyi, 1993).<sup>31</sup>

Against this increase in non-performing assets stood the legacy of an extremely thin capital base. In 1987 70 per cent of commercial bank liabilities were due to

loss by raising interest rates on corporate loans. All this is closely related to the undercapitalisation of the banking sector, and ultimately to the delay in the enforcement of banking supervision. See also Budapest Bank (1993).

<sup>31</sup> Note the parallel to Chile's experience with financial liberalisation, in which cross ownership of the banking sector by the "grupos", large industrial conglomerates, eventually led to the collapse of the banking system under the burden of non-performing loans. See Raiser (1993b).

the National Bank of Hungary on account of its refinancing facilities (Estrin et al., 1992). At the end of 1990 46 billion HUF in paid up capital and reserves of the banking sector stood against 43 billion HUF in bad debts. In sum the legacies of the communist era in Hungary not only perpetuated political interference in the allocation of credit, but they also created a banking system that was fundamentally weak and undercapitalised. To redress this situation the new government should have tightened banking supervision and improved incentives to stop the lending to inefficient companies.

Unfortunately, none of this happened. Indeed, as long as the banks enjoyed an unchallenged monopoly position, their weak capital base did not prevent them from harvesting huge profits in their corporate lending activities. The central bank refinancing rate was kept far below inflation in 1990 (Estrin et al., 1992), allowing some build-up of bank capital on account of central bank credits. However, capital asset adequacy ratios were only introduced in December 1991. In fact, the government had a substantial share in the profits of the banking sector, whose net transfers to the budget reached 7.6 per cent of total fiscal receipts in 1990 (Abel and Bonin, 1992). This explains the reluctance to allow banks to build up reserves from their pre tax income. The lack of incentives for prudence in credit allocation was topped up by the possibility to charge customers penalty interest on overdue payments. As the government lacked a clear commitment to enforce bankruptcy on those economic entities in repayment default, these would take up new loans to roll over old ones, in the hope that a bail-out would be forthcoming in the future. The banks, sharing this belief, were happy to extend a fresh loan as this increased their operating profits, even if by sound accounting standards they should have written off the old claims as a loss.

It is thus no surprise to find that bad debts in the banking sector rose to 252 billion HUF by September 1992, up by more than 500 per cent over the figure two years earlier.<sup>32</sup> By the time banking regulations were tightened in December 1991, the level of risk reserves of the three largest commercial banks was still only 41 billion HUF (Szanyi, 1993). Compared to total bank credit to the commercial sector, the official figures would put the share of non-performing assets in September 1992 at roughly 30 per cent, taking the larger unofficial estimates this rises to 40 per cent.

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<sup>32</sup> Unofficial estimates put the total of dubious claims in the banking sector at more than 300 billion HUF.

There is one final element of perverse capital allocation in transition economies that is related to the problem of ineffective monetary policies. The counterpart to non-performing assets in the banking sector are payment defaults between enterprises, the so called involuntary trade credits or inter-enterprise credits. If loans from the banking sector are unavailable, or lending rates on such loans are too high, then enterprises may bridge a temporary liquidity crisis by delaying payments to suppliers. This phenomenon is present in Western market economies, too, but in transition economies, temporary liquidity crises have turned to a protracted fall in enterprise revenues, and thus inter-enterprise arrears have accumulated and involved increasing instances of open breach of contract (Kornai, 1993). There is also a relation to the bad debt problem, as firms that are not paid by their customers cannot in turn service their bank debts. Hence a spiral of rising mutual indebtedness may develop, raising the spectre of a large number of triggered bankruptcies.

A priori the extent to which inter-enterprise credits are a substitute to official bank credit depends on the costs of contract violation. In principle it is also possible that inter-enterprise credits rise simultaneously with total bank credit, because firms do not expect any sanctions from misbehaviour. In fact, the access to bank loans during 1990 and 1991 do not limit the spread of interenterprise credits in Hungary (Table 7). Just as the neutral monetary policy could not limit the fall in industrial output it did not prevent the massive rise in payment defaults in the enterprise sector. Of course, it could still be claimed that this would have supported an expansionary rather than neutral monetary policy. However, during 1992, when credit tightness really began to bite, involuntary trade credits were reduced by almost one half. At the same time the New Bankruptcy Law was enacted in January 1992. This suggests that, indeed, the rise in inter-enterprise credits has more to do with the enforcement of financial discipline than with the stance of monetary policy.

Czechoslovakia started its capital market reforms much later than Hungary. Only in 1990 was a two-tiered banking system introduced. The assets of the monobank were distributed among two state owned banks, one for commercial activities (Kommerčný Banka, KB) and one for long term investment (Investičný Banka, IB). The State Bank of Czechoslovakia was established as central bank. Hence, the Czechoslovak banking sector inherited much the same sectoral segmentation as its Hungarian counterpart. The banks were similarly undercapitalised with a low 1.5 per cent capital asset ratio by early 1991 (Buch and Schmieding, 1992). With the two major commercial banks in state ownership, the scope for political interference continued to be large. Finally, if

Table 7 - Involuntary Trade Credit, Hungary 1979-1982

	Number of involuntary creditor enterprises	Total involuntary credit (HUF bn.)
1979	52	7.9
1980	25	3.8
1981	27	4.7
1982	85	15.2
1983	167	33.8
1984	159	38.4
1985	127	28.3
1986	82	14.0
1987	82	14.0
1988	208	45.5
1989	314	72.8
1990	432	90.5
1991	1 017	159.8
Apr. 1992	1 143	197.0
Dec. 1992	642	104.0

Source: Kornai (1993).

we include the 180 billion Kcs in Perpetual Inventory Credits (PCIs), extended at a fixed interest rate of 6 per cent with no final maturity to finance the working capital of SOEs in the 1970s, inherited non-performing assets were probably at least as large in Czechoslovakia than in Hungary. How did the Czechoslovak government deal with these legacies?<sup>33</sup>

First, it kept refinancing rates low during the initial months of transition. Hence, it used a similar avenue to Hungary in building up the initial capital base of the banks. The State Bank's discount rate stayed at 5 per cent per annum until November 1990 and thereafter rose to only 10 per cent for most of 1991. Real lending rates were negative until June 1991.

Second, the government actively intervened in credit allocation by fixing credit lines to SOEs for each commercial bank, while also imposing interest ceilings on corporate loans. Thus it doubly reduced the incentive for banks to lend out to SOEs. Indeed, the Czechoslovak credit crunch was not related to the cost of credit but consciously administered by government decree. In fact, banks were often more cautious in assessing an enterprise's creditworthiness as asked for by the government. All new entrants into the banking system had to comply with an

<sup>33</sup> In what follows we draw heavily on Buch and Schmieiding (1992).

8 per cent capital asset ratio, while the target for the old banks was fixed at 6.98 per cent for 1992. Crucially, risk reserves were tax deductible from the beginning.

Third, the recapitalisation of banks was not left to their current operations alone. Three months after the start of transition a Consolidation Bank was set up that exchanged a total of 110 billion Ksc of PICs for fixed interest bearing bonds with an 8 year maturity. With the current inflation rate around 12 per cent the real interest on these bonds is positive. Until mid-1992 the Consolidation Bank managed to reduce the stock of PICs to 95 billion Ksc by collecting repayments from enterprises (Buch and Schmieding, 1992). Moreover, in October 1991 the National Property Funds of the Czechoslovak federation, and the Czech and Slovak Republics issued a total of 50 billion Ksc in government bonds. The aim of these bonds is to selectively write-off non-performing loans to enterprises on the conditions that they were taken out prior to 1989 and that the respective firms were "potentially healthy". In December 22 billion Ksc of such loans were cancelled.

It was as a result of these various interventions that the share of credit going to SOEs was greatly reduced (see also Section 4.b). The tight liquidity conditions imposed on SOEs through credit ceilings forced them to reduce real wages substantially, thereby contributing to lower unemployment. The rapidly growing private sector at the same time was able to benefit from bank loans at low real interest rates.<sup>34</sup> We now turn to the issue of payment defaults during economic transformation in Czechoslovakia, to see whether the impact of monetary and credit policies might nonetheless have been lessened by loose financial discipline in Czechoslovakia, too.

The extent of non-performing assets in the Czechoslovak banks is hard to gauge. Until the third quarter of 1992 dubious credits and loans temporarily in arrears showed almost no increase, suggesting that the measures writing off old debts and limiting the extension of new credits to enterprises were successful (Table 8). However, after an internal audit by foreign experts was conducted in a number of Czech banks, the total of dubious claims alone increased to 10.4 per cent of short term credits and 2.8 per cent and 8.2 per cent of medium and long term credits respectively by the end of 1992. In the Czech Republic alone, the Ministry of Finance estimates the sum of "risky" credits (dubious and temporarily in arrears credits) to have reached 114.1 billion Ksc in October

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<sup>34</sup> Moreover, the early move on recapitalisation of the banking sector is a precondition for maintaining low real interest rates in the future.

1992, but falling to 100.8 billion Ksc by December. Against this, Czech banks had accumulated 44.9 billion Ksc in reserves. It thus seems that the financial sector was in distress in the Czech Republic in spite of the early move to write-off a substantial share of the debt.<sup>35</sup>

Table 8 - Bad Debts as a Percentage of Total Credit in that Category, Czechoslovakia, 1991-92

	1991				1992			
	1	2	3	4	1	2	3	4
Short term credit temporarily in arrears	3.7	4.7	5.4	4.2	5.9	6.1	5.0	4.5
dubious credits	-	-	-	0.7	0.4	0.1	10.6	10.1
Medium term credit temporarily in arrears			0.02	0.3	0.4	0.5	8.9	9.1
dubious				0.1	0.07	0.06	6.3	2.8
Long term credits temporarily in arrears				0.14	0.38	0.5	3.4	4.4
dubious				0.05	0.006	0.02	4.6	8.2

Source: Own calculations based on: SBCZ (1992).

There is, however, reason to believe that this will not affect the stability of the Czech banking system in the future. First, according to the IMF representative in Prague, only 15 billion of bad debts in the Czech banks are non-performing loans for domestic production. The rest are trade credits that are frozen on transfer rouble clearing accounts and will be assumed by the Consolidation Bank. This information is consistent with the claim by KB, the by far largest holder of corporate debt, that it sold another 8 billion Ksc of bad loans to the Consolidation Bank in 1992.<sup>36</sup>

Second, the banks have played a major role in the first round of mass privatisation in the Czech Republic.<sup>37</sup> This gives them an interest in the solution of the bad debt problem and the capacity to monitor enterprise performance more effectively. If a bank continues to extend dubious loans to firms in which it has equity, this will ultimately reduce the value of these assets. The important thing to note is the connection between positive incentives for banks and strict

<sup>35</sup> The situation in Slovakia is worse still, as its former heavy dependence on trade with the CMEA has led to the accumulation of trade arrears in Slovak enterprises, which in turn limits their repayment capability.

<sup>36</sup> The major difference to Hungary is, of course, that the government is much less able to grant debt write-offs, on account of its fiscal problems. Recent consolidation efforts in Hungary are considered below.

<sup>37</sup> Three of the largest four investment funds, bidding in the two consecutive rounds of auctions, are run by commercial banks (PlanEcon, 1993). The Czech Savings Bank, the IB, and KB together accounted for roughly 60 billion Ksc of the total 470 billion Ksc book value of firms approved for privatisation.

rules set by the government. Thus, the sum of each bond issue is fixed in advance, so that banks will attempt to select those companies for write-offs, that have the largest potential.<sup>38</sup>

Two further pieces of evidence should serve to strengthen our positive assessment of capital market reforms in the Czech Republic in particular. As mentioned above bad debts have started to decrease from October 1992 onwards. More interesting, still, is the behaviour of inter-enterprise credits. As Table 9 shows, they more than doubled during 1991. SOEs took by far the largest share with 149.6 billion Ksc of the total of 174.3 billion Ksc. Clearly, it was possible even in Czechoslovakia to avoid credit ceilings and the extremely tight monetary policy. At the end of 1991, the share of inter-enterprise credits to total bank credit to enterprises was 25 per cent. However, if we add the increase in inter-enterprise credits in Czechoslovakia to the change in the stock of total credit to enterprises at the end of 1991, we still get an overall decrease in real terms of almost 20 per cent. In Hungary the increase in inter-enterprise credits over 1991 came on top of a roughly constant real enterprise debt to the banking sector. As in Hungary, inter-enterprise credits in Czech SOEs declined with the start of 1992, inspite of the continously tight liquidity conditions they were facing. Although the Czech bankruptcy law was due to come into effect only in October, and eventually was delayed for another six months, Czech enterprises at least felt that there was a considerable cost associated with payment defaults. The surprising fact is that this was achieved without recourse to drastic sanctions as in Hungary in 1992. We contend that the underlying cause is to be found in the consistency and credibility of Czechoslovak policy making.

Table 9 - Suspended Payments, end of period: billions of KSC

	1991				1992		
	I.	I.-II.	I.-III.	I.-IV.	I.	I.-II.	I.-III.
<b>Czech Republic</b>							
All firms	55.6	88.4	100.2	113.2	107.8	109.6	94.2
State-owned firms	....	....	....	101.2	98.8	97.8	80.4
<b>Slovak Republic</b>							
All firms	23.0	34.6	46.9	61.1	62.4	....	60.2
State-owned firms	....	....	....	48.4	....	....	47.3

Source: Data provided by the Czech Ministry of Finance.

<sup>38</sup> The liabilities of banks to voucher holders, whose confidence is crucial for the acquisition of equity, strengthens this motivation. This should minimise moral hazard problems in the process.



The second piece of evidence comes from a comparison of interest spreads in Czechoslovakia and Hungary over 1992. Table 10 shows that the margins between nominal lending and deposit rates in Czechoslovakia have stayed constant over 1992, while they have dramatically increased in Hungary. This reflects the confidence of Czechoslovak banks that their capital asset ratios are adequate and that they can meet the standards laid down by the government. According to Budapest Bank (1993), by contrast, only very few Hungarian banks will be able to comply with banking regulations, which explains why they have become extremely cautious lenders. Thus, while Hungary's corporate sector continues to be starved of funds that it badly needs to increase investments, because banks are still licking the wounds of the past, their Czech competitors have enjoyed falling lending rates in recent months. The Czech State Bank has done its share by reducing the discount rate from 9.5 per cent to 8 per cent and decreasing mandatory reserve requirements for commercial banks in June 1993 (CBU, 1993). In sum, the above has exposed the inconsistency of Hungary's early capital market reforms, while showing how Czechoslovakia steered around a major financial crisis. The inadequacy of Hungary's supervisory framework was recognised in 1992 and bankruptcy legislation, new accounting standards and, in the second half of the year, a loan consolidation programme were finally introduced. With these measures, Hungary has been able to enforce financial discipline more effectively, which has been reflected in declining inflation rates, in spite of a roughly constant pace of broad money growth. However, as we attempt to show in the final subsection, Hungary's recent reforms still fail to create incentives conducive to an efficiency oriented financial restructuring process, actively monitored by the banks. Instead, the pendulum would seem to have swung too far, involving enterprises in liquidation procedures that may have been profitable with some injection of new capital.

Table 10 - Interest Rate Structure, 1991-92, Hungary and Czechoslovakia, Monthly

	1991											
	Jan.	Febr.	Mar.	April	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
<b>Hungary</b>												
av. lending	27.8	27.9	27.4	28.7	30.6	28.8	31.4	32	32.2	30.3	33.5	34.3
av. deposit	29.1	28.6	28.8	28.9	30.7	30.4	30.9	31.1	31.5	31.9	31.9	31.1
real	-4.7	-2.1	-0.8	0.5	0.7	0.8	2.1	2.8	1.5	1.7	1.6	1.4
lending spread	-1.3	-0.7	-1.4	-0.2	-0.1	-1.6	0.5	0.9	0.7	-1.6	1.6	2.2
<b>Czechoslovakia</b>												
av. lending	-	15.8	-	15.3	16.3	15.2	14.9	15.0	14.9	14.8	14.9	15.2
av. deposit	-	7.6	-	7.4	8.0	9.0	8.5	8.9	8.6	8.2	8.1	7.8
real	-	-13.3	-	-1.7	-0.2	2.1	1.4	0.7	1.6	1.4	0.1	0.5
lending spread	-	8.2	-	7.9	8.3	6.2	6.4	6.1	6.3	6.6	6.7	7.4
	1992											
	Jan.	Febr.	Mar.	April	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
<b>Hungary</b>												
av. lending	36	36.1	35.5	35.3	35.6	34.3	33.3	32	30.3	29.6	29.6	28.8
av. deposit	31.9	31.4	29.8	28.6	28.1	26.4	22.1	20.6	19.6	18.4	18.4	17.6
real	-0.2	0.3	1.1	1.7	1.5	2.3	2.5	1.9	0.1	0	0.9	1.3
lending spread	4.1	4.7	5.7	6.9	7.5	7.9	11.2	11.4	10.7	11.2	11.2	11.2
<b>Czechoslovakia</b>												
av. lending	14.1	13.9	14.0	14.5	13.8	14.9	14.2	14.1	13.6	13.6	-	
av. deposit	8.8	8.8	8.9	7.0	6.9	6.8	6.8	6.6	6.3	6.6		
real	-0.1	-0.8	1.0	0.4	-0.1	0.6	0.5	1.0	0.7	0.5		
lending spread	5.3	5.1	5.1	7.5	6.9	8.1	7.4	7.5	7.3	7.0		

Source: PlanEcon (1993).

*d) Sanctions but no Incentives: Hungary's Capital Market in 1992*

The following two provisions contained in the Act on Accounting and the new Bankruptcy Law introduced in December 1991 and January 1992 respectively have fundamentally changed economic incentives in the financial sector:

- all businesses are entitled to create reserves against any doubtful claims from pretax profits;
- any enterprise that defaults on outstanding payments for more than 90 days is obliged to file for bankruptcy, and any creditor may initiate liquidation proceedings, if a debtor is in default on a payment for more than 60 days (or 30 days after the receipt of a call for payment).

The first provision has finally created the conditions for the recapitalisation of banks out of current operations. From 1992 banks are required to maintain a weighted capital asset ratio of 7.25 per cent for non-sovereign debt, rising to 8 per cent by 1993. Thereby, claims of "below average" quality carry a 20 per cent reserve requirement, "doubtful" claims a 50 per cent reserve requirement, and "bad" claims have to be provisioned for at full face value.<sup>39</sup> As a result of this change in banking regulations Hungarian commercial banks have become extremely cautious lenders. We posit that this shift in banking behaviour can only be explained by a change in their expectations about future government policy. With the simultaneous enactment of the Bankruptcy Law the determination of the government to no longer tolerate loss making in the Hungarian economy was underlined. Nonetheless, as the evidence about rising interest spreads presented in the previous subsection illustrates, the process of recapitalisation of Hungarian banks is slow and, compared to Czechoslovakia the prospects for a revival in corporate lending are rather bleak.

The second provision mentioned above had potentially even more far reaching consequences for the Hungarian economy than the change in banking regulations. As Table 11 reveals the number of bankruptcy filings skyrocketed in April 1992, 90 days after the new Bankruptcy Law had come into effect. The 2259 enterprises that filed for bankruptcy in that month alone can be regarded as the overhang of insolvent firms in the Hungarian economy that had so far been carried along by rescheduling arrangements, payment deferments etc.. The

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<sup>39</sup> Below average claims concern mainly loans to enterprise with a high sectoral risk, doubtful claims include loans in interest or repayment default for more than 60 days, and debts to enterprises with operating losses for two continuous years in a row, and claims are qualified as bad if the debtor is in default for more than 360 days or currently in liquidation procedures.

number of liquidation proceedings initiated against debtors in default similarly rose dramatically to 2617 from January to March and 1281 in April 1992 (Kornai, 1993). Szanyi (1993) claims that by September 1992 a total of 10 per cent of Hungarian enterprises were involved in either bankruptcy or liquidation proceedings. These firms produced 26 per cent of GDP, employed 16 per cent of the total labour force, and generated 37 per cent of export receipts. The enforcement of bankruptcy regulations in Hungary has been accompanied by a further decline in industrial production of 9.8 per cent and a rise of unemployment to 12.3 per cent at the end of 1992. Closing loss-makers may entail substantial costs, a warning that has not gone unheard in Czechoslovakia and has influenced the latter's strategy in limiting the number of liquidations in the process.

Table 11 - Number of Bankruptcy Proceedings in 1992

	Number of filings	Number of official announcements by the court
January to March	786	285
April	2 259	205
May	201	465
June	145	482
July	154	300
August	113	69
September	151	104
October	150	190
November	118	225
December	154	175
<b>Total in 1992</b>	<b>4 231</b>	<b>2 500</b>

Source: Kornai (1993).

As the fall in inter-enterprise arrears by 50 per cent during 1992 shows the bankruptcy law was indeed effective in enforcing financial discipline in the Hungarian enterprise sector. Nonetheless, its implementation uncovered a number of serious deficiencies that may impair financial stability in the Hungarian economy in the near future. First, the formulation of an obligatory bankruptcy filing clause, the so-called "Harakiri"-clause, has pushed a number of firms into bankruptcy procedures that actually were net creditors and had developed sound financial strategies for the future (Szanyi, 1993). For them the

law caused unnecessary trouble and may have deterred potential investors from injecting their money, when it was most needed. The point here is that the sheer numbers involved in bankruptcy procedures have exacerbated investment uncertainty. This is not helped by the considerably administrative bottlenecks that prevent the smooth conclusion of court cases.

Second, the role of the banks as potentially important monitors of enterprise performance has been neglected in the implementation of bankruptcy in Hungary. In the list of creditors to be repaid in case of liquidation banks are last, behind administrators, workers and the tax authorities. As total claims against an enterprise not seldomly exceed its total assets, and banks have to make 100 per cent provisions against debts of firms in liquidation, banks have no real incentive to participate in the process. The possible leading role of banks in financing a restructuring plan is thereby eschewed.<sup>40</sup> Thus, while a firm may easily be forced to enter liquidation procedures, its most important creditors, namely the banks, lack the motivation to conclude the case. Enterprises continue to produce in an effective state of limbo, while banks hope that their debtors might be selected for write-off. Because unanimous consent is necessary to agree upon a liquidation or restructuring plan, 60 per cent of 4231 bankruptcy cases in 1992 have been postponed (Szanyi, 1993). The uncertainty created by the Harakiri clause is thus exacerbated by an incentive structure that prevents quick agreements.

In more general terms the problem of implementing bankruptcy procedures amounts to choosing a way that maximises the long run value of the enterprise concerned. The stereotypical case of an SOE during economic transition is one, where the liquidation value of the firm is below the book value of its non-performing assets and below the costs of restructuring the enterprise. If, however, the enterprise survives it may generate a future revenue that enables it to repay its entire debt. If disputes about the distribution of a firms assets delay the liquidation process, the situation is likely to be one of "drift", where managers further decapitalise the enterprise and creditors may never see much of their money back. The alternatives are either to liquidate the firm swiftly or to write-off some of its debt, so that the present value of its future income stream is increased, raising the incentives to restructure the firm. Hence, it makes sense to

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<sup>40</sup> As we saw in the case of Czech privatisation, the role played by the large commercial banks in managing investment funds and monitoring the restructuring process in those enterprises in which they have acquired an important stake leads to rather optimistic predictions concerning the introduction of a bankruptcy law there.

write-off enterprise debts before pushing them into liquidation, which is precisely what Czechoslovakia has been doing. If not all debts can be written off, banks should be allowed to choose those enterprises most likely to generate a future income stream, for instance by giving them a global role in voucher privatisation or by allowing debt equity swaps.

Towards the middle of 1992 there was an increasing recognition in Hungary too that the role of banks in the financial consolidation of the economy had to be addressed. Simply enforcing discipline by pushing firms into self-bankruptcy or liquidation was not enough if the major creditors had no incentives to take an actively monitoring role in the process. Hence a consolidation scheme was designed for the commercial banks that would enable them to exchange uncollectable receivables into government bonds (Abel and Bonin, 1993). The bonds were to carry an interest equal to the average Treasury Bill yield, however, 50 per cent of the returns had to be paid as participation fee in the deal. The maturity of the bond was to be 20 years after which the full face value would have to be paid back by the bank. The debt conversion applied to loans before December 1991 with a 50 per cent discount, thereafter bad loans could be exchanged at 80 per cent of face value. Thus the loans consolidation scheme resembled its Czechoslovak counterpart of 1991 in many respects, except for the "balloon" payment at the end. However, it may be argued that, once again, Hungarian policy makers acted too little and too late. Indeed, of the 14 commercial banks selected for the scheme because they failed to meet the 7.25 per cent capital adequacy ratio, the three largest commercial banks did not participate (Szanyi, 1993; Budapest Bank, 1993). Arguably this is because, when inflationary expectations are low and the yield on Treasury Bills falls below a certain level, the burden of the balloon payment exceeds the net present value of its expected income stream (Abel and Bonin, 1993). Thus the Hungarian loan consolidation programme has no write-off element and thus offers only limited relief.

The danger in the current situation is that Hungary opts for a return to eclectic reforms. Political criteria, connected to sectoral and regional disparities in unemployment and the resulting social costs of transition may serve to keep some SOEs afloat with the aid of public money (Budapest Bank, 1993). Already 13 big public companies have been selected for unconditional debt write-off, i.e. without any link to a change in ownership or management of the companies (Szanyi, 1993). If this path is indeed followed political criteria would dominate economic viability and the Hungarian government it would abolish exactly those

sanctions against financial misbehaviour that have proven so effective during 1992.

The dilemma for the Hungarian government is that any incentive scheme for creditors to take an active role in financial restructuring will impose costs on the budget. Enhancing the monitoring role of banks by linking them closer to privatisation, such as in the Czechoslovak voucher scheme or by the promotion of debt-equity swaps will reduce government revenues from the sale of state assets. Debt write-offs, if they are to effectively improve the banks' capital base, increase the national debt. However, as the banks are still predominantly in state ownership their recapitalisation amounts to nothing else but a shift of resources within the public sector. As this would remove one major obstacle to renewed investment and ultimately would lead to rising government tax revenues, too, there is no good reason to delay actions on this front, although Hungary's fiscal situation is substantially more fragile than that of the Czech Republic. After three years of transition in Hungary, the challenge for government has become no less.

#### **CONCLUDING REMARKS:**

In this paper we promised an evaluation of the different reform strategies in Czechoslovakia and Hungary, in particular, in order to gain insights on the appropriate role of government during the transition from socialism to a market economy. Specifically, we addressed the issue, whether state intervention in monitoring the transition process may help to reduce friction in economic adjustment in the presence of institutional legacies that may distort economic incentives. The evidence from the two countries supports an active role for government during the transition. The following lessons may be derived from our analysis.

First, the Czechoslovak success with keeping down inflation, unemployment, and budget deficits must at least in part be attributed to specific policy measures. The conclusion of a general agreement with trade unions that helped to reduce real wages significantly during the crucial initial phase of adjustment must be judged an important institutional substitute for a well-functioning labour market. The willingness of the Czechoslovak and recently Czech authorities to stick to their tight control of wages as long as the majority of the labour force was still employed in the state sector has spared the country of the vicious circle of wage push inflation, rising unemployment, leading to increasing fiscal deficits and again more inflation. Now that the private sector is growing rapidly enough to

absorb SOE workers and redundant public servants, adjustment in the labour market could be left to market forces. Moreover, the control of wages was combined with strict credit limits to SOEs that prevented them from granting wage increases even had they wanted to.

Second, direct interventions in labour and capital markets were complemented in Czechoslovakia by extremely restrictive macroeconomic policies. It may be argued that this induced domestic demand to undershoot the level necessary for internal equilibrium. But it was of crucial importance for the eventual success of Czechoslovakia's stabilisation programme that it never became prone to erratic policy shifts. Thereby it created a predictable, if harsh environment for Czechoslovak enterprises. This on the one hand eased the enforcement of direct controls, while on the other hand it would later prevent moral hazard problems in the solution of the financial distress associated with the economic crisis. In sum, the combination of active monitoring of industry during the transition with a restrictive macroeconomic framework was the basis on which the government was able to build its reputation of unconditional commitment to reform. The credibility this entailed for any policy measure automatically improved its effectiveness and thereby reduced the costs of transition.

Third, the fiscal room created by macroeconomic policies in Czechoslovakia allowed swift and thorough action in dealing with perverse incentive structures in capital markets. The legacies of bad debts and the temporary explosion of inter-enterprise credits were largely brought under control within two years of the start of transition. This has put Czechoslovakia in the fortunate position of being able to use interest rate policies in leading the path to recovery. The shift from passive to active monetary policy in Czechoslovakia was achieved on the basis of relatively generous and early debt write-offs and a determined move towards a fundamental change in ownership rights. Hence banks in the Czech Republic at the end of the first round of voucher privatisation not only possess a huge outlet for the funds accumulated during the first two years of transition, their active involvement in the privatisation process through the management of investment funds also puts them in a controlling position in important parts of the economy. With further consolidation among the large number of funds taking place under the influence of competition, universal banking may become the hallmark of investment-led recovery at least in the Czech Republic.

Fourth, the Hungarian experience does not support the view that eclecticism is the right policy stance in the transition to a market economy. In spite of its head start, Hungary wasted two entire years in which perverse incentive structures, in



the capital market in particular, led to the proliferation of financial indiscipline. While this did not prevent some structural adjustment to take place, as is evidenced by the rapid reorientation of trade, Hungary now pays the price for previous imprudence as new investments are delayed, interest spreads rise, and losses multiply. It is important to note that restrictive macroeconomic policies may not prevent such developments in the absence of sanctions against misbehaviour. Indeed, the Hungarian experience once again confirms that the expectations of economic actors about the likelihood of future government help determines the extent to which they are able to rely on money substitutes. An active monetary policy is thus first and foremost a matter of government credibility and predictability. This is hard to square with the recommendation of trial and error during transition.

Fifth, the enforcement of financial discipline can be achieved relatively quickly with the introduction of appropriate legislation, containing effective sanctions against violating payment contracts. The rapid decline in involuntary trade credits in Hungary bears evidence to the potency of bankruptcy regulations in establishing financial discipline. However, the costs of enforcing bankruptcy in a transition economy depend largely on the incentives of the different parties involved in the process. As long as banks, for instance, are burdened with non-performing assets any solution that reduces their claims on a firms' assets without compensation may be unacceptable to them. Moreover, if the returns from a possible investment to restructure an SOE accrue mainly to the state as the current owner, the amount of liquidations may by far exceed the level that would be required on grounds of efficiency. At least a partial debt write-off for banks and the possibility of debt-equity swaps should be considered as important measures that help to reduce the costs of enforcing financial discipline. Finally, the administrative regulations should be made as simple as possible to speed up the process.

These five lessons can certainly be amended by others. To a certain degree the Czech Republic was also lucky in inheriting a stable macroeconomy and being close to the large German market. But while the factor "luck" may be unevenly distributed it can also easily be wasted by bad policies. Of course, it would be an exaggeration to point at Czechoslovakia as an unmitigated success story and characterise Hungary as a problem child in Central and Eastern Europe. However, if one takes foreign capital inflows as a proxy for the shifting perceptions abroad of which of the three Central European countries is currently ahead with economic reforms, Hungary seems to have lost ground at least

against the Czech Republic.<sup>41</sup> Hence our positive assessment of the latter country's economic policies seems to be not so far off the mark. In conclusion we may thus reiterate the central point of the paper. In the transition from socialism to the market governments can and must do more than react eclectically to developments in the economy. The question for policy makers is not whether to intervene at all, but how to counteract market imperfections in a way that makes precisely those interventions less and less necessary.

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<sup>41</sup> According to PlanEcon (1993) by the second half over 1992 Foreign direct Investment (FDI) into the Czech Republic reached \$ 420 million per quarter, compared to Hungary's \$ 480 million. In 1991, Czechoslovakia's total FDI inflow was one third of Hungary's.

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