Promising Signs in Czechoslovakia

By Thomas S. Sigel

Before World War II, Czechoslovakia was one of the most industrialized countries in Europe. The Czech lands had been the industrial heartland of the Hapsburg empire; per capita income equaled that of Austria. More than 40 years of communism has isolated the country from the West and repressed most private initiative through a program of collectivization and state ownership more extensive even than those of the other East European countries.

After the collapse of the old political system, will the country be able to regain its traditional position as an important industrial nation and through close economic and financial ties become an integral part of western Europe? The chances are good even though the transition to a market economy is still proving difficult. The potential breakup of Czechoslovakia, or the Czech and Slovak Federal Republic (CSFR), is the biggest question looming over the future of the state, which was formed in 1918. Since the agreement to dissolve the country was signed on 23 July, the premiers of the Czech and Slovak republics have had second thoughts about the breakup and have been working on ways to save aspects of the federation rather than go through a complete "velvet divorce," which is scheduled for 1 January 1993. Although Slovaks elected Prime Minister Vladimir Meciar in June on a platform of full independence for Slovakia, most of them now agree that breaking up the union is a mistake. Most Czechs feel similarly. The differences between the republics are vast and the breakup would have more negative affects on Slovakia than it would on the Czech lands of Bohemia and Moravia.

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Shock of reform

The Czechoslovak government's reform program, which was introduced in January 1991 by then finance minister (and current Czech prime minister) Vaclav Klaus, consisted of a shock therapy for the economy: price decontrol, drastic cuts in public subsidies to enterprises, liberalization of foreign trade, and internal convertibility of the country's currency, the koruna (or crown). Because of Klaus' monetarist leanings, the government did not try to hold down price increases but instead chose to squeeze out inflation with a very tight monetary policy. The sharp increase in consumer prices in 1991 (up 58%) was primarily the result of the liberalization of prices. During the first half of 1992, inflation has dropped to about 13% annually, the lowest rate among the countries in central and eastern Europe.

These policies had a harsher affect on Slovakia whose weaker and more vulnerable economy was dealt a severe blow. The Czech Republic, whose exports account for 80% of CSFR exports, is able to take advantage of liberalized trade regulations. Slovakia, which has been slower to implement market reforms, contains a larger share of arms-related and other heavy industries which will bear the brunt of the restructuring of obsolete industries.

The abrupt transition from central planning to a market economy has left very deep marks. Real GNP in Czechoslovakia fell by about 16% in 1991; industrial output fell by 23% and should fall by the same amount in 1992. This year, economists expect real GNP to fall another 6%. The economy could start to rejuvenate in 1993, but won't start really picking up until 1995. According to official statistics, unemployment is currently around 7% (12% in Slovakia, under 3% in the Czech lands), but should increase next year. The decline in output is mainly due to an extremely tight monetary and fiscal policy which has severely curtailed the investment activity of state-owned companies. State enterprises have been extending credit to each other in order to keep production moving—and sometimes to avoid a restructuring—despite a lack of funds.

Czechoslovakia introduced the voucher system in order to privatize 75% of the state enterprises by the end of 1992 while allowing the populace to participate in the privatization process by buying shares in these enterprises. For a nominal fee citizens buy voucher booklets which may be exchanged for shares in privatized enterprises or in investment funds. (For more detail on the voucher system, see *E/W Letter,* vol. 1, no. 2, Spring 1992.) The voucher scheme is a coura-

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geous strategy, the success of which is being watched closely by officials in other former centrally planned economies. Through a fast change in ownership, the government hopes to break the firms' old planning and hierarchical structures.

The change in ownership is only the first step toward paving the way for a market economy and needs to be followed by a restructuring of companies. In a way, it only provides the foundation for the actual transformation of the firms into units able to function in a market economy. The voucher system poses many questions: while the populace will only receive some shares of those firms not sold to foreign investors, were the state firms not already owned by the population, that is, all people? If stock holding—and therefore ownership—of particular firms is widely dispersed under the voucher system, can the painful, but necessary steps toward restructuring be introduced? (Poland, for instance, has a different structure for its voucher system to try to avoid this problem; for reviews of privatization programs generally, see future issues of the *Letter*.) How is the value of the firms' capital determined? When will an efficient stock market be set up? What would happen if there were a wave of stock sales?

> The potential breakup of Czechoslovakia is the biggest question looming over the future of the state.

Foreign trade and investment

Czechoslovakia's main trading partners had been the countries of the former Council of Mutual Economic Assistance (CMEA); trade was based on below-world-market prices and the use of the "transferable ruble," an artificial currency used only in CMEA trade. The shift to dollar-based trade with these countries has also contributed to the contraction of the economy by forcing Czechoslovakia to use scarce hard currency resources to buy previously "cheap" goods, especially oil. Czechoslovakia, which had exported primarily machinery to the former USSR, has been especially hard hit; its machines are generally not competitive with Western goods on which Russia and other former CMEA countries would prefer to spend their scarce hard currency resources.

Although Czechoslovakia is currently undergoing a deep recession, the medium-term opportunities should not be overlooked. The country is in a better starting position than other central and eastern European countries and has considerable economic potential. For example, Czechoslovakia possesses a highly skilled workforce, especially in areas of high technology. The technological standard is among the most advanced in the former CMEA.

In addition, Czechoslovakia's ties to international financial markets are intact. Foreign debt amounts to $9.1 billion, or just under 80% of annual exports of merchandise and services—a very low figure by international standards. The government continues to pursue its traditionally cautious debt management. Czechoslovakia's current account surplus in 1991 reached $350 million.

Owing to its favorable geographical location and low wage costs, Czechoslovakia's export potential is very strong. At current exchange rates, average industrial wages are only one fourteenth those in western Germany. Many goods destined for the European Community (EC) countries could be manufactured very cheaply in Czechoslovakia. The association agreement reached with the European Community at the end of 1991 gives Czechoslovakia's manufactured goods relatively free access to the EC market; the export potential is enormous. Even prior to this agreement, over 40% of Czechoslovakia's exports went to the EC in 1991 compared with 24% in 1988. The development of exports will thus probably be very dynamic and start the economic upturn. However, this agreement may have to be renegotiated individually with the Czech and Slovak republics if they indeed separate; if negotiations for a customs union between the Czech lands and Slovakia are successful, a new agreement with the EC will not be necessary.

The first signs of Czechoslovakia's export potential can be seen already. While over 60% of export deliveries still went to the former CMEA countries in 1989, this rate fell below 30% last year. Foreign trade is turning more toward the West, especially toward Germany. In the areas bordering Germany and Austria, primarily in the Czech lands, many export-oriented, medium-sized private firms have mushroomed and their output is growing fast.

Western investors are beginning to recognize opportunities in Czechoslovakia, in particular in the Czech lands. In 1991, the inflow of foreign direct investment totaled almost $600 million, after having practically stood at zero in the years before. Through the first 8 months of 1992, additional foreign equity capital has reached an estimated $1.2 billion, 80% of which is in the Czech lands. The only other country that has seen a similar high amount of direct investment has been Hungary. The Czech Republic would probably attract even more foreign investment after the

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split with Slovakia. On the other hand, Slovakia, which will no longer receive much-needed subsidies from the Czech lands, will be less attractive to foreigners.

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Along with opportunities also come risks. Will Czechoslovakia continue to exist in its present form or, as planned, will Slovaks and Czechs create two independent republics and go their own way? Will the country be unable to take political action and thus paralyze the reform program as had been the case in Poland? The uncertainty resulting from these unresolved questions cannot be ignored. A separation would certainly have negative consequences for both republics, but it is questionable whether it would slow down the western orientation of the economy, especially in the Czech lands. Certainly, Slovakia has more to lose from an end to federation; Slovak premier Meciar underestimated the importance of this when he threatened independence hoping to extract concessions from the Czechs. Czech premier Klaus simply took Meciar at his word and began separation talks. Despite the fact that a broad majority in both regions prefer federation, and the CSFR parliament recently tried to block it, the Czech and Slovak leadership continue to prepare to end their union. [The next issue of the *E-W Letter* will have a discussion of the economic consequences of the Czech-Slovak split—Ed.]

While the prospect of separation is not nearly the threat to stability and prosperity which the world has witnessed in the Balkans and elsewhere, the Czech-Slovak split seems to cloud an otherwise bright future with a great deal of uncertainty. Perhaps with this impression in mind, the leaderships of the two republics have been working to retain or create those common institutions which will continue to aid them in becoming productive economies and to make them attractive to international investment. ◊

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