



Understanding the Czech Transition Reform

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What Is “THE REFORM?”

- Czech context:
- Pragmatic definition of a movement towards a more market oriented economy
 - **in the context of a politically open society**
- Reform policies consist of changes in
 - **both formal and**
 - **informal institutions and**
 - **rule enforcement.**

Switching Regimes

- Regime transformation as consisting of
 - **several reforms executed in**
 - a parallel or
 - subsequent fashion, often
 - **determined by**
 - political rather than
 - economic forces.
- The transformation process as a whole cannot be fully understood without
 - **the political factors and**
 - **their dynamics.**

Switching Regimes

- Transformation in the Czech Republic was characterized by
 - **the parallel reform of**
 - the high-level, political institutions and
 - the lower-level institutions
- Less agreement about the principles of the future economic system
 - **thus the kind of reforms the government should implement or steps to be taken.**
 - **all the parties agreed that the collapsing command system could not be sustained.**

Reform Dependency

- Complexity of the reform process
 - **strong path-dependency of outcomes**
 - **various steps complementing major reforms were taken later.**
- Insufficient design at the implementation stage is a key determinant of the reform result due their path-dependency.
 - **Microeconomic deficiencies are not quickly propagating to macroeconomic imbalances**
 - **tend to be neglected**
 - **once they reveal at the macroeconomic level**
 - it is often too late to easily and
 - costlessly implement remedies.

Focal Points – Understanding Reform

- Reform programs applied
 - had insufficient *ex ante* implementation details
- Outcome need not be a failure
 - if the government is able to quickly and appropriately respond to emerging problems.
- Example: Banking sector failure,
 - the more delayed is the solution or reaction to a problem,
 - the costlier is the final bill.

Focal Points – Understanding Reform

- Reform adjustments
 - more likely to be blocked in the implementation rather
 - than design stage

- The ex ante insufficient design leads to
 - unintended or
 - unforeseen
 - emergence of new
 - interest and
 - pressure groups

- These want to keep the problematic status quo.

- Moving Ahead:
 - external pressure (like EU membership)
 - crisis (banking sector failure)
 - to foster further reform steps that would be otherwise blocked by these internal forces.

Initial Conditions

- Former Czechoslovakia - weaknesses
 - one of the smallest private sectors, ~ 1.2% of the labor force
 - producing a negligible fraction, <3%
 - quantity was preferred to quality
 - stress on the production of machinery
 - consumer goods and services were in shortage and of low quality
 - specialization was on heavy industry,
 - the Czech economy did not possess any comparative advantage
 - Information flow devastated by
 - administratively set prices, NO information about cost structure.
 - Over-employment
 - waste of human resources
 - self-reliance among the population was extremely low
 - economic structures over-centralized

Initial Conditions

- Former Czechoslovakia – strengths
- Starting position seemed better
 - **healthy macroeconomic situation**
 - **no significant external debt**
 - **low inflation**
 - **positive trade balance**
 - **balanced government budget**
- Reform in the Czech Republic was driven
 - **Neither by fiscal stresses**
 - **Nor by other macroeconomic imbalances**

Reform Cause

- Bhattacharya and Patel (2003):
 - “[r]eform and restructuring, in the sense of transitioning to market-based systems with increased private participation, in the developing countries has been predominantly driven by fiscal stresses, often initiated following macroeconomic crises.” (p. 5)
- This was not cause in CS
- The major reform driver
 - **population wide consensus on the rejection of the inefficient command system**

First Stage

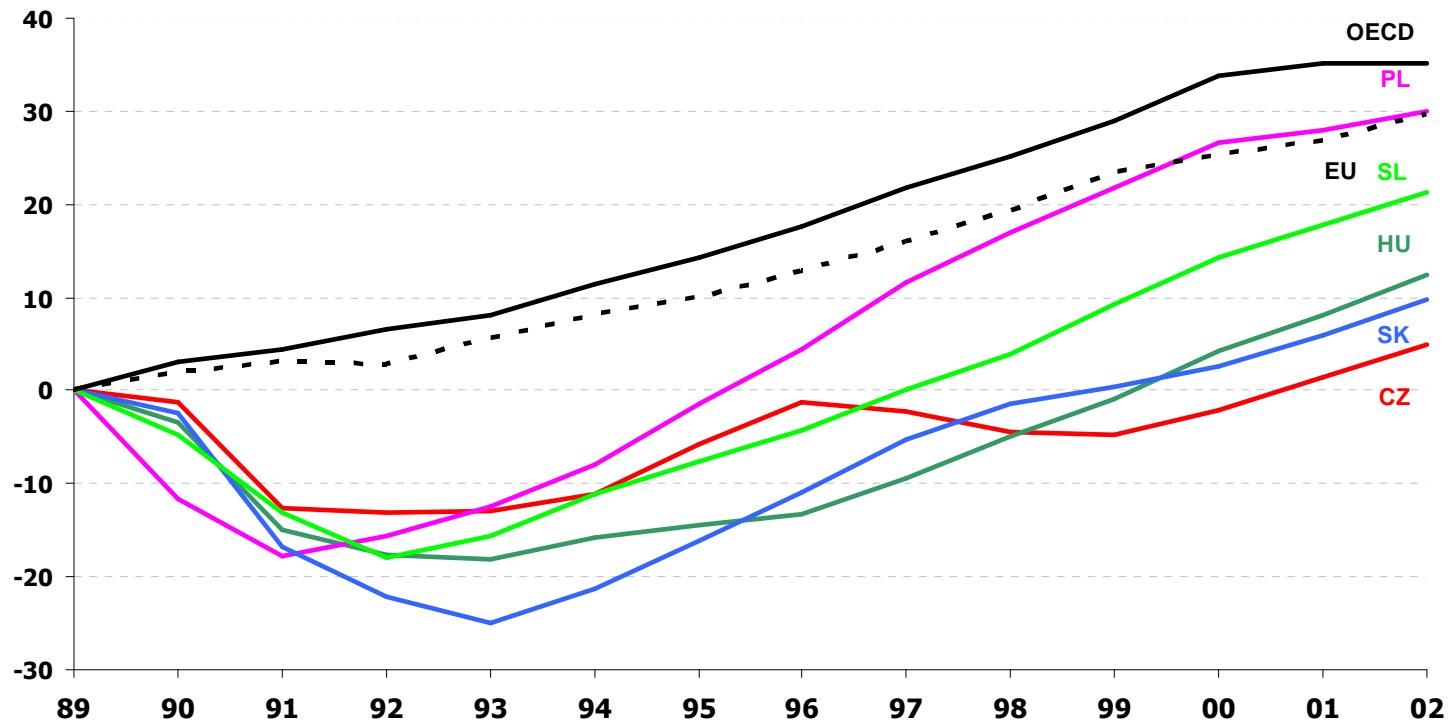
- within 3 years:
 - liberalized nearly all prices
 - privatized much of the economy
 - decentralized the wage setting
 - opened the country to world trade
 - maintaining a relatively balanced budget
 - low inflation
 - low unemployment
- Czech Rep. stated as an example of a big bang reform strategy
 - seemingly radical reform
 - not so radical in its effects.
- Massive Enterprise restructuring did not take place
 - soft economic environment
 - banking socialism

Window of Opportunity

- Czechoslovakia at the beginning of 1990s
 - winners and losers of reforms were not known
 - large majority of the population had positive expectations about the reform outcomes.
- Interest groups
 - Did not play an important role in the design of reform policies
 - The old interest groups disintegrated with the old system
 - The new ones had not formed yet
- Window of opportunity
 - No substantial opposition in the promotion and implementation of reforms

The Big Fall

Real GDP Growth in the Region, %



Micro Problems Propagate to Macro

- The implicit liabilities became explicit
 - **soft loans to large old firms**
 - **worsening performance of the economy**
 - **increase of the public budget deficit**
 - **attack forced the surrender of the fixed exchange rate regime**
 - **crown depreciated**
- Government fall
- Why?

Micro Problems Propagate to Macro

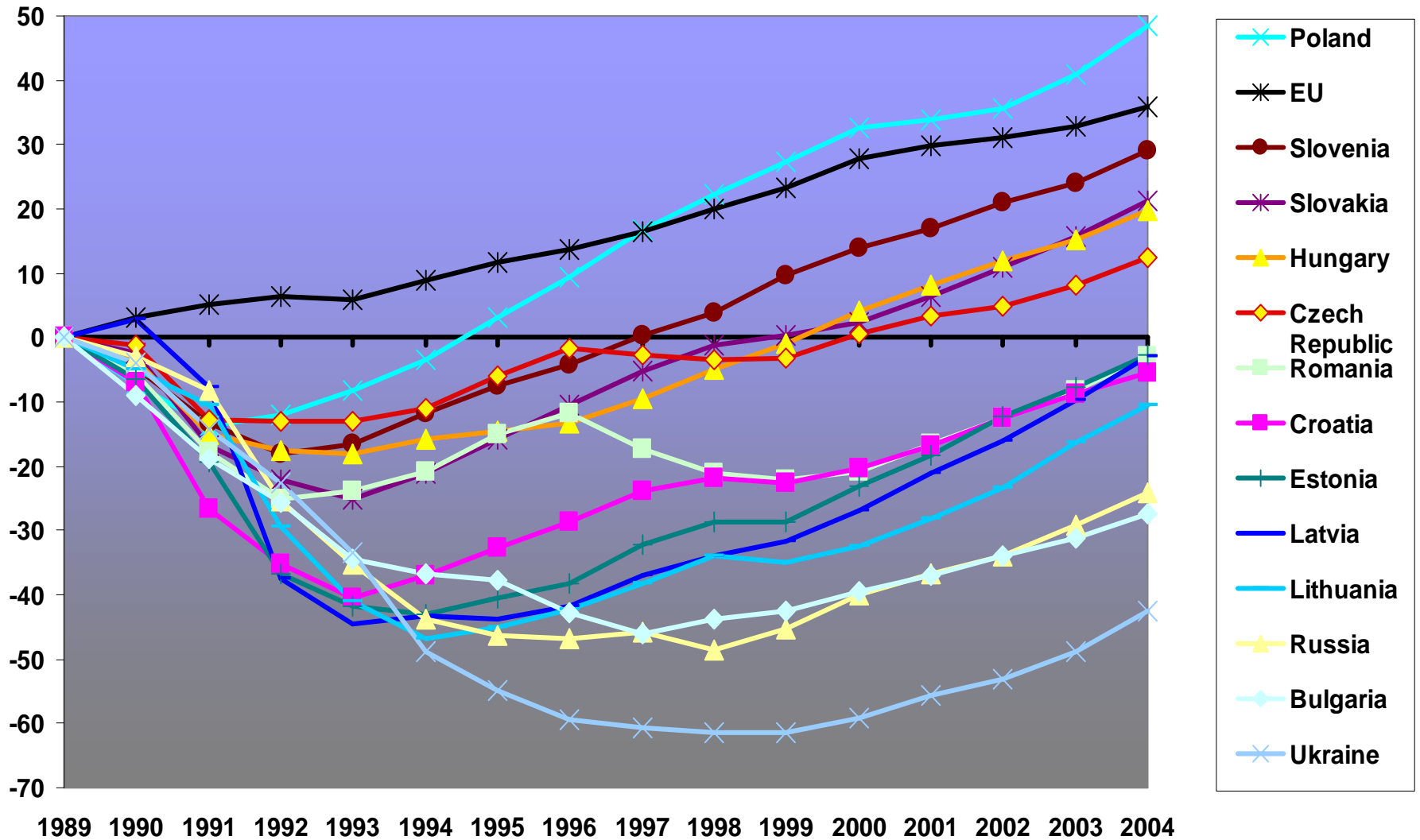
- Economic problems were at the core of the political failure
- Trigger: the scandal
 - **political parties received secret donations from the major financial and industrial groups.**
- Beginning of the 1990s
 - **non-existence of various interest groups**
- Partial reforms
 - **Privatization & capital market**
 - **without an adequate legal and regulatory framework**
 - **enabled some groups to obtain substantial economic benefits.**
- New interest groups
 - **had a strong interest in retaining the status quo**
 - **hoped to win further benefits**
- The emergence of interest groups
 - **uncalled-for albeit unavoidable by-product of the reform process**

New Wind

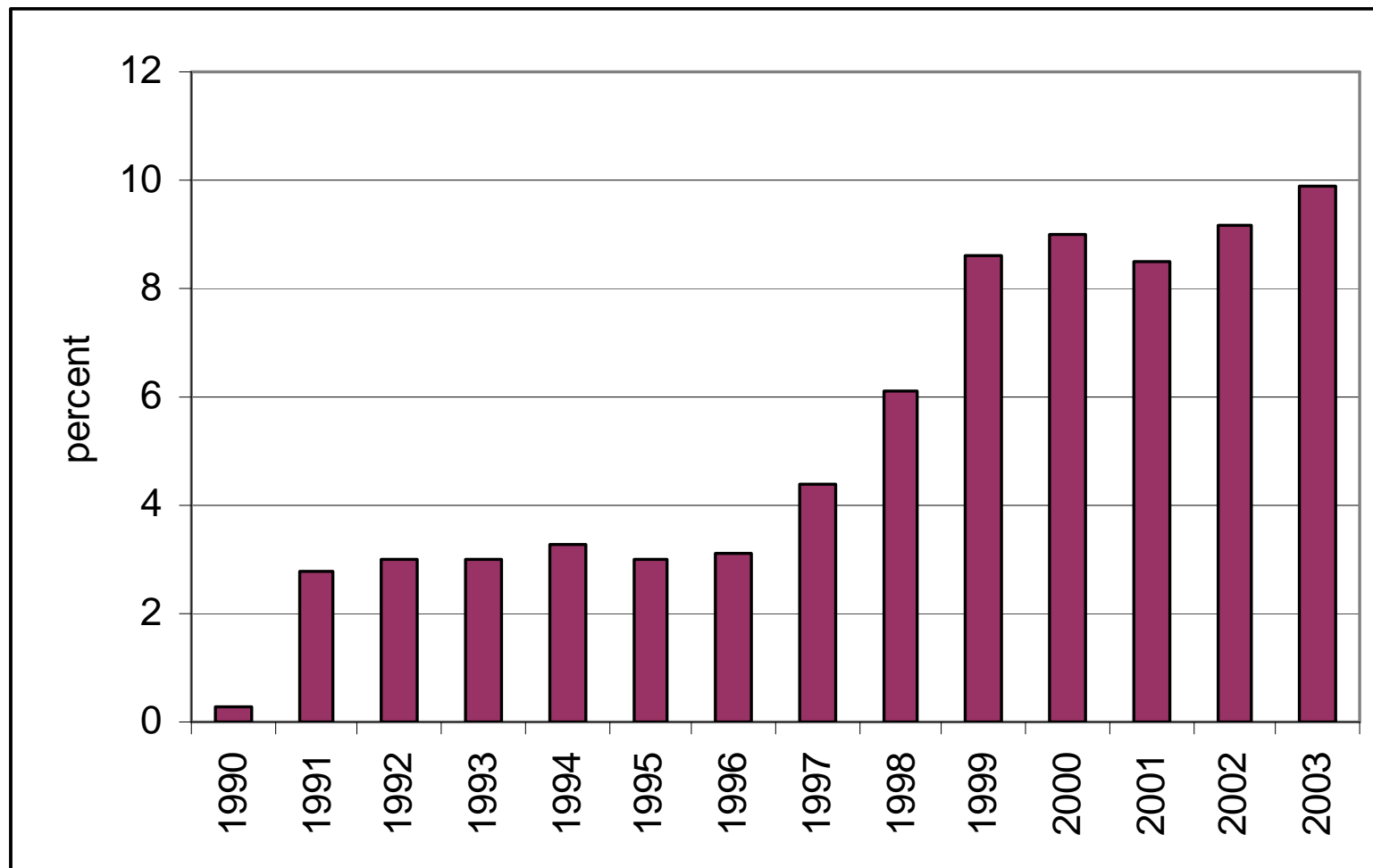
- Change of government
 - Recession looming
 - revived structural reform and privatization
 - aggressive foreign direct investment (FDI) incentive package for manufacturing investors
 - privatization of the large, state-controlled banks
 - Surprise:
 - a left-wing government is expected slow down the reforms or even reverse
 - No revenue motive, the bank privatization ended in red numbers

- Explanation:
 - right-wing government:
 - perceived as a continuation in the reform path that became unpopular
 - new government
 - credibly communicate to the people that the bank privatization is necessary and will be beneficial.
 - Public: perception of governmental insights, not ideology

Real GDP Index (1989=100)



Unemployment



Private Sector Share of GDP

	1990	1994	1995	1996	1997	1998	1999	2000
Czech Republic	5	65	70	75	75	75	80	80
Croatia	10	40	45	50	55	55	60	60
Hungary	20	55	60	70	75	80	80	80
Poland	25	55	60	60	65	65	65	70
Slovak Republic	5	55	60	70	75	75	75	75
Slovenia	10	30	45	45	50	55	55	55
Estonia	10	55	65	70	70	70	75	75
Latvia	10	55	60	60	60	60	65	65
Lithuania	10	50	55	65	70	70	70	70
Albania	5	50	60	75	75	75	75	75
Bulgaria	10	40	45	45	50	50	60	70
Romania	15	35	40	60	60	60	60	60
Russia	5	50	55	60	70	70	70	70
Ukraine	10	30	35	40	50	55	55	60

Privatization Methods

- *Restitution*
 - restored assets to those who had owned them before they were nationalized by the communist regime after 1948.
- *Small-scale privatization*
 - concerned primarily small economic units such as shops, restaurants or smaller industrial enterprises that were sold at public auction.
- *Large (mass) privatization*
 - was by far the most important privatization program in the Czech Republic. This process began in the spring of 1991 and was formally concluded in the spring of 1995.

Privatization Effects

- Worsening performance of many of the privatized firms
- due to the following issues:
 - **soft budget constraints of privatized firms;**
 - **dispersed ownership structure;**
 - **weak regulatory framework,**
 - especially with respect to minority shareholders;
 - **managerial inability to adhere to costly restructuring**
- No restructuring occurred until
 - **the control of a strategic owner,**
 - **domestic or foreign,**
 - **able to change the management and carry out the necessary restructuring measures.**
- Second consequence of state control:
 - **incestuous ownership relations**
 - **Micro evidence on performance available**

Micro Evidence

- Voucher scheme accounted for ~ 40% of the property
- Outcome different from the intention.
 - **Dispersed ownership structure**
 - **weak shareholder protection**
 - **absence or insufficient enforcement of capital markets rules**
 - **lack of experience with the shareholder position**
- resulted in a lack of any control over the management.
- Moral hazard
 - **on the side of state officers and politicians**
 - **also on the side of new quasi-owners,**
 - **those who were given power without ownership**
- Situation did not promote restructuring but resulted in an extensive expropriation

Corporate Performance - Micro Evidence

- Findings are complex.
- Concentrated and private ownership
 - correlated with better economic performance,
 - only if the owners were foreign.
- Domestic private ownership in many respects
 - did not improve performance over state ownership
- Foreign firms
 - increase profits and sales
 - Strategic restructuring,
- Domestic owners
 - reduce sales and labor costs
 - Defensive restructuring.

Corporate Performance - Micro Evidence

- Presence of a large domestic stockholder
 - **may not result in superior performance if this shareholder “loots” the firm.**
- “golden share.”
 - **prevents looting and has proved to be surprisingly efficient**
 - **state induces profit-oriented restructuring**
 - **also pursues the social objective of employment generation**
- Label “private ownership” should not be overestimated
- What matters is not the label, but the real ownership structure.

Strategic Investors – Anecdotal Evidence

- Goal to privatize to strategic investors? They're so efficient...
 - **strategic partners are chosen is often flawed with errors.**
- Optimally:
 - **(1) there should be one clear criterion according to which the individual bids would be assessed;**
 - **(2) the qualification criteria for bidders should not be too restrictive to allow maximum participation and attract large number of bidders; and**
 - **(3) the bidding format should be open rather than sealed.**
- Czech government has often violated all the three principles

Banking Sector

- Poor performance
 - period of optimism and large credit expansion, followed with:
 - period of insufficient capital adequacy,
 - non-transparent ownership structure,
 - related lending,
 - asset stripping, and
 - huge bad loan problem.
- Domestic banks suffered losses
- Large state banks as well as small banks had to be bailed out
- Banks under foreign control remained profitable.

Banking Sector

- Reasons
- Managers were not subjected to efficient shareholder control
 - **were tempted to please politicians**
 - **rather than maximize the value of the bank.**
- State's controlling stake and the too-big-to-fail phenomenon
 - **government would not admit the bank's failure**
 - **=> Managers are not prudent**
- *aggravated moral hazard* problem

Banking Sector

- Explanations
 - **state is a bad owner**
 - state officials that should execute the property rights do not have the right incentives to do so properly
 - **state as the major shareholder creates a soft environment**
 - weakens incentives because of the implicit assumption of bail out
 - **too-big-to fail phenomenon and the risk of systemic crisis**
 - More likely to get bail-out
 - **Contrary: CSOB**
 - able to maintain prudential standards
 - level of non-performing loans on a level close to western standards

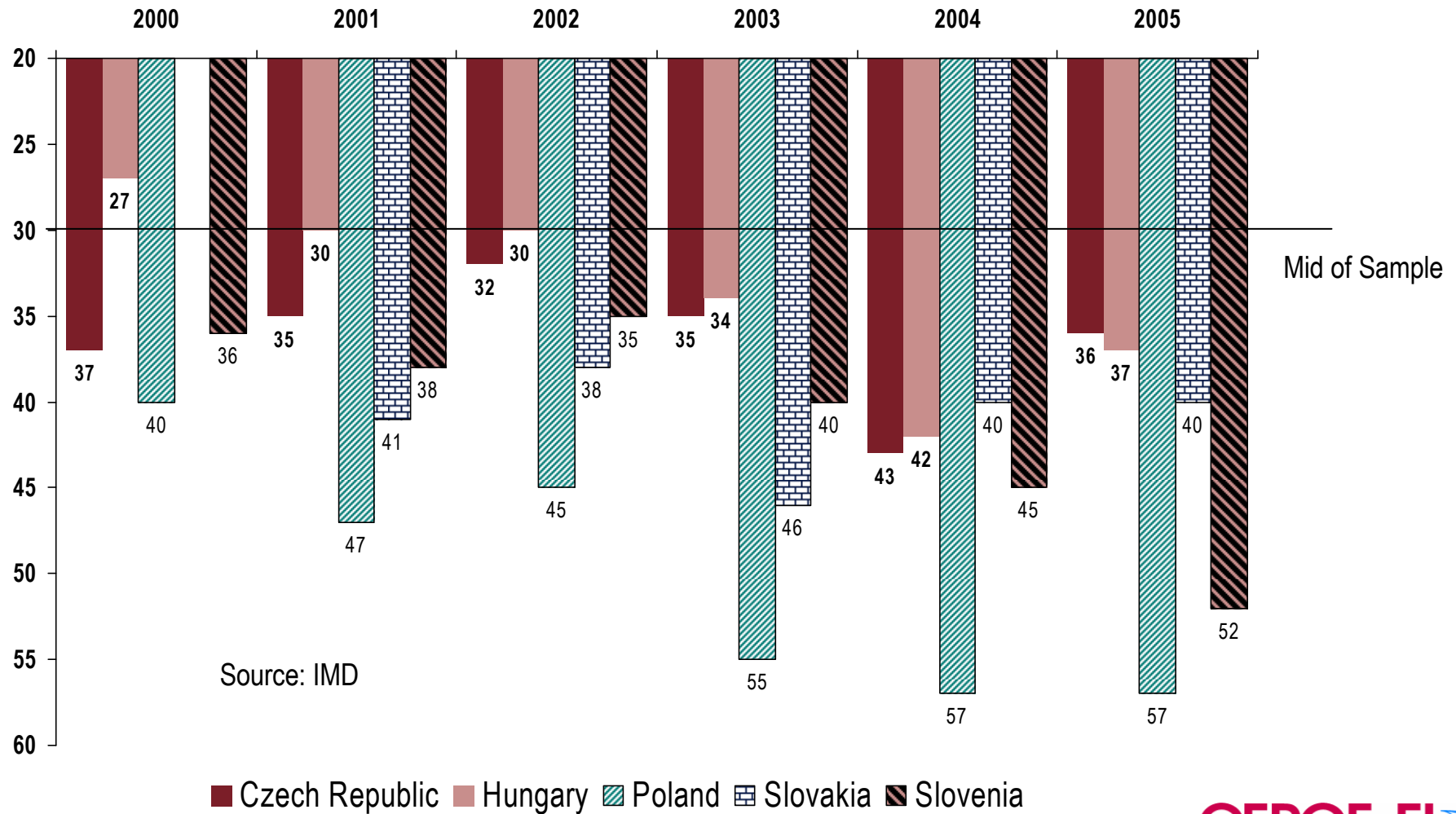
Banking Sector

- Mixed goals explanation
 - Officially: standard profit-maximizing institutions
 - Generally accepted:
 - (and it was also the main reason why they were not privatized early on)
 - Banks would finance the transition process
 - the bankers followed unexpressed, but well understood, politicians' wishes
- Confusion whether
 - to maximize profit or
 - to follow broader set of goals
 - had a deteriorating effect on incentives.
- Dewatripont et al. (1999a, 1999b)
 - institutions with broad and potentially ambiguous purpose tend to be less successful in achieving their goals than those with a narrow and clearly defined goal
- Bhattacharya and Patel, 2003,
 - Mixing objectives not only causes confusion, but in the process of delegation, those responsible for implementation typically have enough discretion to impose their preferences

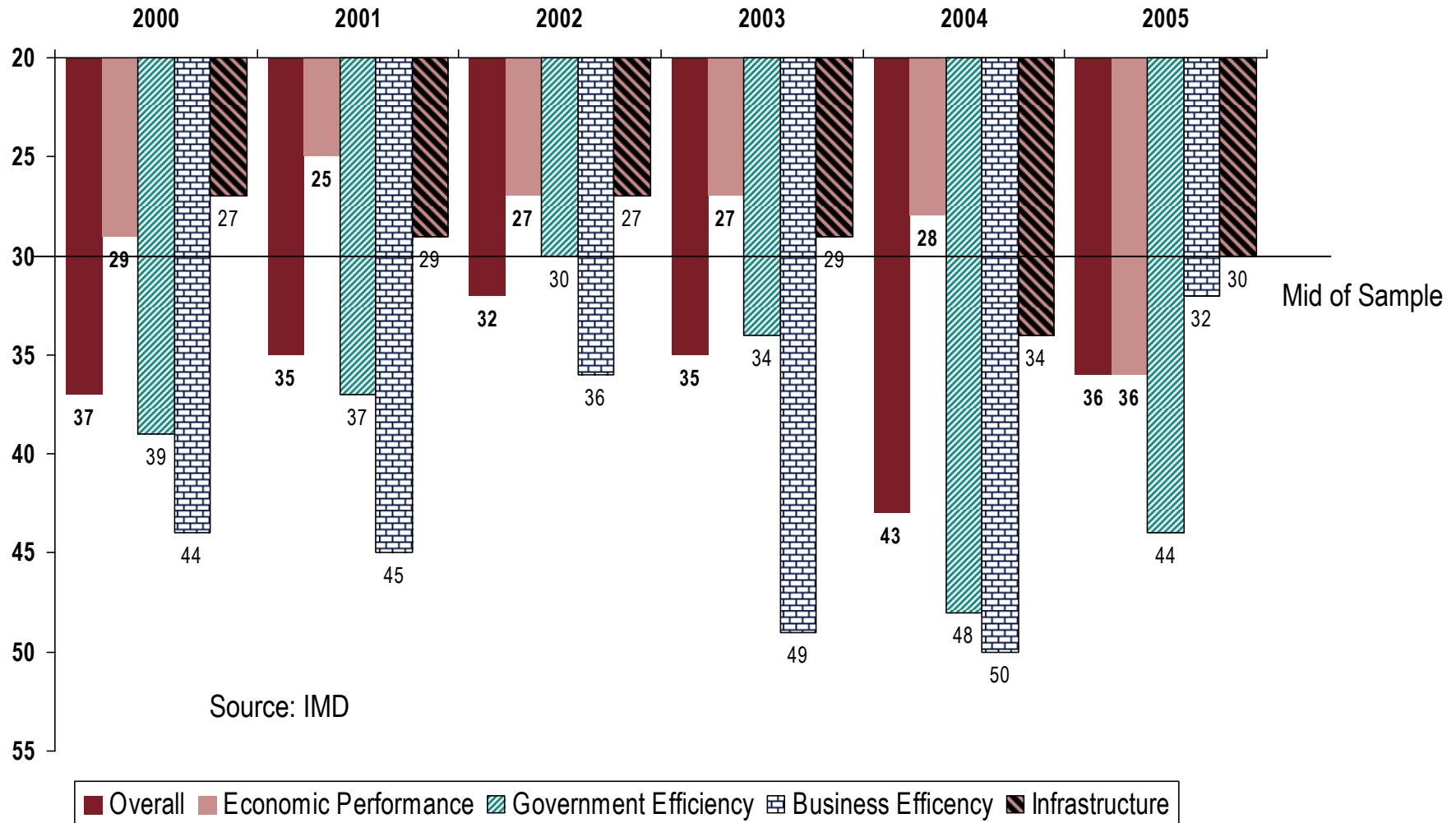
Institution Building

- Institutional and Regulatory Framework
 - **inadequate laws and,**
 - **insufficient enforcement,**
 - **meaning that even the minimum of legislated rules was not observed**
- weak regulation caused problems
 - **lack of separation of banking from the real economy**
 - **=> Bank Socialism**

CEECs Ranking - IMD



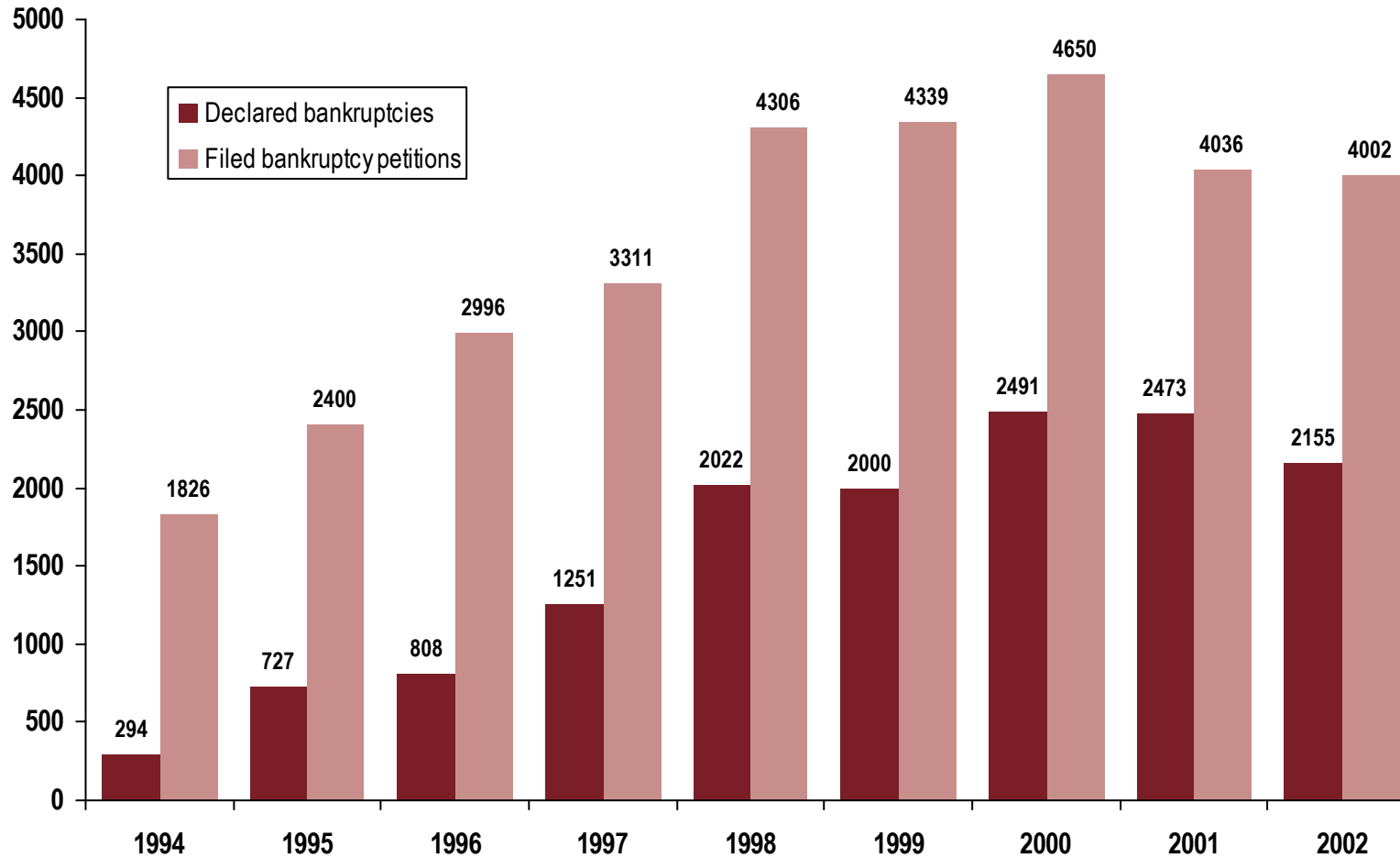
Czech Republic Ranking



Competitiveness Hampered:

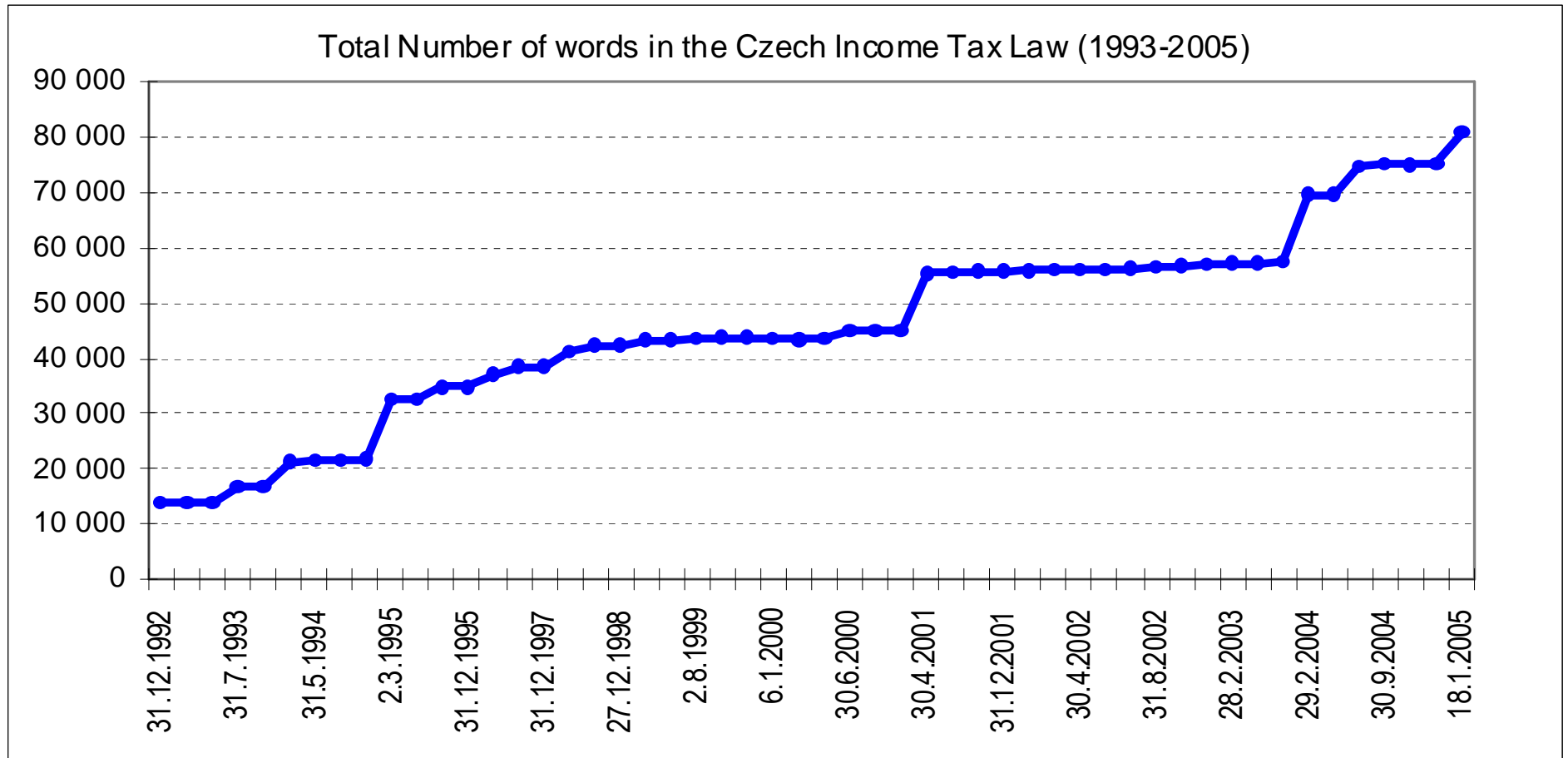
- Problems in Plain Language
 - Small Share of Labor with High Education, Low Flexibility
 - Wrong Labor Skill Structure for Modern Economy
 - Red Tape and Regulation, Transparency
 - High Taxes, especially on Labor
 - Generous Welfare
 - Wrong Incentive Security Scheme
 - Fiscal Deficits
 - Unsustainable Social Security (Demography)
 - Banking and Stock Market

Bankruptcies in the Czech Republic

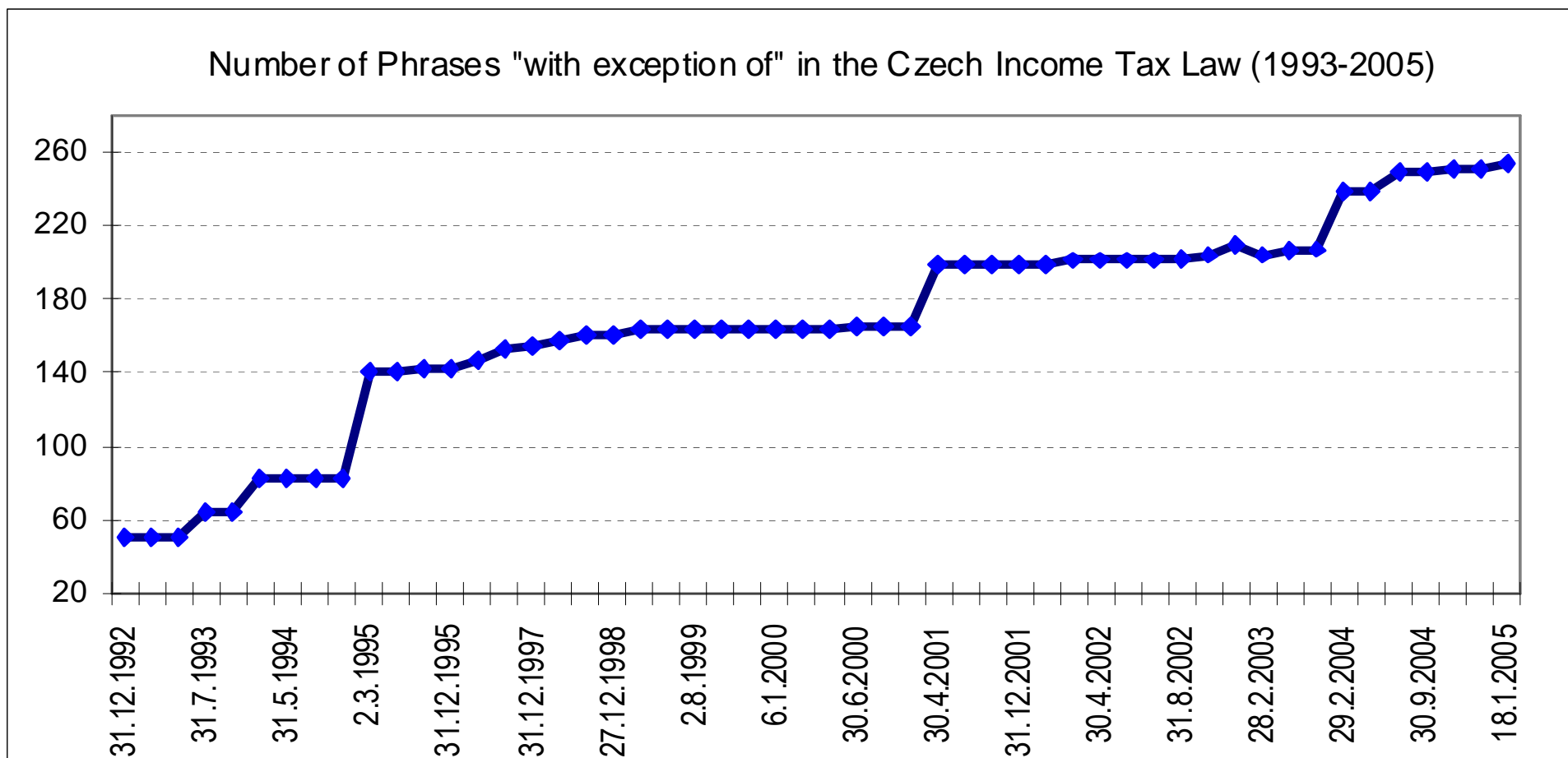


Source: Ministry of Justice, Ministry of Industry and Trade

Too Simple Laws?



Use Exceptions to Improve...



Doing Business (2003/5)

Country Country	Starting a Business			Enforcing Contracts			Closing a Business	
	# of Procedures	Duration (days)	Cost (% GNI per capita)	# of Procedures	Duration (days)	Cost (% Debt)	Actual Time (in years)	Actual Cost (% of estate)
Czech R	10	55	10.0	22	300	9.6	9.2	38
Czech R	10	40	9.5	21	290	9.1	9.2	14
France	9	42	1.2	21	75	11.7	2.4	18
France	7	8	1.2	21	75	11.7	1.9	9
Germany	9	45	5.8	26	184	10.5	1.2	8
Germany	9	24	4.7	26	175	10.5	1.2	8
Hungary	6	52	40.4	21	365	8.0	2.0	38
Hungary	6	38	22.4	21	365	8.1	2.0	14
Poland	10	31	21.1	41	1,000	8.7	1.5	18
Poland	10	31	22.2	41	980	8.7	1.4	22
Slovak R	10	103	9.4	27	655	15.0	4.8	18
Slovak R	9	25	5.1	27	565	15.0	4.8	18
Slovenia	10	61	13.7	25	1,003	16.2	3.7	18
Slovenia	9	60	10.1	25	913	15.2	3.6	14
United K.	6	18	0.9	14	288	15.6	1.0	8
United K.	6	18	0.7	14	288	17.2	1.0	6
United States	5	5	0.5	17	250	7.5	3.0	4
United States	5	5	0.5	17	250	7.5	2.0	7

Educating Future Labor...

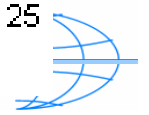
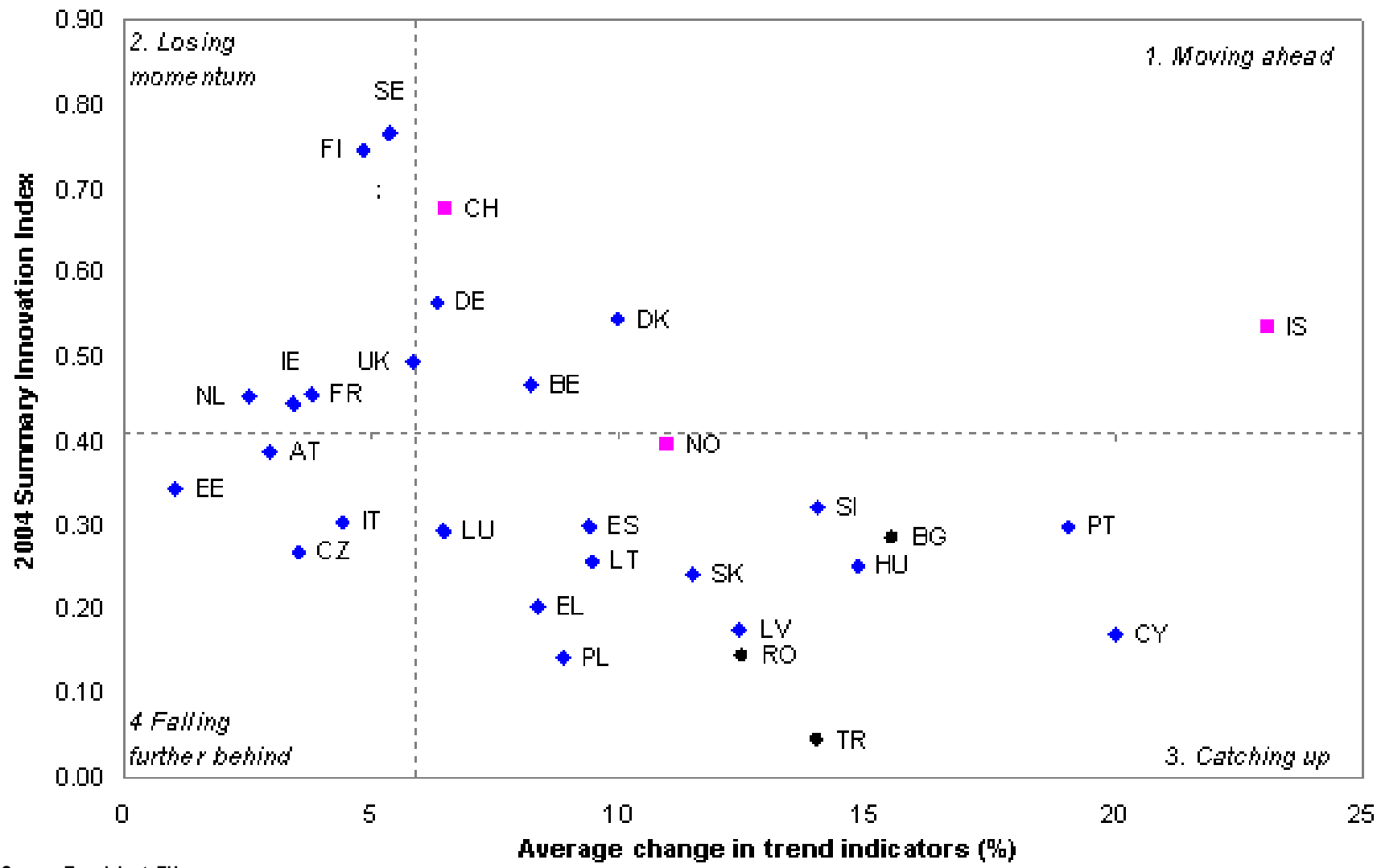
- Educational attainment of the 25-64 year-old (2002)
 - **Slovak Republic** **11.0**
 - **Czech Republic** **11.9**
 - **Poland** **12.1**
 - **Hungary** **14.2**
 - **OECD country mean** **23.0**
 - **Germany** **23.4**
 - **France** **24.0**
 - **United Kingdom** **26.9**
 - **Finland** **32.6**
 - **United States** **38.1**

Educating Future Labor...

- Percentage of 20 to 24-year-olds in education (2002)
 - **Slovak Republic** **22.1**
 - **Czech Republic** **25.7**
 - **United Kingdom** **30.8**
 - **United States** **33.9**
 - **OECD country mean** **37.5**
 - **Hungary** **37.7**
 - **Germany** **38.0**
 - **France** **53.2**
 - **Poland** **53.8**
 - **Finland** **56.1**

Summary Innovation Index – 2004

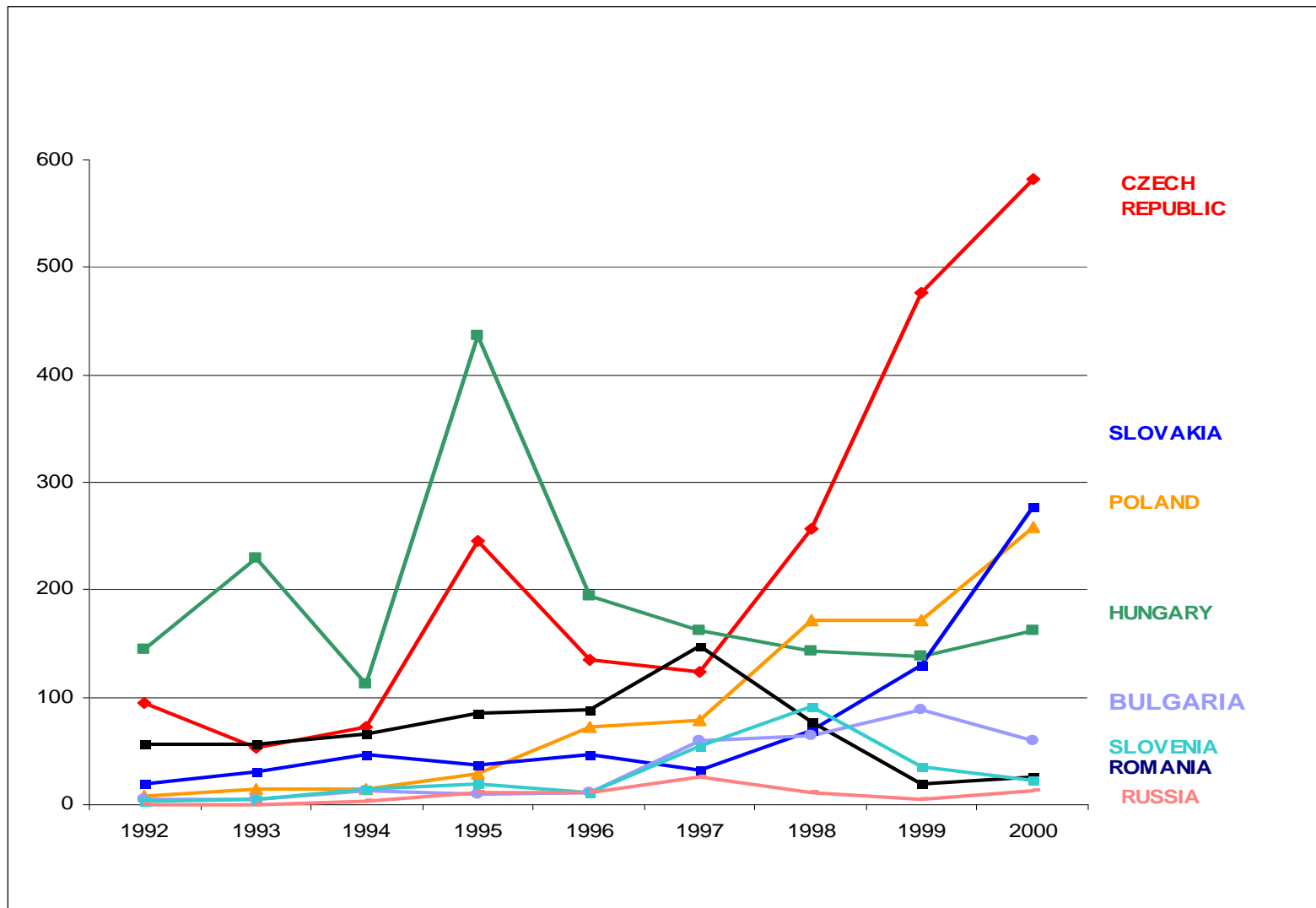
Figure 2. Average country trend by SII



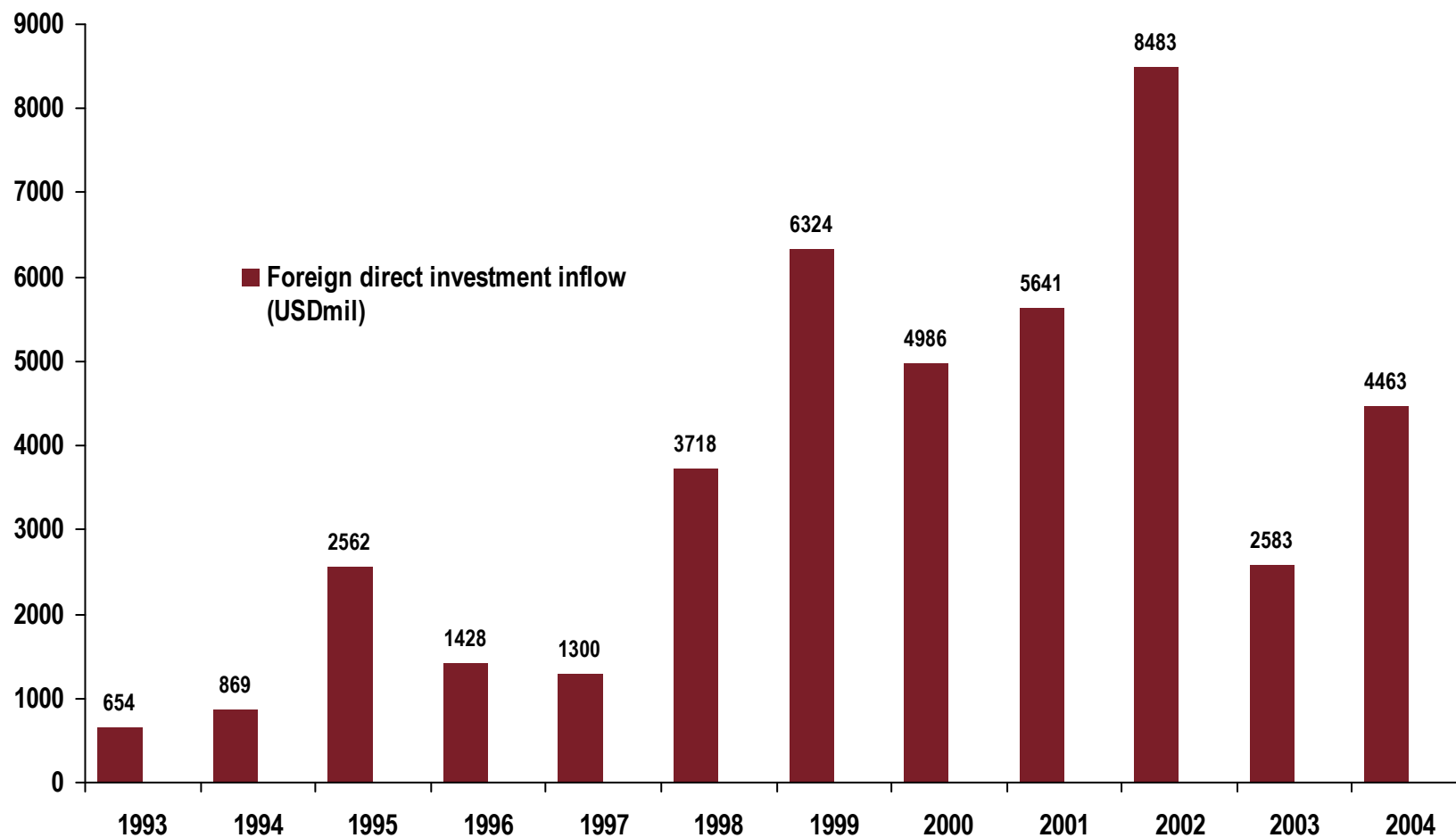
Positive Outcome?

- Puzzle:
- Despite all the problems on the micro-level, the Czech industrial structure experienced positive development.
- Solution:
 - **Favorable development of FDI**
 - **Investors appreciated the favorable geographic position**
 - **human capital of Czech workers**
 - **long tradition in manufacturing.**
 - **=> positive endowments of the Czech economy,**
 - **which counterbalanced the negative effects of the unhealthy development in the banking sector, capital market, law-and-order enforcement and privatized enterprises.**

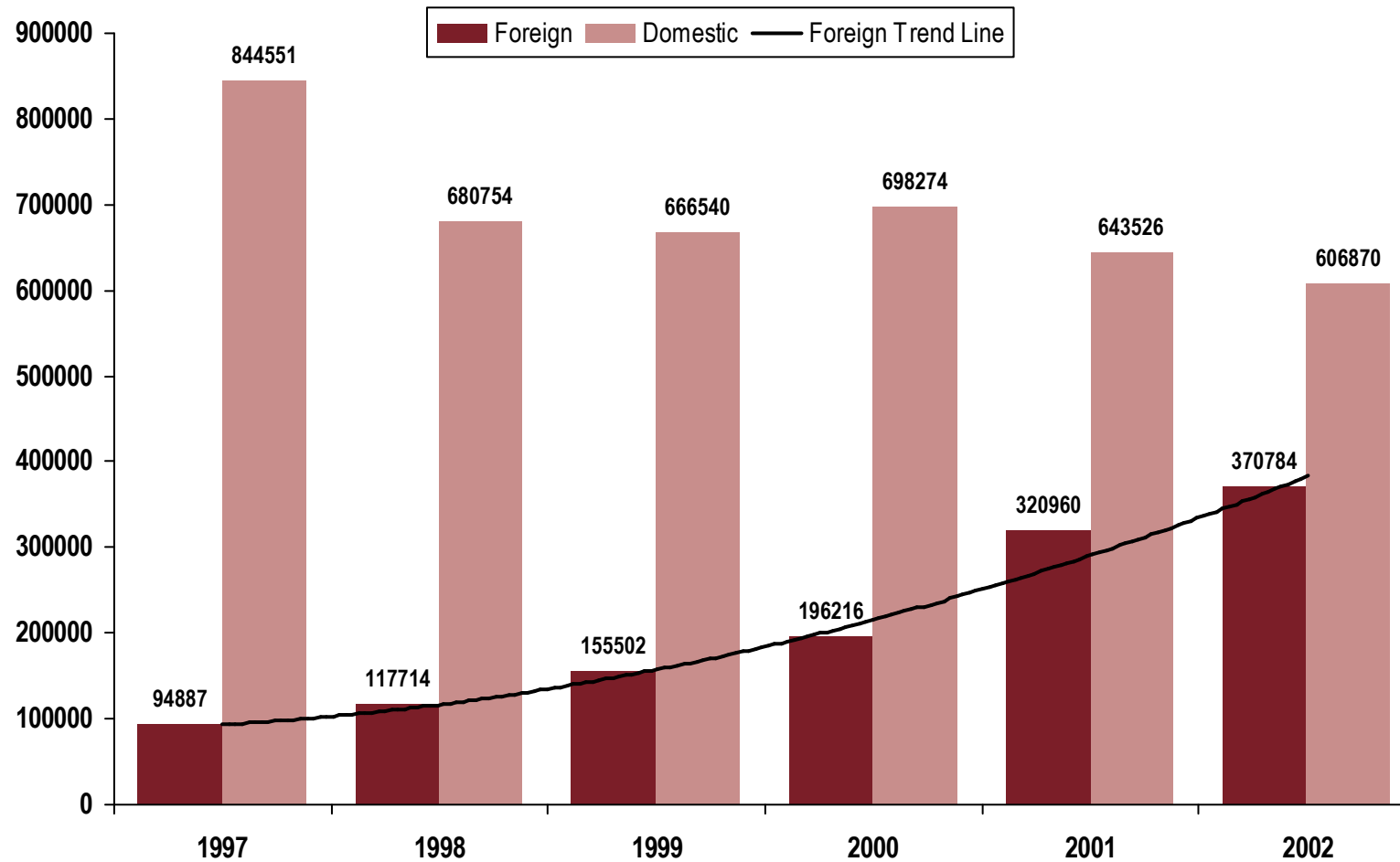
Foreign Direct Investment Per Capita



Foreign Direct Investment Inflow - CZ



Value Added Creation, mil. CZK



Source: CZSO

Value Added Creation

- In 2002 the annual value added per employee was
 - **CZK 683 000 in firms under foreign control,**
 - **CZK 408 000 in domestic firms.**
- => foreign firms have productivity higher by 2/3.
- Increasing value added in companies under foreign control is due to
 - **acquisitions**
 - **higher productivity**

Conclusions

- *institutions matter*
- Representation took time to realize
 - regulation is not only an unfavorable intervention in the free market
 - but also a state's obligation to implement the rule of law
 - The improvement of the quality of the economy's legislation and of the state's ability to enforce it represents as important determinant of the reform process as macroeconomic stabilization, competition, privatization, or price liberalization.

Gaining Reform Momentum

- government has repeatedly adopted various atypical solutions
 - transition to market economy was unique process
 - understandably required non-standard forms of treatment
 - too many of the adopted approaches were non-standard (or short-sighted)
 - augmented the transition process with new impediments or created blockades for future steps (see Stiglitz, 2000).

- Reform push
 - Economic crises (like 1997)
 - External pressures (like 2004)
 - European Union entry ruled out the non-standard solutions' approaches
 - implicit commitment to satisfy economic criteria that condition EMU entry

Thank you