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Stabilization and Structural Reform in Czechoslovakia: An Assessment of the First Stage

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Abstract

This paper analyzes the Czechoslovak reform program which was launched on January 1, 1991. Under this program, Czechoslovakia has taken decisive steps to establish a market economy, while achieving price stability and a viable external position through restrictive financial policies. But there has been a sharp decline in output. The eventual output recovery is predicated on completing structural market reforms, such as the development of financial markets and the safeguard of their stability, privatization of large enterprises, minimizing government interference with economic signals, and the imposition of the "hard" budget constraint.

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Table of Contents

	Page
I. Introduction	1
II. Background to Reform	2
1. Developments in 1990	2
2. The external environment	6
III. The Reform Program of 1991	7
1. The policy sequencing problem	8
2. Price liberalization	9
3. The exchange and trade liberalization	10
4. Exchange rate policy and reserve management	12
5. Fiscal policy	13
6. Monetary policy	16
7. The debt overhang of enterprises	18
8. Interest rate policy	20
9. Incomes policy	22
10. Privatization	23
IV. Economic Developments During the Stabilization Phase	27
1. Price developments	27
2. Output developments	28
a. The external shock	29
b. Changes in the structure of production	29
c. Price jump cum restrictive policies	29
d. Fall in domestic demand	30
e. Relative importance of supply and demand factors	30
3. Balance of payments developments	32
V. Lessons Learned and the Task Ahead	34
Table 1. Czechoslovakia: Selected Economic and Financial Indicators, 1987-91	5
Table 2. Czechoslovakia: Fiscal Operations, 1990-91	15
Table 3. Czechoslovakia: Monetary Survey, 1989-91	17
Table 4. Czechoslovakia Output and Price Changes in the Industrial Sector	31
Table 5. Czechoslovakia: Balance of Payments, 1990-91	33
Chart 1. Czechoslovakia: Rates of Increase in Prices, 1991	28a
References	37

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Summary

On January 1, 1991, Czechoslovakia introduced a comprehensive reform program, including the liberalization of domestic prices and of external trade, and a mass privatization program. The collapse of the Soviet economy and the terms of trade deterioration that followed from the dismantling of the Council for Mutual Economic Assistance (CMEA) trading system worsened the prospect for inflation and the balance of payments at the critical, initial phase of reform. To minimize the risk of financial instability, the structural policies were supported by mutually reinforcing macroeconomic policies comprising a pegged exchange rate regime and restrictive fiscal, monetary, and wage policies.

The reform program has been remarkably successful in quickly stabilizing prices and achieving a viable balance of payments position. Moreover, considerable progress has been made in initiating structural reform measures, most notably privatization and tax reform, although it will take some time before these reforms are fully implemented. At the same time, output has been declining sharply. In part, this decline is the consequence of structural changes: many productive sectors have become noncompetitive under the emerging market framework, while those sectors that do enjoy comparative advantages have yet to be expanded. The eventual takeoff of investment and growth is predicated on completing structural reforms, such as the development of financial markets and the safeguarding of their stability, privatization of large enterprises, minimizing government interference with economic signals, and the imposition of the "hard" budget constraint.

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I. Introduction

On December 10, 1989, it had been over forty years since the Communist Party had taken control of the Czechoslovak Government, and over twenty years since the short-lived reform efforts of the "Prague Spring". This was the legacy inherited by the new "Government of National Understanding" formed on that day, and by its successor, the democratically elected Government that took office in June 1990, and which closely resembled the interim government in its composition. On the economic front, the legacy was shaped both by the distant past--Czechoslovakia's pre-war history as a major industrial power--and by the characteristics of the more recent Communist regime.

Even before its foundation as an independent state in 1918, and up to German occupation in 1938, Czechoslovakia had enjoyed a well-developed market system. By contrast, under the Communist regime, state control over the economy was perhaps more pervasive than anywhere else in Central and Eastern Europe. Almost all productive capacity, including agriculture and small businesses, was in the hands of the state, and the only significant physical asset in private hands was about half of the housing stock. Virtually all decisions relating to production, investment, and foreign trade were made by the state. Prices were set centrally, and wages tightly controlled. Although efforts were made in the mid-1960s to reform this system and, in particular, to delegate more decision-making power to enterprise management, these efforts were entirely reversed in the period following 1968. Thus, although a memory of a market system survived, most of the skills associated with that system had been lost by the 1980s.

Prior to 1948, Czechoslovakia had been a major industrial power. The industrial sector enjoyed a privileged position during the Communist era, and was relatively advanced by the 1980s, although plagued by outdated technology and by other inefficiencies. Industrialization since 1948 had been guided both by the planners' preference for heavy industry and by the international division of labor within the Council for Mutual Economic Assistance (CMEA), which was only loosely related to Czechoslovakia's comparative advantage in a worldwide setting. Consequently, the economy had become extremely vulnerable to the type of terms of trade shock which came about with the collapse of the CMEA in January 1991.

Both Czechoslovakia's integration into the world economy and the (long stifled) expression of the preferences of its citizens will necessitate drastic changes in production patterns. The industrial legacy of the country will affect this process in several ways. On the one hand, Czechoslovakia is endowed with a well educated and skilled workforce; it has also been left with a sizable stock of capital, at least some of which will be usable in the new environment. Both of these factors augur well for the success of reform in the longer term. On the other hand, Czechoslovakia's highly-processed products are geared to very specific needs and markets, and their redesign will require know-how, investment, and time. Thus, in the

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short run, Czechoslovakia's relatively advanced industrial structure cannot but complicate and slow the reorientation of production.

Finally, both in pre-Communist and Communist days, Czechoslovakia consistently implemented cautious macroeconomic management. Unlike other Central European countries, it did not experience runaway inflation in the 1920s. 1/ During the Communist era, fiscal and credit policies were consistently conservative, and budgetary subsidies to enterprises were relatively small. Foreign debt was kept low (at an estimated 16 percent of GDP in 1989), and domestic imbalances were clearly smaller than in most of the other centrally planned economies in the region. Recorded inflation was low, at an average of about 1 1/2 percent a year over the 1980s, and hidden inflation is thought to have amounted to no more than 2-3 percent annually. Moreover, both anecdotal evidence (the absence of pervasive shortages) and trends in the income velocity of money (which had declined only slightly during the 1980s) suggested that excess demand had not built up in the form of a large monetary overhang.

From a macroeconomic point of view, therefore, Czechoslovakia enjoyed perhaps the best starting conditions for reform in Central and Eastern Europe--although the near-complete domination of production by the state and virtual absence of any market mechanisms called for perhaps even more extensive structural reform than in the other planned economies. The Communist regime had initiated only a few cautious steps towards reform in late 1987. These included a small liberalization of the exchange and trade system aimed at encouraging exports in convertible currencies, a slight move towards greater enterprise autonomy, and a rationalization of wholesale prices, which continued to be administratively determined.

II. Background to Reform

1. Developments in 1990

Preparations for reform began in earnest under the new Government in early 1990. 2/ The interim Government acted quickly in several relatively uncontroversial areas, while pursuing the task of developing a comprehensive strategy of reform and building a consensus around it. Extensive discussions within the interim Government culminated in the adoption in May of a resolution setting forth a program of rapid reform, particularly in the areas of price and trade liberalization. This resolution was subsequently endorsed by the new Government, which was formed following the June elections, and the program was further elaborated in the "Scenario of

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1/ A more complete historical background is provided by Prust and IMF Staff Team (1990) and Solimano (1991). For experiences with hyperinflation in the 1920s, see Dornbusch and Wolf (1990).

2/ For further insight on the preliminary steps for economic reform, see Dyba and Svejnar (1991) and Klaus (1990).

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Economic Reform", submitted to Parliament in September, which outlined "a comprehensive set of measures involving price liberalization, liberalization of imports and internal convertibility [i.e., unrestricted access by businesses to foreign exchange for current account transactions], promotion of the growth of the private sector, macroeconomic anti-inflationary policy and the policy of social guarantees and social protection." A target date of January 1, 1991 was set for the launching of the radical phase of the reform program.

In the meantime, various preparatory measures had already been put in place. The new Government allowed two measures that had been prepared under the previous regime to come into force on January 1, 1990. First, a two-tier banking system was created through the breakup of the State Bank; as an adjunct to the new banking structure, a discount rate was established--initially at the level of 4 percent--for banks seeking refinance resources. Second, a mixed system of centralized and decentralized prices was introduced. Under the new system, prices ranged from centrally determined to "contract prices", but even in the latter case prices remained subject to central intervention, so that in practice 1990 saw very little price liberalization.

The new Government also acted quickly to signal the new orientation of macroeconomic policy by declaring the need for fiscal and monetary austerity. The 1990 state budget that had been prepared under the previous Government was withdrawn and a new, tighter budget was presented, which showed a surplus of half a percent of GDP. At the same time, tight credit ceilings were imposed on the commercial banks. In addition, the new Government took a first step toward addressing the foreign exchange imbalance. The commercial and noncommercial exchange rates for the koruna were unified on January 8, 1990, at a level of Kcs 17 per U.S. dollar, representing sizable depreciations of both rates, and a "tourist" exchange rate was introduced, at a much more depreciated level still.

Although prices remained essentially controlled throughout 1990, the new Government took steps to address some of the most glaring price distortions. On July 9, armed with the public mandate it had received from the elections, the Government raised retail food prices by an average of 25 percent, so as to eliminate retail subsidies amounting to over 3 percent of GDP. The population was compensated for these price increases by means of monthly income transfers of Kcs 140 (close to 5 percent of the average wage) per person. Some further administrative price adjustments, notably in the area of transportation, were implemented in the following months with a view to further reducing subsidies.

A second set of crucial price adjustments was also initiated in July, this time in response to adverse external developments. As a result of the deepening economic crisis in the U.S.S.R., the source of almost all of its oil imports, Czechoslovakia was forced to purchase oil on the world market, at prices that were then inflated by the Middle East crisis. In an effort to reduce consumption, the retail prices of gasoline and diesel were raised

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between July and October, eventually to double their levels of early 1990. In effect, as far as retail prices of gasoline and diesel were concerned, the price adjustments that would be made necessary by the collapse of the CMEA in January 1991 had been completed in advance.

As the year progressed and the strategy of radical reform took shape, expectations of inflation and of devaluation became widespread--the latter boosted by some open discussion of various devaluation options in the Scenario of Economic Reform. The discount rate was raised to reach 8.5 percent by the end of the year, while deposit rates rose to 7-14 percent and lending rates to 15-22.5 percent. These moves, however, did not stem the hemorrhaging of foreign exchange in anticipation of devaluation, as enterprises stocked up on imports and prepaid debt by any means available. On October 15, the commercial exchange rate was devalued by a further 35 percent, to Kcs 24 per U.S. dollar.

Throughout 1990, considerable efforts were also devoted to laying the legislative and institutional basis for the establishment and growth of a market economy in general and of private enterprise in particular. Among the most important legislative changes, a law on private enterprise was adopted allowing private sector participation in virtually any economic activity; the monopoly of foreign trade corporations on external trade was abolished; and the joint venture law was amended to allow for 100 percent foreign ownership. In addition, much of the planning apparatus was dismantled, the process of restructuring state enterprises into smaller and more independent joint stock companies was begun, and steps were taken to develop indirect instruments of monetary management.

The economic situation in 1990 was dominated by adverse external developments, in the form of deepening difficulties in trade with the U.S.S.R. and with other CMEA countries undergoing adjustment, and by the response to the very first steps of reform (Table 1). Net material product is estimated to have fallen by 3 percent, and the balance of payments to have deteriorated substantially, leaving gross international reserves at the end of the year equivalent to just over one month of imports. Consumer prices rose by 18 percent over the course of the year, largely as a result of the administrative price adjustments; producer prices, which towards the end of the year were permitted to adjust to reflect part of the impact of the October devaluation, rose only slightly less. The Government recorded a surplus of approximately 1 percent of GDP 1/, and, despite the substantial price increases, credit to the nongovernment sector rose by only about 1 1/2 percent over the course of the year.

1/ Abstracting from certain stock adjustments relating to export credits to the U.S.S.R. and to devaluation losses of the banks.

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Table 1. Czechoslovakia: Selected Economic and Financial Indicators, 1987-91

	1987	1988	1989	1990 Estimated	First Half 1991 Estimated
Real sector (change in percent)					
Real gross domestic product	2.1	2.5	1.4	-3.1	...
Consumer prices:					
Period average	0.1	0.2	2.3	10.8	...
End period	0.1	0.6	1.5	18.4	49.1
Industrial wholesale prices:					
Period average	0.1	--	-0.7	4.4	...
End period	...	...	-0.7	16.6	53.3
Public finance (Kcs billions)					
Central Government 1/					
Revenue	343.8	359.9	362.3	383.3	219.7
Expenditure 2/	344.4	376.1	367.4	376.4	201.1
Surplus/deficit 2/	-0.6	-16.2	-5.1	6.9	18.6
Overall Government					
Surplus/deficit 2/	-3.8	-18.0	-67.3	-48.3	30.2
Money and credit (end period, percent change)					
Net domestic assets	6.5	10.5	1.1	4.7	6.5
Credit to enterprises and households	3.3	3.1	-2.7	1.4	13.1
Broad money	6.0	11.5	3.5	0.5	5.6
Interest rates (percent)					
Credit to enterprises and cooperatives	5.1	5.1	5.7	6.5	19.5
Household savings deposits	4.0	4.0	4.0	4.3	13.0
Balance of payments (US$ billions) 3/					
Merchandise exports	15.7	15.1	14.3	11.7	4.7
CMEA	9.6	9.0	7.8	5.7	1.6
Other	6.1	6.1	6.5	6.0	3.1
Merchandise imports	15.8	14.7	14.0	13.2	5.0
Trade balance	-0.1	0.3	0.2	-1.5	-0.3
Current account	0.8	1.5	0.3	-1.3	--
Net international reserves (end-period)	...	...	...	-2.6	-2.6
Gross international reserves (end-period)	1.5	1.7	2.3	1.2	1.7
In months of following year imports in convertible currencies	3.6	4.2	4.9	1.2	...

Source: Data provided by the Czechoslovak authorities, and IMF staff estimates.

1/ Includes federation and republics. A methodological change in July 1991 increased both revenue and expenditure for 1991 by Kcs 44 billion.

2/ Excluding takeover of export credits, and transfers to the banks and foreign trade organizations on account of devaluation profits and losses.

3/ Transactions with CMEA members in transferable rubles in the years prior to 1991 converted at cross-rates.

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2. The external environment

The launching of the radical reform phase on January 1, 1991 was to coincide to the day with a major deterioration of the external environment that was associated with the shift in trade arrangements among the members of the CMEA to pricing at world market prices and to settlement in convertible currencies. Evaluated at cross-exchange rates, CMEA trade accounted traditionally for over half of Czechoslovakia's exports and imports. 1/ The shift to world prices represented both a large inflationary impulse and a major terms of trade shock, while the shift to convertible currencies would inhibit exports.

Up to 1990, almost all trade with the CMEA was denominated in transferable rubles. Prices in transferable rubles did bear some relation--discussed more fully below--to world prices, but this relation was based on the official exchange rate of the transferable ruble against the U.S. dollar, of TR 1 = US$1.60 (known as the "IBEC" exchange rate, for the Moscow-based International Bank for Economic Cooperation). Against the Czechoslovak koruna, on the other hand, the transferable ruble was valued at Kcs 9, equivalent on average in 1990 to US$0.50 and after the December devaluation of the koruna to only US$0.32. Abstracting from disparities between old transferable ruble prices and world prices, therefore, the abolition of the transferable ruble would have meant a fivefold increase in koruny prices of CMEA imports and exports. 2/

In addition, the move to world prices worsened Czechoslovakia's external terms of trade. Czechoslovakia's imports from the CMEA consist mainly of raw materials and energy, and its exports to the CMEA mainly of capital goods and other manufactured products. Within the CMEA, the pricing systems for these two types of goods were different: prices of raw materials (at the IBEC exchange rate) were explicitly linked to a moving average of recent world prices, through the so-called "Bucharest formula", whereas prices of manufactured goods were set on the basis of bilateral negotiations. Over time, the relative prices of manufactured goods had risen. In Czechoslovakia, it was estimated that--with transferable rubles converted into U.S. dollars at the IBEC rate--the move to world prices would reduce the dollar prices of imports from the CMEA by perhaps 5 percent, and the dollar prices of exports to the CMEA by about 25 percent. As a result, the terms of trade with the CMEA would deteriorate by over 20 percent.

With the shift to settlement in convertible currencies, Czechoslovak products stood to lose an important advantage that they had enjoyed in

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1/ As discussed below, the use of cross-rates underestimates the weight of the CMEA in total trade.

2/ This comparison assumes that the exchange rate of the transferable ruble against the koruna would otherwise have remained unchanged; another counterfactual would yield a smaller impact of the abolition of the transferable ruble, but a larger impact of the devaluation of the koruna.

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competing for CMEA markets with products from other countries. This loss of competitiveness put additional pressure on export prices. Moreover, the clearing system had been instrumental in sustaining trade flows within the CMEA, as shortages of foreign exchange were felt throughout the region--most notably in the U.S.S.R.--and the abolition of the clearing system thus brought with it the risk of a decline in export volumes. Exports to the U.S.S.R. were likely to decline in any event as a result of the economic crisis in that country, and exports to the other former CMEA members would also come under pressure as economic reform and adjustment cut into these countries' ability to import.

For a time, it seemed that the rise in international oil prices due to the Persian Gulf crisis would further worsen the difficult external environment in which Czechoslovakia was determined to embark on its radical reform program. The fall in oil prices in early 1991 removed this aggravating circumstance. Nevertheless, the collapse of the CMEA and the contraction of some of its major export markets were sufficient to present Czechoslovakia, for the first time in years, with a need for a serious stabilization effort, at the very same time that the crucial phase of reform was being launched.

The unfavorable external circumstances at the time the reform program was launched were bound to complicate further the transition to a market economy. 1/ However, the advance setting of January 1, 1991 as a fixed and non-negotiable deadline for launching the program was instrumental in coalescing the political forces and pushing through the necessary reforms without delay. Without the strong commitment to a specific date, pressures might have mounted regarding details not yet worked out, thereby causing delay or even stalling the reform process.

III. The Reform Program of 1991

The comprehensive reform program that was implemented on January 1, 1991 comprised a major liberalization of domestic prices and of external trade, and a rapid privatization program following an initial preparatory phase. The very unfavorable external environment made it even more pressing to proceed promptly with the reform measures but, at the same time, worsened the prospects for inflation and the balance of payments. To minimize the risk of financial instability in the critical initial phase of reform, the structural policies were supported by a mutually-reinforcing package of financial policies comprising a pegged exchange rate and restrictive fiscal, monetary, and wage policies.

1/ It is interesting to note that the unfavorable external environment itself was to a large extent a part of a wider trend to economic reform--the collapse of the CMEA being an integral part of the reform of the former centrally planned system, and the loss of export markets being due in part to reform efforts in neighboring countries.

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1. The policy sequencing problem

The extensive nature of the economic reforms to be undertaken raised an important issue of strategy, namely, in which order should the multiple reforms be implemented. 1/ Does it make sense to free markets (to liberalize prices and foreign trade), while production and trade are still in the hands of a few monopolistic state enterprises? Should price and trade liberalization be attempted simultaneously, or should the opening to foreign trade be postponed until enterprises are in a stronger competitive position?

The answers to these questions derived mostly not from advantages that could be obtained by following a particular sequencing strategy, but instead from the existence of major roadblocks--of both economic and technical nature--in the way of alternative paths. Postponing market liberalization until privatization had been completed would have implied a major delay in the launching of the reform process. For largely technical reasons, it is virtually impossible to transfer a major part of the state enterprise sector to private control in less than two or three years. The problem with this delay is that the intervening period could witness a major economic collapse, as the economy would find itself in a "no-man's land" in which the central planning system has lost its ability to function (even at its normally poor level of efficiency), but new market-oriented initiatives are choked by price controls and economic restrictions. The situation in the Soviet Union in the past few years, with its breakdown of traditional economic relations and multiplication of shortages, exemplifies this type of situation. Moreover, this kind of sequencing would further complicate the sale of public enterprises, because the true market value of enterprises would be even more difficult to assess; even a short experience under liberalized markets can provide some basis for evaluating the potential profitability of state enterprises.

Several considerations are germane to the question of whether foreign trade liberalization and the introduction of limited currency convertibility should be postponed in order to give enterprises more time to adjust. First, a staggering of price and trade liberalization entails successive waves of relative price adjustments, with each wave imposing additional adjustment costs on enterprises--involving e.g., investments, personnel and technical changes. By contrast, a simultaneous liberalization of prices and trade allows the new "equilibrium" relative prices to be established quickly, thus minimizing the adjustment costs. Secondly, a postponement of trade liberalization would risk the creation of vested interests--for example in import-competing sectors--that could make the process of opening up the economy more difficult politically. Finally, foreign trade liberalization is the only way of rapidly injecting substantial competition

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1/ See Calvo and Frenkel (1991a), Dornbusch (1991), and Fischer and Gelb (1991) for more general treatment of the sequencing problem in the Eastern European context.

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into a severely monopolized system, and hence of avoiding abuses of market power. In so doing, trade liberalization also allows international prices of traded goods to serve as guidelines for the adjustment of all domestic prices, and a fixed exchange rate can become a strong anchor to hold down domestic inflation. 1/

Thus, it was considered that the only feasible strategy was to proceed to price and trade liberalization in a "big bang" fashion, while imposing hard budget constraints on state enterprises and undertaking the process of privatization as rapidly as possible. Aggregate demand policies were designed to be on the tight side in order both to ensure the success of stabilization and to enforce financial discipline on state enterprises. For the first time, state enterprises were to find that their very existence depended on maintaining a viable financial position. Price subsidies were kept to a minimum, and a strengthened--though broad, in the absence of adequate targeting mechanisms--social safety net used instead to alleviate the effect of price increases on the lowest income segments of the population. Foreign exchange was made freely available to businesses for their current account transactions, and direct restrictions and barriers to trade were minimized. Under these conditions, price and performance signals would begin to function as indicators of the potential market value of enterprises, facilitating their privatization.

2. Price liberalization

A cornerstone of structural change in Czechoslovakia was the liberalization of prices, which had been administratively set for the previous 40 years. On January 1, 1991, prices of goods and services representing about 85 percent of the total value of sales were freed, both at the producer and retail levels. Prices of public utilities, transport, and rents, as well as a few products of vital importance such as medicines, remained under regulation (these items accounted for 6-8 percent of total turnover in the economy). In addition, temporary price guidelines were introduced for a list of specified goods, such as foodstuffs and intermediate goods of critical importance, in order to discourage speculative price rises. The concern was that in the absence of established competition and traditions of price setting, the monopolistic structure of many industries could lead to unwarranted price increases in the immediate period following the liberalization. These temporary price guidelines were eliminated by November 1991.

The liberalization of prices was reinforced by the removal of consumer subsidies. Following the earlier removal of retail subsidies on food, subsidies on industrial products were eliminated on January 1, 1991. After an initial postponement, subsidies on almost all energy products were

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1/ Conditions for a successful convertibility are discussed by Portes (1991) and--more specifically for the case of Czechoslovakia--by Hrncir and Klacek (1991).

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eliminated in May 1991; as a result, coal prices rose by 240 percent, gas prices by 100 percent, and heating rates by 320 percent. Partial compensation for these price increases was granted to pensioners and families with children in the form of monthly income support of Kcs 80 per person (about 2 percent of the average wage). Thus, budgetary subsidies, which as recently as in 1989 had amounted to about 16 percent of GDP, were reduced to about 7 percent of GDP. Remaining items included: agricultural subsidies (amounting to about 3 percent of GDP), partly to support minimum producer prices for a number of products; transport subsidies (a little over 1 percent of GDP) for the railway, inter-city road transport, and urban transport; housing subsidies (about 1 percent of GDP) for maintenance of state-owned rental apartments and for low-interest loans; and small subsidies to oil- and gas-fired heating plants, which are more costly to operate but less damaging to the environment than the coal-fired plants.

The price structure was expected to change drastically in early 1991, not only because of the liberalization and the continued reduction in subsidies, but also because of external factors, including changes in the CMEA trading arrangements and the rise in the international price of oil. As a result of these external factors--which would raise prices of some raw material imports by as much as 300 percent--as well as the devaluation, prices of tradable goods were expected to rise substantially in early 1991. A precise quantification of the once-and-for-all impact of these external factors was impossible, but rough calculations suggested that, at a minimum, they would raise the price level by 25 percent. In addition, prices of goods that had been in short supply under central planning were expected to rise.

An important challenge in the early stage of reform was to ensure that the initial jump in prices did not give rise to an inflationary spiral. The formulation of fiscal and monetary policies was therefore based on the very conservative target of limiting the initial price jump to 25 percent and the subsequent underlying inflation in the remainder of the year to an annual rate of 5 percent. These targets were clearly ambitious, even allowing for the absence of a major monetary overhang such as that observed in the other centrally-planned economies. But it was recognized that an overestimation of the initial price jump in the formulation of fiscal and monetary policies could in fact become self-fulfilling. Of course, aggregate demand policies based on an underestimated initial price increase could adversely affect economic activity, but it would be far easier to take corrective action in such a case than to err on the other side and be forced to control runaway inflation or a balance of payments crisis in the midst of a program of fundamental structural reform.

3. The exchange and trade liberalization

The opening of the economy to international competition was the second cornerstone of the reform program. In order to infuse competition and bring the domestic price structure into line with international prices, virtually all restrictions on businesses' current account transactions were removed on

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January 1, 1991, while a full foreign exchange surrender requirement was imposed. Capital account transactions remained subject to control, to minimize the risk of destabilizing capital outflows, particularly in view of the limited level of foreign reserves. Under the new system, the annual foreign exchange plan was abandoned, and trade activities by all registered businesses (state or private) were freely allowed. Only a few strategic imports remained subject to import licensing. Subsequently, profits and dividends were made fully remittable (in February), and the annual entitlement to foreign exchange for individuals travelling abroad was raised from Kcs 2,000 to Kcs 5,000 (in April). In addition, the system of levies and subsidies, which bridged differences between domestic and international prices, was abolished on January 1, as was the export premium scheme, which subsidized exports to the convertible currency area; and export licensing requirements on a large number of products were removed.

An important adjunct to trade reform was the dismantling of the CMEA trade and payments arrangements. Effective January 1, 1991, trade with CMEA members was to be conducted on the basis of world prices and payments to become due in convertible currencies, replacing bilateral and multilateral arrangements. However, already prior to that date and increasingly as 1991 progressed, it was evident that trade within the CMEA was in danger of collapsing on the new basis; exports to the Soviet Union, in particular, appeared to be hardly feasible on a convertible currency basis, because importers were unable to secure the necessary foreign exchange. To avoid the loss of these markets, which, owing to the specificity of most manufactured exports, would be difficult to replace in the short run, some temporary arrangements were necessary. These took the form initially of dollar-denominated clearing arrangements under which goods on the "indicative lists"--which defined areas of trade of mutual benefit--could be traded; later in 1991 a framework for clearing accounts denominated in national currencies was also created.

With the liberalization of imports, there was concern that pent-up demand for consumer goods might lead to a surge in imports in early 1991. Thus, in order to contain pressures on international reserves, the authorities imposed, on a temporary basis, a 20 percent surcharge on virtually all imports of consumer goods. This surcharge was reduced to 15 percent by mid-1991, and it is expected that it will be eliminated in the near future in conjunction with a planned restructuring of the tariff system. Since the planning system relied on the foreign exchange plan to regulate imports and protect domestic industries, the present tariffs are generally low, averaging about 5 percent. The authorities have accordingly decided to review and modify the tariff structure beginning in 1992, with a view to providing domestic industries with appropriate protection, in

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particular in light of subsidies given by some neighboring countries to the agricultural sector. 1/

Foreign investment has been promoted in the context of the structural reform in general, and the privatization program in particular. The Joint Ventures Act, as amended in 1990, together with the Foreign Exchange Act, has established a framework for joint ventures and foreign-owned companies, under which these companies could be subject to less restrictive regulations than those applicable to domestic enterprises regarding foreign exchange accounts abroad and borrowing from foreign banks. In addition, foreign investors may freely repatriate capital. Moreover, bilateral agreements that would guarantee even more favorable conditions for foreign investors have been reached, or are under negotiation, with most western industrial countries.

4. Exchange rate policy and reserve management

A critical aspect of the stabilization program was the choice of the exchange rate regime. In the choice between a flexible or a pegged exchange rate, a number of issues had to be considered. Under a flexible regime, the determination of the level of the exchange rate would be left to market forces. However, such a regime entailed substantial risk, given the absence of an established foreign exchange market, as well as the substantial uncertainty relating to changes in both the price structure and the trade patterns in the aftermath of price and trade liberalization. A major concern was that, under those circumstances, a freely floating system would be very fragile, and the initial price jump or an initial surge in imports would trigger a vicious circle of sharp speculative depreciation of the koruna, domestic inflation, and accompanying wage increases. The risk of speculative attacks on the koruna was heightened by the low level of international reserves. The uncertainty relating to the extent of intervention necessary to stabilize the exchange rate, as well as the authorities' relative inexperience in managing a floating exchange rate, was expected to influence adversely the availability of foreign exchange resources from both official and private sources. 2/

Against this background, the authorities decided to unify the commercial and tourist exchange rates at a competitive level, and to peg the rate to a basket of currencies of major partner countries in the West. The pegged rate, together with restrictive fiscal, monetary, and incomes policies, was designed to provide an effective anchor for stabilizing prices in the period following their liberalization. The commitment to a pegged rate was also expected to enhance the authorities' credibility in putting in

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1/ In July 1991, pending this tariff restructuring, the Government imposed temporary import quotas on certain agricultural products, in order to stem subsidized imports from neighboring countries.

2/ See Aghevli, Khan, and Montiel (1991) for general considerations on the choice of an exchange rate regime.

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place restrictive aggregate demand policies and therefore discourage speculative capital outflows. Furthermore, in the absence of futures markets or hedging facilities, a pegged regime would facilitate trade by reducing exchange rate volatility.

In order to ensure the viability of the pegged regime, it was critical that the initial exchange rate parity be set at a level that was both consistent with a sustainable current account position over the medium term and credible from a short-term perspective. In setting this rate, it was therefore necessary to anticipate a substantial erosion in external competitiveness in early 1991 owing to large domestic price increases of other origin, which were difficult to project accurately. This consideration, together with a precarious level of international reserves, dictated that any error in setting the exchange rate be on the side of overdepreciation. Although it was recognized that any such overdepreciation could by itself amplify the initial price increase, it was feared that a small devaluation would induce large capital outflows given strong speculation by the public that the koruna would be devalued by a large amount. Accordingly, on December 28, 1990, the exchange rate of the koruna was set at the level of Kcs 28 = US$1; this action represented a devaluation of the koruna (at the commercial rate) by about 15 percent, implying a total devaluation of over 45 percent during 1990.

Notwithstanding the substantial devaluation of the koruna in 1990, it was recognized that a structural transformation could be attained only after a time lag and that, in the meantime, the trade and payments position was likely to deteriorate. 1/ Thus, a sound financial program in the context of a pegged exchange rate required an adequate level of reserves at the outset. In this context, large-scale financial support from the IMF was indispensable. Access to IMF resources in the amount of up to US$1.8 billion was provided under a stand-by arrangement and the compensatory and contingency financing facility. Of this amount, about $0.7 billion was disbursed in early January to boost the initial level of reserves to about one and a half months' imports. Support from the IMF provided a respite, while other financial support could be arranged. Subsequently in 1991, commitments of about US$1 1/2 billion were made by the European Community, the other industrial countries of the Group of 24, and the World Bank--of which about half is expected to be disbursed in 1991 and the remainder in 1992.

5. Fiscal policy

Fiscal policy was designed to achieve two broad aims: to further the disengagement of the state from the economy, and to help stabilize the economy in the turbulent period following the "big bang" and the terms of

1/ The requirement of external support for reform programs is certainly a common feature in the formerly centrally-planned economies. For a general assessment, see Collins and Rodrik (1991) and Diwan and Saldanha (1990).

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trade shock. With the former objective in mind, the rates of profits tax were reduced by 10-20 percentage points and largely unified; the myriad rates of turnover tax (sales tax) were reduced to three (in addition to a zero rate); and, as explained above, subsidies were drastically reduced. 1/

To further the stabilization objective, fiscal policy for 1991 was aimed at an overall budget surplus of about 1 percent of GDP (Table 2). 2/ The implied improvement of less than 1 percent of GDP in the budget balance (over 1990) substantially understated the adjustment effort. In particular, the ratio of revenue to GDP was--again conservatively--estimated to fall by about 10 percentage points, owing in part to policy decisions, but principally to exogenous factors, including the expected difficulties of enterprises and the projected fall in employment and real wages. Furthermore, proceeds from privatization were not to be included as budgetary revenues but were to be blocked in the accounts of the National Property Funds with the banks. Consequently, the envisaged budget surplus required considerable expenditure restraint. Even under the conservative target of a 30 percent price increase in 1991, all components of expenditure would decline substantially in real terms, lowering the ratio of government spending to GDP by about 11 percentage points. The most severe cuts fell on subsidies, and the least severe on the social safety net. Public investment, which was recognized to have a crucial role to play in the face of urgent infrastructural needs, was cut only slightly more than government consumption expenditure.

The fiscal stance in early 1991 was substantially tighter than envisaged, reflecting a temporary surge in profits tax receipts due mainly to capital gains on inventories (high penalties on late payment of taxes--of half a percent per day--ensured that tax payments ranked among enterprises' highest priorities). In addition, expenditures were deliberately limited with a view to bolstering the anti-inflationary stance in the crucial first few months of the year; thus pensions and government wages were increased with a significant lag following the price jump, and payments over which the Government had discretion--notably subsidies and capital transfers--were postponed. Altogether, the overall budget surplus in the first quarter amounted to about 2 1/2 percent of (annual) GDP. 3/

1/ As in other socialist economies, the tax system in Czechoslovakia was highly distortionary, with extremely high profit tax rates. See Tanzi (1991).

2/ The overall budget comprises the budgets of the Federal Government, the two republics, and the local authorities, as well as extrabudgetary operations. It does not include operations of the National Property Funds, to which the proceeds from privatization accrue.

3/ All references to the fiscal balance in 1991 exclude certain stock adjustments that were carried out to adjust the distribution of assets and liabilities between the Government and other parts of what was formerly the state. These are listed in Table 2.

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Table 2. Czechoslovakia: Fiscal Operations, 1990-91

	1990 1/	1991 Budget	1991 Jan.-June Actual	1991 Revised Budget 2/	1991 Jan.-Sept Actual 2/
		(In billions of koruny)			
Central Government (Federation and republics) 3/					
Revenue	399.2	406.1	220.1	482.5	344.8
Individual income taxes	0.3	39.8	18.2	56.1	40.7
Profit taxes	93.4	91.7	81.3	136.8	105.1
Payroll tax	81.4	90.1	34.2	107.2	70.1
Taxes on goods and services	147.8	154.3	63.5	141.9	91.7
Taxes on international trade	25.8	11.0	5.4	8.8	8.5
Other	50.5	19.2	17.5	31.7	28.5
Expenditure and net lending	385.9	395.1	203.0	478.5	340.0
Current transfers	248.1	216.2	109.0	297.5	206.9
To enterprises and cooperatives	103.2	44.8	25.7	64.6	45.3
To subsidized organizations	3.2	4.5	2.0	11.4	5.5
To local authorities	33.4	9.8	10.5	63.0	44.2
To households	108.3	157.2	70.7	158.4	111.8
Unemployment benefit and retraining	--	9.8	1.2	9.8	2.3
General income support	12.7	32.9	12.8	32.0	...
Other	95.6	114.5	56.7	116.6	...
Other current expenditure	86.5	139.5	76.8	138.2	102.1
Capital expenditure	7.2	16.0	4.8	14.3	8.3
Capital transfers	45.1	27.6	12.9	33.2	20.2
To local authorities	30.2	14.1	8.2	15.2	11.9
Other	14.8	13.5	4.7	18.0	8.3
Net lending	1.0	-4.3	-0.5	-4.7	2.5
Surplus/deficit	13.3	11.0	17.1	4.0	4.8
Stock adjustments 4/	-51.3	-1.5	16.9	15.4	16.9
Adj. for complementary period 5/	-9.8	-0.5	8.2	5.5	5.7
Local authorities	-0.9	-1.0	3.1	--	7.9
Revenue	162.4	86.2	54.3	95.6	...
Of which: transfers from central Government	63.6	23.9	18.7	78.1	56.1
Expenditure	163.3	87.2	51.2	95.6	...
Extrabudgetary funds	-0.2	--	0.3	--	0.6
Overall surplus/deficit	-48.9	8.0	45.6	24.9	36.0
Excluding stock adjustments	2.4	9.5	28.7	9.5	19.1

Sources: Data provided by the Czechoslovak authorities; and IMF staff estimates.

1/ 1990 figures are not comparable with 1991 because of changes in the division of revenues and expenditures between central and local Government.

2/ Methodological changes compared to the original budget consist of: the transfer of certain own revenues of the local authorities (individual income taxes and payroll tax; full-year total Kcs 44.4 billion) to the central budget, with an equivalent increase in transfers to the local authorities; and the transfer of certain "other" current expenditures (full-year total Kcs 6.8 billion) to transfers to subsidized organizations.

3/ Revenue and expenditure adjusted for off-budget transactions.

4/ Includes transfers of devaluation losses and profits of banks, takeover of export credits to the U.S.S.R., and transfers to cover devaluation losses of foreign trade organizations.

5/ Adjusts the fiscal balance of central Government from an accrual to a cash basis.

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The exceptionally strong fiscal performance of the first quarter was not expected to endure. In particular, most sources of revenue were expected to be adversely affected by the economic decline, while government spending relating to the social safety net would increase owing to the rise in unemployment. In addition, expenditure allocations for some sensitive services (notably health and education) had to be revised upwards as a result of the higher-than-expected price jump, but this revision was not approved until July. In light of very weak domestic demand, the authorities were concerned that the unwinding of the tight fiscal stance might be too slow. Thus, to give both a signal and an immediate boost to domestic demand, the rates of turnover tax were lowered by 1-3 percentage points in mid-1991.

Expectations of a turnaround in the fiscal position were confirmed in the third quarter. After a small additional surplus in the second quarter, the Government recorded a deficit of about 1 percent of (annual) GDP in the third quarter. As the windfall gain on profits tax subsided, all the major sources of revenue began to show the effects of declining economic activity, and the lags in expenditures began to unwind. For the year as a whole, the overall fiscal position is expected to be broadly balanced--somewhat weaker than originally budgeted, as the effects of the sharp drop in activity offset the initial windfall gain on profits tax. With the revision of expenditure allocation in July, nominal spending exceeded the original budget but, in real terms, the spending cuts were significantly larger than originally envisaged. This tight fiscal stance has proved instrumental in checking price rises and alleviating pressures on the balance of payments, although it has inevitably contributed to the weakening of domestic demand. It should be noted, however, that the dependence of the 1991 fiscal results on the windfall gain on profits tax and on favorable lags foreshadows the even greater challenge that will face the authorities in maintaining an appropriately anti-inflationary fiscal stance in 1992.

6. Monetary policy

Monetary policy, like fiscal policy, was designed to be restrictive so as to bolster the exchange rate anchor and help stabilize prices. A tight credit policy was intended to ensure that the initial price jump did not trigger a process of protracted inflation.

The velocity of broad money was expected to increase, reflecting the greater availability of nonmonetary assets, including consumer durables and equity obtained through the privatization of small-scale enterprises in early 1991 and of larger enterprises (albeit on a limited scale) later in the year. Thus, the monetary program had to allow for a shift in savings from monetary to real assets, which would reduce the demand for money. In line with the projected increase in velocity and the targeted balance of payments, the financial program envisaged a tight credit policy, particularly in the period immediately after the liberalization of prices (Table 3). The envisaged decline in net credit to the Government corresponding to the budget surplus, together with the expected proceeds

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Table 3. Czechoslovakia: Monetary Survey, 1989-91

	1989	1990	1991 March	1991 June	1991 Sept.
			(In billions of koruny)		
Net international reserves 1/	17.8	-4.3	-12.8	-9.6	-2.0
Foreign assets 2/	37.8	27.7	32.8	41.3	58.8
Foreign liabilities	20.0	32.0	45.6	50.9	60.8
Net domestic assets	530.0	555.0	558.5	593.5	628.1
Domestic credit	583.6	640.2	656.0	667.3	702.2
Net credit to Government	5.9	54.2	37.9	8.6	18.2
Net credit to Property Funds	0.0	0.0	-0.9	-4.2	-11.7
Credit to ent. & households	577.7	586.0	619.0	662.9	695.7
Credit to enterprises	530.8	536.0	567.8	611.3	642.6
Credit to households	46.9	50.0	51.2	51.6	53.1
Broad money	547.8	550.7	545.7	583.9	626.1
Money	311.1	291.2	279.9	294.3	324.7
Currency outside banks	68.0	73.7	72.9	76.2	80.7
Demand deposits	243.1	217.5	207.0	218.1	244.0
Households	107.5	103.3	95.7	92.0	92.0
Enterprises 3/	135.6	114.2	111.3	126.1	152.0
Quasi money	236.7	259.5	265.8	289.6	301.4
Time and savings deposits	232.5	231.7	240.2	254.0	259.1
Households	170.2	167.4	171.3	180.1	188.1
Enterprises 3/	62.3	64.3	68.9	73.9	71.0
Foreign currency deposits 1/	4.2	27.8	25.6	35.6	42.3
Households	1.7	9.8	12.6	16.3	21.0
Enterprises	2.5	18.0	13.0	19.3	21.3
Other items, net 4/	53.6	85.2	97.5	73.8	74.1
Memorandum items:	(Change in percent of broad money at beginning of year)				
Broad money	3.5	0.5	-0.9	6.0	13.7
Money	0.3	-3.6	-2.1	0.6	6.1
Quasi money	3.2	4.2	1.1	5.5	7.6
Net international reserves	2.6	-4.0	-1.5	-1.0	0.4
Net domestic assets	0.9	4.6	0.6	7.0	13.3
Domestic credit	7.7	10.3	2.9	4.9	11.3
Other items, net	-6.9	-5.8	-2.2	2.1	2.0

Source: Data provided by the State Bank of Czechoslovakia; and IMF staff estimates.

1/ End of period. At current exchange rates through 1990, and at end-December 1990 rates for subsequent periods.
2/ From 1990 is strictly comparable with international reserves at end-period exchange rate. Earlier data use State Bank valuation of monetary gold.
3/ Including insurance companies.
4/ Including net nonconvertible assets and long-term assets of Obchodni Bank.

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from privatization (to be held by the National Property Funds), would provide adequate room to meet the credit needs of the nongovernment sector under the credit ceilings. In the event, the price jump turned out higher than anticipated, and the financial program was revised accordingly.

Credit policy was to be implemented mainly through direct ceilings on commercial banks. While such ceilings inevitably create inefficiencies and distortions, the rudimentary nature of financial markets made it impossible to rely on reserve money management and other indirect instruments. The State Bank, however, introduced a number of measures to move toward a system of reserve money management. These include: the requirement that interbank accounts be settled in the State Bank's books--a prerequisite for State Bank control over reserve money; a change in the reserve system to one based on an average monthly holding period, to smooth the operation of the new interbank settlement system; and the introduction of reserve requirements and refinance auctions. The authorities intend to take further steps in this direction, including the introduction of a Treasury or State Bank bill, so as to allow for the implementation of monetary policy through market-based instruments. In addition, new banking laws are to be introduced, which should promote the independence of the State Bank and further the development of a competitive banking system (including through the entry of foreign banks).

As in the case of fiscal policy, credit conditions in early 1991 turned out to be considerably tighter than planned. Several factors appear to have constrained the supply of credit. On the technical side, the reliance on direct credit ceilings proved inefficient because margins not used by certain banks could not be used by other banks; furthermore, the State Bank and, in turn, head offices of commercial banks built significant safety margins into their ceilings. More fundamentally, the banks were reluctant to lend in the highly uncertain environment, in view of the changing prospects facing enterprises and also of the banks' own inexperience in credit risk assessment. The deficiencies of the banks' balance sheets, due to their low capital-asset ratios and their poor loan portfolios, compounded this reluctance to lend. With the encouragement of the State Bank and helped by the stabilization of the macroeconomic situation, credit picked up after the first quarter, but remained tight--as evidenced for instance by a sharp increase in interenterprise payment arrears. While the tight stance of credit policy, especially in the early months, helped avoid the onset of an inflationary spiral and of pressures in foreign exchange markets, it may have added to the weakness of aggregate demand and the contraction in output.

7. The debt overhang of enterprises

A major obstacle to an efficient functioning of the banking system has been the legacy of large amounts of bank credit extended to enterprises under government direction over many years, a situation described as the "soft budget constraint" (Kornai (1986)). A large portion of bank credits is of questionable value, as enterprises may not be in a position to repay

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them. These loans are not only burdensome to banks, but in some cases may financially choke enterprises which could be profitable on current operations, but which are saddled with large debts incurred through arbitrary price setting and investment decisions under central planning. From the point of view of banks, the carryover of these debts distorts the allocation of credit as well as increases the spread between deposit and lending rates. Moreover, given the weak capital and reserves position of commercial banks, this situation threatens the stability of the emerging financial system, highlighting the need both to put the commercial banks on a sound footing and to introduce proper prudential banking supervision. 1/

To the extent that bad debts are owed by enterprises that are not viable and need to be liquidated, the solution--recapitalization of the banks--is fairly clear-cut. Unfortunately, however, to the extent that the debt overhang also pertains to enterprises that are potentially profitable, there does not seem to exist a "clean" solution. A comprehensive auditing of banks and enterprises to identify the proper action in each individual case would take time, and create serious moral hazard problems in the interim. Moral hazard will also arise if, in an attempt to avoid overestimating the size of the problem in the face of a need for quick action, a debt relief operation is conducted in installments, with no clear signal that it is the last such operation. Moreover, debt write-downs should target enterprises that have the greatest potential for improving their performance and increasing their investment, which means that very good and very bad enterprises should be excluded; the scheme should be carefully designed in this respect because, from the point of view of banks, it is debt write-offs for the worst enterprises that most helps their balance sheets. Finally, not only will a debt relief operation be complicated, but it will also be costly if it is to be comprehensive enough to have an impact on the performance of the economy. This cost, however, should not be overestimated. For enterprises that are to be privatized through direct sales, debt relief will presumably be reflected in higher sale prices. Moreover, to the extent that the authorities wish to protect deposit holders, the bad debt overhang already implies a financial liability for the state, albeit a contingent one. If enterprises are unable to repay banks, and banks become unable to repay depositors, it will be up to the state to cover the resource gap.

As a first step in addressing the banks' portfolio problems, measures were taken in March to carve out of the banks' balance sheets a large part of permanently revolving credits for inventories ("TOZ" credits). These credits, which had originally been extended at 6 percent interest and with no maturity date, were officially abolished at the beginning of 1991, but problems arose when banks and enterprises attempted to negotiate replacement loans with longer-term maturities and at commercial rates. A new agency, the Consolidation Bank, was created to take over the bulk of TOZ loans--some Kcs 110 billion, equivalent to almost one fifth of the stock of bank credit

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1/ See Calvo and Frenkel (1991b).

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to enterprises--with eight-year maturities and at an interest rate of 13 percent (corresponding to its average cost of funds). On its liability side, the Consolidation Bank took over from the commercial banks a portion of their liabilities to the State Bank and of the deposits by the savings banks. By removing a number of questionable loans from commercial banks' portfolios, the establishment of the Consolidation Bank was a first step in the direction of improving the efficiency of the banking system. However, the operation was a very partial one, and a large number of nonperforming loans remained on banks' books. Moreover, the beneficial impact on both banks and enterprises was quite limited: banks gave up low-cost liabilities of a similar value, and, since no provisions were made for write-offs or write-downs, enterprises continued to carry TOZ debts on their books.

Further measures were undertaken in October 1991, when it was decided to transfer to the commercial banks Kcs 50 billion in bonds issued by the National Property Funds. Of this amount, Kcs 10-15 billion was earmarked for capitalization of the banks, thus providing some cushion against the effects of the inevitable bankruptcies; and the rest was to be used to compensate banks for writing off loans of enterprises with large debts but good economic potential. Given the uncertainties surrounding estimates of the amount of bad and doubtful loans outstanding, it is not clear whether this operation will be sufficient to resolve the issue.

8. Interest rate policy

Czechoslovakia's financial markets are not adequately developed to generate autonomously a market-clearing interest rate. The banking system is still in an infant stage, besides being saddled with weak balance sheets and strong oligopolistic elements. Furthermore, the instruments and markets that would enable central bank management of conditions in financial markets are still in a rudimentary state. Thus, interest rate policy was to be designed fairly independently from the targets for domestic credit, albeit with a consideration not to worsen existing disequilibria in financial markets.

The first important issue was the determination of interest rates for the first few weeks of 1991, when prices were expected to jump sharply. Interest rates in the final months of 1990 had not been high enough to prevent large-scale hoarding and capital outflows in anticipation of devaluation and price increases, but with the onset of the price jump on January 1, an entirely new situation would unfold. Should one attempt to maintain, ex-post, positive real interest rates, or should one set interest rates in a forward-looking way with reference only to the expected inflation--and other factors--after the price jump had taken place? The authorities chose the latter course of action, for a number of reasons.

First, raising interest rates would do little to reduce the size of the price jump. As argued above, the price jump was essentially caused by a number of supply-side factors, such as the adjustment of raw material prices and of the exchange rate. On the demand side, interest rates would not

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affect significantly the behavior of consumers. On the one hand, purchases of what had been shortage goods would be unlikely to be reduced or postponed because of the opportunity of earning an ex post real interest rate of a few percentage points during January-February. On the other hand, with the widespread knowledge that prices would jump on and after January 1, purchases for purposes of stocking up would have been largely completed prior to that date; besides, expectations of inflation during the price jump could be low or even negative, as the public, which had little prior experience of inflation, might at any time after January 1 expect that the price jump had worked itself out or even overshot.

Second, unduly high interest rates would have a number of undesirable consequences. Higher interest costs, with widespread cost-plus pricing, would in fact magnify the price jump. An increase in interest rates to levels rarely seen in Western European countries could give a wrong signal that inflation would persist, thereby leading to ingrained inflationary expectations. Finally, a short period of ex-post negative real interest rates would contribute to reducing the inherited high indebtedness of enterprises and to eliminating any existing monetary overhang.

Nevertheless, interest rates needed to be high enough to protect the balance of payments position. Although controls on capital flows were to remain in place, it was clear that, as elsewhere, these controls would not prevent large capital outflows should domestic assets not bear an appropriate premium. In this context, it was of course crucial that the entire economic program be credible, in particular, that the exchange rate be judged adequate to withstand the expected adjustment of prices. On the basis of these assumptions, a premium of a few percentage points over foreign interest rates was judged to be sufficient to make domestic deposits attractive, and interest rate policy was geared to this objective.

The problem of the weakness of banks' balance sheets posed an additional problem in the determination of appropriate lending interest rates. On the one hand, high lending rates would end up worsening the debt overhang problem for some enterprises and, more importantly, it would unjustly (and inefficiently) penalize all new investment projects for the "sins" of years of central planning. On the other hand, both the riskiness of loans to highly-indebted enterprises and the weak financial position of banks called for relatively high lending rates. The permissible interest rate spread started relatively high, but was later narrowed in stages, reflecting mainly the authorities' concern over the oligopolistic structure of the banking system, and anticipating steps to remove doubtful loans from banks' portfolios; the reduction in the spread may, however, have made it more difficult for some of the riskier borrowers--including the emerging private sector--to get access to credit.

Although banks were formally granted some leeway in determining interest rates, the State Bank kept close control over rates with the aid of three instruments: the discount rate, a maximum lending rate, and moral suasion in the area of deposit rates. The discount rate plays a large role

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in the determination of the banks' cost of funds because the large banks rely heavily on State Bank refinancing. Initially, the discount rate was set at 10 percent (somewhat above its end-1990 level of 8 1/2 percent), the maximum lending rate at 14 percentage points above the discount rate, and the notional target for deposit rates at a few percentage points above the discount rate. One-year deposit rates settled in the range of 13-16 percent, with lending rates ranging from 17-24 percent. Apart from loan risk considerations, the high spread between deposit and lending rates reflected high costs associated with the inefficiency of the banks; the oligopolistic structure of the banking system contributed to keep lending rates close to their maximum authorized level. The maximum lending interest rate was later reduced in successive stages to 17 percent by September, and the discount rate was lowered to 9 1/2 percent.

Developments in the first part of 1991 largely confirmed the validity of the assumptions on which Czechoslovakia's interest rate policy was built. There was no evidence of capital outflows on a significant scale. Foreign currency deposits rose only moderately, reflecting a sharp deceleration relative to the growth in this type of deposits during 1990. 1/ In addition, interest rates did not unduly stimulate demand early in the year as both investment and consumer demand were in fact very weak during the first quarter.

9. Incomes policy

An integral element of the anti-inflationary program was the containment of wage growth. To this end, the General Agreement concluded in January by the Government, employers, and trade unions established a cap on wage increases during 1991 consistent with a decline in real wages of 10 percent compared with December 1990--following an earlier decline of about 10 percent over the course of 1990. Wage increases in excess of this guideline would be penalized by prohibitive taxation of enterprises (the so-called "excess wage tax"), except in the case of those with fewer than 25 employees.

In practice, wage increases were contained well below the levels permitted by the General Agreement, reflecting the unfavorable financial position of enterprises and the weak bargaining power of labor in an environment of rising unemployment. Nominal wages in the second quarter are estimated to have been some 12 percent above their level of end-1990, implying a fall of over 20 percent in real terms. In the wake of these deep cuts, nominal wages were expected to increase somewhat during the remainder of 1991, but they should remain well within the agreed guidelines.

1/ Foreign currency deposits of enterprises remained at about their level of December 1990, but were constrained by the new foreign exchange surrender requirements.

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Also as part of the General Agreement, a minimum wage of Kcs 2,000 per month was established in January--well above the previously existing lowest wages in the economy. The authorities are concerned that this minimum wage may contribute to the rise in unemployment, and have resisted pressures for its indexation.

The wage restraint policy has served two important objectives. The first and more immediate objective has been to contain inflationary tendencies arising from the jump in prices that followed their liberalization. But a second important objective is to reinforce other efforts to strengthen financial discipline and to preclude excessive wage increases by state enterprises, particularly those with uncertain prospects. The current excess wage tax virtually excludes the whole emerging private sector because it does not apply to enterprises with fewer than 25 employees, and the Government is considering explicitly exempting all private sector firms from the excess wage tax in the near future.

10. Privatization

Privatization is the most challenging, and, perhaps, the most critical, of the economic reforms being undertaken. Czechoslovakia finds itself in the tenuous situation in which the central planning system has been dismantled, but the lack of widespread private property and of a clear profit motive places it some distance from a full-fledged market system. State enterprises account for virtually all economic activity. Their managers are unfamiliar with and untrained for a market system; moreover, their perception of a highly uncertain tenure creates perverse incentives for excessive wage and bonus payments, low investment, and squandering of the assets of the enterprises.

Compared with the divestment of large enterprises, the privatization of small enterprises is relatively simple, and began in January 1991. The "small privatization" program consists of sales of small businesses through auctions in which all resident Czechoslovak citizens can participate and for which bank financing has been provided. Auctions are being held as often as four times a week throughout the country and over 20,000 small enterprises--mainly but not exclusively retail outlets--had already been privatized by this method by November. Small enterprises are generally sold without their debts, which are repaid out of the proceeds of the auctions; but in a number of auctions held later in the years, some enterprises (typically somewhat larger ones) were sold with their liabilities. In addition, large numbers of small enterprises, which were expropriated after 1948, are being returned to their previous owners.

As regards privatization of larger enterprises, the authorities were determined to proceed at once, even at the risk of difficulties arising from the sheer scale of the effort and the lack of adequate expertise and developed markets, lest the inefficiency of the system of public enterprise management and control blunt the progress of all reforms. But the question was how to proceed with privatization. It was recognized that conventional

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sale methods could have only a limited role for a number of reasons, including the near impossibility of obtaining a meaningful valuation of the enterprises, the lack of domestic savings, equity and political considerations, the absence of sophisticated financial instruments and specialists, and the realization that foreign investors would be interested in only the "elite" of the enterprises. Therefore, the idea of free distribution of equity to the public through a "voucher scheme" was elaborated as a necessary method in terms of speed and comprehensiveness, and a desirable one on grounds of equity and political acceptability.

The voucher scheme is a plan to transfer the ownership of a major portion of the large enterprises of Czechoslovakia to the public in general. Every Czechoslovak citizen over the age of 18 will be entitled to acquire a voucher book that will endow him or her with 1,000 investment points. These points can be used to bid for shares of the enterprises being offered or, alternatively, can be tendered in exchange for shares in mutual funds. The mutual funds ("investment privatization funds", or IPFs) can be established with few requirements beyond a minimum capital and a charter. The IPFs must make their investment objectives publicly known, in order to facilitate the decisions of individuals on the use of their vouchers. The IPFs will permit individuals to avoid getting involved in financial analysis of enterprises and to increase their possibilities for a convenient portfolio diversification.

Three successive "waves" of voucher privatization are envisaged, with the first one beginning in early 1992. A potential 11 1/2 million individuals will be able to purchase and register a voucher book at a cost of Kcs 1,000 (about US$33 or a week's average wages). In a preliminary round, individuals will have the opportunity to pledge their vouchers to one or several IPFs (the smallest denomination of vouchers is 100 investment points, so that an individual could opt for 10 different investments). Next, the first of as many as five rounds of bidding for shares of enterprises will start, with enterprises being offered in prices proportional to their book values. The system will not be a full-fledged auction in the sense of reaching market-clearing prices in the vouchers-for-shares exchange. For example, some trades will be concluded in the first rounds while further price changes will take place in later rounds. Thus, part of the equity of some enterprises may be sold at the price offered in the current round, while the remaining shares are offered again at an adjusted (lower) price in later rounds. Also, individual bids will be given some preference over IPFs' bids in order to simplify the process: thus, it is expected that as soon as individuals' demands are satisfied, it will be possible to auction the remaining enterprises among a few IPFs in a less complicated way. The final round will follow some--as yet undecided--mechanism either to allocate all remaining investment points or to determine what value, if any, unused investment points retain.

The basic structure of the voucher privatization scheme is probably the only one that can achieve privatization on such a major scale in a short period of time. Moreover, the scheme has clear political advantages in that

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it spreads private property widely and avoids favoring the old privileged classes. There are, however, some unavoidable tradeoffs between these advantages and some of the shortcomings of the voucher scheme.

A central problem is related to the effectiveness of corporate governance under very diffuse ownership (spanning millions of small shareholders). Enterprise managers would be subject to little effective supervision by owners, with the result that the control of the enterprises would have changed little after privatization. Effective corporate governance requires the presence of at least one large shareholder. Two basic approaches to this problem have been proposed: a complete "hands-off" attitude, in the expectation that large active shareholders will spontaneously appear in the context of extensive profit opportunities for "corporate raiders," 1/ and an active involvement for the state in designing and organizing financial intermediaries to exercise management supervision on behalf of the public. 2/ The Czechoslovak scheme lies somewhere in between these two polar approaches in the sense that, although the state does not take any initiative in designing structures of corporate governance, the creation of financial intermediaries, in the form of IPFs, is encouraged. 3/

There are some doubts, however, as to whether the IPFs will fulfill the role of active supervisors of management. In some cases, the IPFs may in fact serve as vehicles for management/worker buyouts, with employees of an enterprise creating an IPF for the purpose of acquiring stock in their company. But in the rest of the cases IPFs may limit themselves to providing the possibility of portfolio diversification and other financial services to individuals; while not legally prevented from becoming active shareholders, the IPFs may not naturally tend to assume that role, because that may not be their normal line of business and they may not find it a particularly profitable activity. In addition, there is no mechanism to guarantee the creation of large shareholders, for example by selling shares in large blocks to IPFs. 4/

Aside from problems relating to corporate governance, voucher privatization is subject to various other complications. There may be serious difficulties in achieving "convergence" in a small number of iterations in the process of allocating shares to voucher investment points, and very inequitable situations may arise if the initial prices must be changed substantially in later rounds. Moreover, shares in many of the

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1/ See, for example, Hinds (1991).
2/ See, for example, Lipton and Sachs (1991).
3/ The trade-offs involved in different mass privatization schemes are discussed in Borensztein (1991).
4/ Moreover, with a view to furthering the risk-spreading role of the IPFs, the authorities are considering regulations that would limit their ability to acquire a very large interest in any given company or to concentrate their interests in only one or a very few companies.

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privatized companies may turn out to be a very illiquid investment for individuals, since it is unlikely that the stock market will comprise a very large number of actively traded stocks.

But perhaps the largest obstacle for a successful privatization is the debt overhang of enterprises, discussed above. Since the financial sector has not operated under market conditions, it is quite possible that some enterprises have negative net worth, which will make their privatization impossible even if they are given away free. Even ignoring such extreme cases, highly leveraged positions may cause a large number of failures among the newly-privatized enterprises under the prevailing conditions of large structural changes and contraction in aggregate demand.

Not all large enterprises will be privatized through the voucher method. The Government attaches importance to attracting foreign investment and the attendant capital, know-how, technology, and access to markets; at a minimum those enterprises for which there is definite foreign investor interest (expressed in specific offers) are likely to be excluded from voucher privatization. Still, the scale of voucher privatization will be massive: it might involve some three-quarters of the total of approximately 2,500 large enterprises in the first wave. Some further 10 to 15 percent are expected to be privatized through direct, standard methods mostly to foreign investors or, in some cases, to managers and workers. The remainder of enterprises will require liquidation or, perhaps, restructuring; to facilitate the liquidation process, a bankruptcy law was adopted in July 1991.

As is the case for small enterprises, the laws on restitution of property provide for restitution or compensation for ownership of larger enterprises expropriated after 1948. In order to spare the privatization process from further complications, strict time limits have been set for both applications for restitution and the resolution of claims, and the law has granted the state the option to compensate the claimant in cash (or in equity shares) rather than with the actual property. Enterprises against which restitution claims are pending will not be entered into the privatization process; and any further liabilities that might arise as a result of the restitution process will be liabilities of the state, rather than of the new owners of an enterprise.

Despite the substantial difficulties still remaining, considering both its scale and its advanced stage of preparation, the privatization effort in Czechoslovakia appears to be one of the most advanced in Central and Eastern Europe. While Poland and Romania have passed legislation to support voucher-type mass privatization, they are far behind Czechoslovakia in implementation. Hungary has embarked on a slower process of selling off enterprises, on a case-by-case basis, while Bulgaria is yet to decide which method to adopt. The former GDR has privatized a substantial fraction of industrial enterprises, but this process is becoming far lengthier and more difficult than had been expected, despite the favorable conditions

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associated with its integration in the Federal Republic of Germany (and the European Community). 1/

IV. Economic Developments During the Stabilization Phase

1. Price developments

Price developments following the "big bang" fell into two well-defined stages: the initial price "jump" in the first few weeks after price liberalization, and the subsequent stabilization stage. The magnitude of the price jump widely exceeded the (optimistic) working assumption that was utilized in the formulation of policies. The price jump, as argued below, reflected primarily supply factors, and had little to do with the stance of aggregate demand policies. The first surge in prices worked itself out in the first two months of the year and, after March, inflation was brought under control rapidly. This harnessing of inflation is perhaps the greatest success of the stabilization efforts that were part of the radical reform program of 1991.

The initial price jump came as no surprise. The collapse of the CMEA, and policy actions such as the change in the exchange rate, changes in administered prices, and the removal of subsidies on certain goods, had been anticipated to generate a large increase in the price level. In addition, there was likely to be a direct effect of price liberalization, as relative prices shifted in favor of goods previously in short supply.

At a macroeconomic level, the size of such a price jump is also related to the extent of "monetary overhang", or the monetary disequilibrium existing at the controlled price level. Although the precise concept--and even more so the measurement--of monetary overhang is elusive, a desire of the population to reduce its holdings of money can help fuel an increased demand for goods and thus amplify the price jump. However, the adjustment of prices to the disequilibrium in the money market is probably a much slower process than the price response to direct measures such as a devaluation of the exchange rate or the removal of subsidies. Moreover, indications in Czechoslovakia were that, owing to prudent policies in the past, any monetary overhang was small, and a sharp fall in retail sales as early as January (by over a quarter in real terms, compared with a year earlier) suggests that this assessment was correct.

During January-February, at the producer and retail level, prices jumped on average by about 45 percent. This increase was relatively small when compared with the increases in other previously centrally planned economies that have recently undergone price liberalization, especially considering that liberalization in Czechoslovakia coincided with the move to world prices in CMEA trade. This is an indication of the lesser extent of

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1/ See Lipschitz and McDonald (1990).

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shortages and monetary disequilibrium in the Czechoslovak case, and of the smaller adjustment needed in relative prices such as the exchange rate.

Prices continued to increase after February, but at a rapidly decelerating pace. The prices of some of the important energy products were increased in May. Moreover, the initial price increases set off a chain reaction of cost increases in other sectors that took some time to work their way through the economy; this process included the partial indexation of wages permitted under the Government's agreement with enterprises and trade unions. These secondary waves of price increases explain a good portion of the inflation in months after the price jump, but prices rapidly stabilized nevertheless (see Chart 1). Between March and June, producer prices increased by 4 percent and consumer prices by 11 percent; in the four months from June to October, industrial producer prices fell by 0.5 percent and consumer prices rose by only 0.2 percent. The higher persistence of inflation at the consumer level is in part explained by a slower adjustment of prices at the retail level, as the initial increase was also more moderate in consumer prices than in producer prices.

2. Output developments

In Czechoslovakia, as in all the other formerly centrally planned economies, output fell sharply following the structural reforms. In the first half of 1991, industrial output fell by 17 percent, construction activity by 26 percent, and the volume of retail sales by almost 30 percent, compared with the same period in 1990. For 1991, the fall in GDP may reach 12-15 percent. These figures may exaggerate the actual decline in output and sales owing to underrecording of private sector activity, and, in the case of retail sales, of personal imports. In addition, output figures must be interpreted with caution, given the questionable value of some of the output produced under central planning. However, it is unlikely that the overall picture would change materially if it were possible to correct fully for these factors.

The contraction in output in state enterprises also caused a steady increase in unemployment from the beginning of 1991, with the rate of unemployment reaching 6 percent in October. Layoffs accounted for 90 percent of the approximately 50 thousand workers that became unemployed every month. Reflecting important structural changes in production, the regional disparities are sharp and increasing. In the region of Prague, for example, the unemployment rate was below 1.5 percent in October, while in most parts of Slovakia, where much of the industrial base is becoming obsolete with the changes in the pattern of international trade, unemployment already exceeded 10 percent.

The decline in output was associated with a number of factors--some of them quite independent of the reform process--the relative magnitude of which is not easy to assess. We discuss in turn: the external shock associated with developments in the CMEA, the changes in structure of

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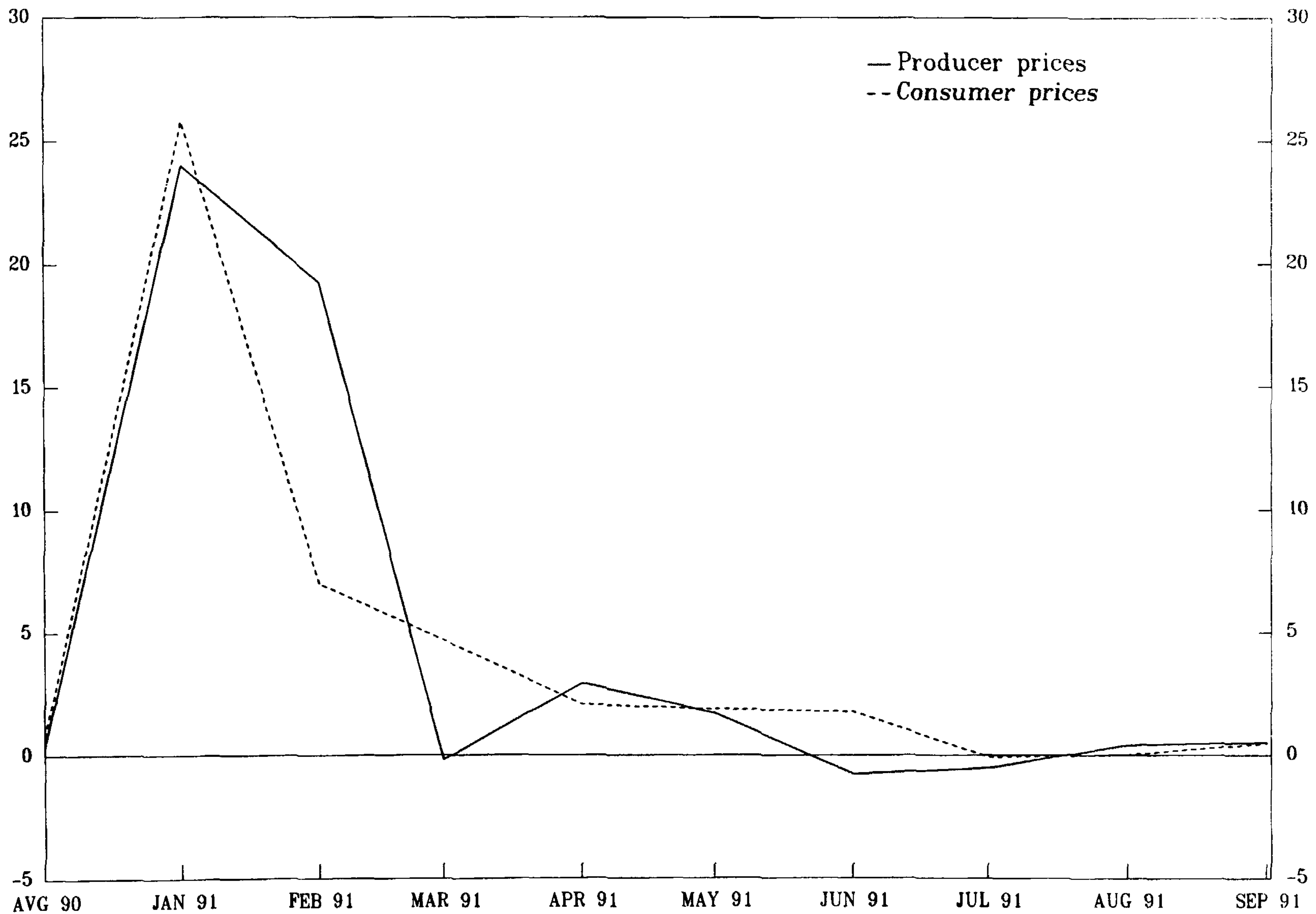
Chart 1. Czechoslovakia: Rates of Increase in Prices, 1991



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production, the combination of the price jump and restrictive policies, and the fall in domestic demand due to uncertainty.

a. The external shock

The Czechoslovak economy suffered a double external shock from developments in the CMEA area. First, exports to the former CMEA area fell precipitously as the economic crisis in the U.S.S.R. worsened and other Eastern European economies faced difficult adjustment processes; moreover, as CMEA trade moved to a convertible currency basis some of Czechoslovakia's competitive edge was blunted, and difficulties were experienced in trading under the new system. Despite some recovery after the first quarter of the year, the volume of exports to the former CMEA is estimated to have fallen by about two thirds for the year as a whole, and could account for a decline in output of 8 percent. Second, the switch to international pricing in CMEA trade meant a terms of trade deterioration for Czechoslovakia: the several-fold increase in prices of energy and other imported industrial inputs could, by itself, account for a significant contraction in output, especially in energy-intensive sectors.

b. Changes in the structure of production

Starting from a widely distorted position, the move to a market system together with the lifting of barriers to international trade necessarily implies large changes in the structure of production. Consumers, free from the "forced substitution" regime that made them buy whatever was available, will turn away from non-competitive products in favor of imports or more acceptable domestic substitutes. It should thus be expected that many enterprises--and some entire production branches--would decline and perhaps not survive under the new system. This effect, per se, does not imply a fall in output, but only a change in its composition. However, an asymmetric speed of adjustment is to be expected in the reallocation of production, because an expansion in the productive capacity of an enterprise requires time for planning, investment and recruitment, building of structures, etc., while a reduction or interruption of production can be effected almost immediately, especially under financial distress. Furthermore, the privatization prospects and uncertainties about the new environment may discourage enterprises from undertaking any long-term decisions to increase or restructure productive capacity, making their response even more sluggish.

c. Price jump cum restrictive policies

Although a sudden price increase in the first weeks of 1991 was unavoidable, a tight and non-accommodating stance for financial policies was thought to be essential to avoid the emergence of an inflationary process. In these conditions, it has been suggested 1/ that tight credit

1/ See Calvo and Coricelli (1991).

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conditions, in conjunction with increased costs of raw materials and other inputs, would generate an aggregate supply contraction. The actual price jump was much higher than assumed when the--deliberately conservative--targets for fiscal and monetary aggregates were established, and financial policies were adjusted with some delay to accommodate the higher price jump. Moreover, for a number of reasons explained above, the policy stance was even tighter than planned, particularly in the first quarter.

d. Fall in domestic demand

Several factors combined to weaken demand by consumers and enterprises over and above the effect of tight financial and incomes policies. 1/ In large measure these factors derived from the situation of uncertainty generated by the transition to a market economy. From the point of view of enterprises, large investment plans were almost precluded in the transition phase because of uncertainty and the expectation of privatization. Uncertainty about future rules and regulations concerning a broad spectrum of legal, tax, and environmental issues, and even about the structure of relative prices makes it difficult to evaluate any investment project. And the prospective privatization would likely entail changes in corporate strategy, and the logical decision by management would be that any large commitment of funds should wait for approval by the new ownership.

From the point of view of consumers, uncertainty about the evolution of the real wage and poor job security must have dampened what had been feared would be a spending burst after years of repressed consumption of domestic and imported goods. In addition--although reliable data on inventories are not available--the demand for (voluntary) inventory accumulation must have fallen sharply as the move to market rules eliminated the main motive for enterprises to keep large holdings of inventories, namely the uncertain availability of inputs, while changes in financial markets curtailed the favorable financing that inventory holding had received in the past. The build up of inventories that took place in the last few months of 1990, in anticipation of devaluation and price increases, probably accentuated the depletion of input inventories in 1991. On the other hand, as sales fell short of production, there is thought to have been an involuntary accumulation of output inventories, probably presaging a further fall in output.

e. Relative importance of supply and demand factors

An examination of the evolution of the different branches in the industrial sector may shed some light on the relative importance of the different determinants of the drop in output (Table 4). The data display the change in production level in the first half of 1991 relative to the

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1/ See Blanchard, Dornbusch, Krugman, Layard, and Summers (1991) on aggregate demand behavior in the transition phase.

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Table 4. Czechoslovakia Output and Price Changes in the Industrial Sector

Industrial Sector	Change in Output 1/	Change in Relative Price 2/	3/
Fuel	2.4	-26.2	-4.7
Energy	-1.7	4.8	39.6
Iron metallurgy	-7.7	20.9	4.8
Nonferrous metallurgy	-30.8	33.0	14.9
Chemical and rubber	-18.9	-14.8	27.9
Machinery	-18.7	11.9	-2.6
Electronics	-28.4	12.5	-2.1
Building materials	-26.9	12.5	-2.7
Woodworks	-12.4	11.2	-3.8
Metalworks	-19.5	31.3	14.3
Paper and cellulose	-4.9	24.2	7.0
Glass, ceramics and porcelain	-19.0	26.0	9.3
Textiles	-25.0	17.9	1.7
Clothing	-36.7	-0.4	-14.0
Tanning	-26.0	20.0	3.7
Printing	-19.5	39.4	20.3
Food	-21.6	-20.6	-31.5
Frozen foods, spring water and tobacco	-19.8	51.0	30.5
Others	--	7.1	-7.4
Total industry	-17.6	--	--

1/ January-June 1991 relative to January-June 1990 (in percent).
2/ Relative price increase from January to June 1991 (in percent).
3/ Relative price increase from July 1990 to June 1991 (in percent).

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same period in 1990. Although the output contraction is fairly generalized, the sharpest fall took place in sectors that are believed to include some of the products with the least comparative advantage, such as clothing and electronics. 1/ Another of the largest drops was in construction materials, reflecting the low level of investment in structures. However, the fact that, with the exception of the fuels sector, all sectors experienced a decline in output does suggest that macroeconomic forces also played a role. There is no clear correlation between output and relative price changes--neither negative, which would suggest a leading role for supply-side factors nor positive, which would suggest a predominance of demand-side factors.

3. Balance of payments developments

Several opposing influences combined to produce, in the aggregate, a better than expected balance of payments result during the first half of the year (Table 5). A very weak demand for exports by countries in the CMEA area generated a drop in export receipts, while exports to other areas were also somewhat disappointing--especially in the first quarter. The fall in exports, however, was more than offset by a very steep drop in imports. The capital account suffered from delays in expected disbursements of official balance of payments support, but foreign investment inflows were substantial--albeit driven mainly by a single large transaction.

The drop in exports to the CMEA countries, although larger than projected, was to be expected. However, the sluggish expansion of exports to market economies, particularly in the first quarter of the year, was something of a puzzle especially in light of the gain in competitiveness following from the exchange rate depreciation and the policy of wage restraint. Clearly, the particular structure of the export sector of Czechoslovakia was not conducive to a rapid increase in exports to Western markets. 2/ Also, several other factors worked to offset some of the effect of improved competitiveness: the policy-induced reduction in exports of armaments; the increase in the cost of key raw materials imported from the former CMEA; the loss of economies of scale as demand from the former CMEA area and from domestic sources fell sharply; and the disruption of previous trading links as enterprises specialized in foreign trade were restructured.

1/ As the sectors thought to have the least comparative advantage are also often those that exported significantly to the rest of the CMEA, it is of course difficult to discern the relative importance of the opening to competition and the loss of CMEA markets.

2/ Prominent among Czechoslovakia's exports are armaments, heavy machinery with a slow marketing process, and manufactures that may not be competitive outside the CMEA area; also potentially important are agricultural, steel, and textile products that face various trade barriers in Western Europe in particular.

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Table 5. Czechoslovakia: Balance of Payments, 1990-91

(In billions of U.S. dollars)

	1990 Revised			H1 1991		
	Non-CMEA	CMEA 1/ & Clearing	Total	Convert. currency	Clear-ing	Total
Current account	-0.9	-0.3	-1.2	-0.4	0.3	--
Trade balance	-0.7	-0.8	-1.4	-0.5	0.2	-0.3
Exports, f.o.b.	5.9	5.8	11.6	3.6	1.2	4.7
Imports, c.i.f.	-6.5	-6.5	-13.1	-4.1	-0.9	-5.0
Of which: oil and gas 3/	(-0.2)	(-2.9)	(-3.1)	(-1.0)	(-0.6)	(-1.6)
Services balance	--	0.2	0.2	0.3	0.1	0.4
Receipts	1.7	1.0	2.7	1.0	0.2	1.2
Payments	-1.6	-0.8	-2.4	-0.8	-0.1	-0.9
Income balance	-0.3	0.1	-0.3	-0.1	--	-0.1
Receipts	0.4	0.1	0.5	0.1	--	0.1
Payments	-0.7	--	-0.8	-0.2	--	-0.2
Transfers (net)	--	0.2	0.2	--	--	--
Capital account	0.1	0.4	0.5	--	-0.5	-0.5
Direct investment (net)	0.2	--	0.2	0.4	--	0.4
Suppliers' credits	-0.1	0.4	0.3	-0.4	-0.5	-0.9
Net MT/LT credit ext.	--	-0.2	-0.2	0.3	-0.2	0.1
Net MT/LT credit rec.	0.3	--	0.3	-0.3	--	-0.3
Short-term (net)	-0.3	0.6	0.2	-0.3	-0.3	-0.6
Valuation changes, errors and omissions	-0.6	-0.1	-0.7	0.3	0.2	0.5
Overall balance	-1.4	--	-1.4	--	--	--
Financing			1.4			--
Use of gross reserves			1.1			-0.5
Use of Fund credit			n.a.			1.0
Other official support			n.a.			--
EC						
G-24						
IBRD+Japan						
Other bank liabilities			0.3			-0.5
ST liabilities			-0.3			-0.3
Market borrowing			0.5			--
Net others (including valuation changes)			0.1			-0.2
Memorandum items:						
Total B/P support			n.a.			1.0
Gross reserves at end-period			1.2			1.7
(In months of following year's imports)			(1.4)			
Net reserves at end-period			-2.6			-2.6

Sources: Data provided by the authorities and IMF staff estimates.

1/ Data were converted from transferable rubles to U.S. dollars at cross rates, and therefore are not comparable to data for 1991.

2/ The revised program was presented in EBS/91/89. However, trade and services data shown here differ from those presented in that document, as data have now been adjusted from a trade basis to a balance of payments basis, so as to be comparable with the actual data for the first half of 1991 and the current projections for 1991.

3/ Indicative only; data are on a trade basis and are not strictly consistent with the overall import figures shown.

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The low level of non-oil imports is obviously linked to the weakness of domestic demand, both for investment and consumption purposes. Imports may also have been dampened by a slow response of the import sector to bring onto the domestic market imported consumer goods that enjoy a competitive advantage over their local substitutes. An additional factor might have been the imposition of the temporary import surcharge on consumer goods. Although at its original level of 20 percent the surcharge might appear to be only a moderate influence, the fact that it was known to be temporary might have encouraged potential importers to postpone their purchase plans.

Tight financial policies and adequate interest rates--including a moderate premium over those prevailing in international capital markets--helped prevent major pressures on international reserves; the lack of large-scale speculative outflows was also reflected in the fact that the premium in parallel foreign exchange markets never reached significant levels after January 1.

V. Lessons Learned and the Task Ahead

The example of Czechoslovakia's early stabilization success has shown that a previously centrally planned economy with limited macroeconomic imbalances can weather the cumulated effects of a large-scale liberalization and a severe terms of trade shock without letting either inflation or the external imbalance get out of hand. In Czechoslovakia's case, the key to this success was a combination of restrictive fiscal, monetary, and incomes policies, as well as a realistic and stable exchange rate. Exchange rate policy had been the subject of particularly intense debate, but events seem to confirm that the exchange rate anchor provided a reference point around which newly freed prices arranged themselves quickly. Interestingly, and in contrast to some of its neighbors, Czechoslovakia allowed ex post real interest rates to be negative during the period of the price jump. This policy does not seem to have interfered with the stabilization effort at all, suggesting that, abstracting away from the initial price jump, inflationary expectations may have indeed been quite low.

At the same time, the decline in economic activity has been large. It is impossible to say quite how much of Czechoslovakia's productive structure has become uneconomic, following the dismantling of the special trade arrangements of the CMEA and the opening of the economy to the rest of the world. What is clear is that the new activities, which must eventually offset the termination of old ones, are emerging slowly. At the same time, however, it is possible that the decline in output has not been large enough. Many enterprises appear to be continuing to produce, for inventory or at a loss, while financing themselves by any means possible--notably by accumulating large debts to their suppliers. There are also other worrisome signs that enterprises may begin to clamor more loudly for the relief from Government--in the form of subsidies, guarantees, and subsidized credits--that has hitherto been denied them. The Government will need to stand firm in these areas and seek the rapid termination of loss-making production, to

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avoid crowding out new initiatives and to avert the danger of a financial gridlock in the enterprise sector.

In large part, these developments may be a characteristic of the "no-man's land" in which central planning has already been abandoned but a market system is still far from established. Ahead of both large-scale privatization and action to deal with enterprises' inherited debt burden, plans to invest or to change the structure of production await decisions of new owners, and banks cannot properly evaluate projects. Although no Central or Eastern European country can yet offer any lessons on methods of privatization, the Czechoslovak example does demonstrate the perils of remaining in such a no-man's land and the need for the greatest possible speed in structural reform.

The success of Czechoslovakia's initial stabilization effort thus marks only the first step in a long process of transformation. It is essential now that the hard-earned success of stabilization be safeguarded through the coming period, which will likely become even more difficult on the fiscal front. But internal and external balance are only a necessary, and by no means sufficient, condition for growth, and the uncharted path of creating a dynamic market economy out of the remnants of the old system still lies ahead. As was the case with its introduction, the dismantling of central planning is happening for the first time in history. The ultimate objective of the transformation is clear, and a great deal is known about the framework, institutions, and policies that shape market economies. There is, however, no blueprint for getting from here to there.

Some crucial steps have already been taken in the process of structural reform. On January 1, 1991, those elements of reform that could be instituted at the stroke of a pen--large-scale price and trade liberalization and devaluation--were implemented, putting in place the main signals necessary for the workings of a market system. There now remains, however, the much more complex work of ensuring the effective transmission of these signals through the economy, and ensuring that appropriate incentives are in place to make economic agents react in an efficient manner. Four tasks stand out in this regard.

First, the Government will have to provide the entire framework of a market economy. A large part of the necessary legal system has already been put in place. However, the building of institutions to administer this system (such as anti-trust and bank supervision offices) and to fulfill the other supportive functions of Government (such as labor exchanges or trade and investment promotion activities) will inevitably take time, as will the provision of modern basic infrastructure.

Secondly, government interference with market signals should be minimized, and the Government will need to refine the rather blunt instruments with which it has thus far conducted macroeconomic policy. To this end, a number of plans are underway, including: a major tax reform in 1993, which should "level the playing field" and permit a more even

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spreading of the tax burden through a widening of the tax base; a replacement of the clearly distortionary direct credit ceilings on banks with instruments of reserve money management; and a phasing out of the excess wage tax.

Thirdly, "noise" from the past should not be allowed to contaminate signals in the present. In this respect, it is particularly worrisome that the burden of bank debt inherited by enterprises from the old system obscures their current viability. Various solutions to this problem have been proposed, ranging from a complete write-off of debts as of some cut-off date to case-by-case debt workouts. A full solution is urgent; in October 1991, the Czechoslovak Government announced an important step in this direction in the form of a plan to write off a certain amount of enterprise debts ahead of privatization.

Finally, ensuring a "clean" transmission of signals through the system is not sufficient to ensure an efficient allocation of resources: economic agents need also to react to these signals in an efficient manner. Thus, more than all other structural measures, privatization is the key to the success of the reform effort. As outlined above, the absence of well-established markets implies that conventional methods would not achieve privatization on any major scale within the time frame desired. The Government's chosen strategy is an eclectic mix of methods, which seeks a balance between the sometimes conflicting objectives of speed, of attracting appropriate know-how and capital, of raising public resources, and of political expediency. It cannot be overemphasized that little improvement in economic performance can be expected ahead of privatization, and hence that all efforts should be made to accelerate the process.

The structural measures required to lay the basis for a thriving market economy will take time. Moreover, there will be lags between implementation of these measures, decisions by economic agents to react to them, implementation of these decisions, and, finally, results. The near-complete absence of an entrepreneurial tradition will lengthen this process significantly. It is impossible at this stage to predict just how long all these lags will delay an improvement in economic performance, particularly in the context of a highly uncertain, and perhaps worsening, regional economic climate. The challenge facing the Czechoslovak authorities now is to persevere with reform without losing the support of the public. This task will require political leadership capable of explaining the process and of containing the aspirations and impatience of the population; but the maintenance of a relatively firm political and social consensus on reform through the turbulent early phase of reform has raised the odds in favor of success.

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