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# The Transformation of the Czech Economy - Present and Future Developments

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**Abstract:** This paper presents the most important results of the report *Czech Republic in 2005: Economic Scenario* which was elaborated within the framework of the project „Central and Eastern Europe in 2005“ sponsored by the EC Commission (DG 12). An analysis of present macroeconomic and microeconomic conditions and the main problems experienced by the Czech economy during the initial phases of its transformation are presented and a tentative forecast of possible development until 2005 outlined. The main macroeconomic trends in GDP, employment and unemployment, inflation and external relations are described and the state of microeconomic restructuring (property rights change, financial and real) is evaluated. Microeconomic restructuring is considered to be unsatisfactory in some important areas, thus creating barriers for further sustainable development. The forecasts are based on overcoming these barriers and are connected with policy recommendations.

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## Introduction

In the report<sup>1</sup> summarised in this paper we have tried not to limit our focus to the analysis of the present day conditions, prerequisites and possible solutions of the short run transformational problems; instead we have attempted to present a realistic vision of the „desirable“ future development of the Czech national economy over the next ten years. Creating such a vision may not appear very sensible at first glance due to the number of uncertainties concerning the possible economic, political and social developments in the region. But the main reason for the elaboration of such a „normative“ vision is to stimulate more thorough and precise thoughts as to the necessary conditions to be met, barriers to be crossed and problems to be solved along the development path.

Our analysis and forecasts are based on the assumption that the main transformation processes from the Soviet-type economy to a market one may, in the case of the Czech economy, reach a relatively satisfactory level about 1995-7. By this time conditions for prevailing standard market behavioural patterns should have been established.

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<sup>1</sup> ) This paper aims at presenting the most interesting results of the report *Czech Republic in 2005: Economic Scenario* which was elaborated in the framework of the project „East Central Europe 2000“. The original Economic scenario was written by the present author, Karel Kouba, Vladimír Nachtigal and Jaroslav Hutař on the basis of background studies which covered the major issues and problems in the Czech economy from the transformation to 2005. The project was sponsored by the EC Commission (DG 12).

From 1997 the private sector should produce the decisive share of GDP, and the national economy should have a structure approaching that of the West European standard market economies. Certainly, some „Soviet-type behavioural patterns“ will only cease to exist due to the process of generational change, and may codetermine the development of the Czech economy for a long time to come, but the „new“ rational market behavioural patterns should prevail at the microeconomic level.

Forecasting under the conditions of contemporary Central and Eastern Europe is certainly a very difficult and somewhat questionable task given the great uncertainties concerning internal and external developments. Under these conditions a quantitative assessment of possible future developments in particular may be of a very tentative character. Econometric methods are not applicable due to the break-even nature of the transformational development and its highly unstable character. Even the task of securing reliable data on the present situation, especially at the microeconomic level, has proved almost impossible.

All over Central and Eastern Europe we may observe a highly uneven development, growing uncertainty, falling output and mounting unemployment and inflation, public budget and debt problems etc. Some positive developments have occurred in certain areas, but as yet we lack positive evidence that the transformation strategies employed might produce satisfactory and sustainable results. The current outcomes of the transitional process in Central and Eastern Europe should even make us think about the necessity of providing better theoretical foundations for the socio-economic reconstruction of this region, as has been proposed by the AGENDA-Group [cf. Kregel, Matzner, Grabher 1992].

Certainly, the transition has important spontaneous dimensions at the microeconomic level, but in order to avoid its becoming a drawn-out process of development requiring two or three generations, the government and parliamentary institutions should play a significant role, especially in restoring the legal order necessary for the normal evolution of markets as well as in the active creation of market institutions and regulatory bodies. The existence of markets and standard market behaviour is a necessary prerequisite for the efficient functioning of a market economy. The lack of effective market structures and of an adequate institutional framework creates the conditions of a relative systemic vacuum in post-Soviet-type economies, such that a relatively high degree of state involvement becomes a necessity if the transition is to be successful.

Considering the macroeconomic development in the region it is tempting to single out the Czech Republic as an example of highly promising development since in the Czech Republic certain macroeconomic data may be even compared to developed market economies. After experiencing some „inflationary bubbles“, following the price liberalisation in 1991 and the introduction of a new tax system based on VAT as of January 1, 1993, inflation was brought under control, and the rate of unemployment has been lower than in most countries. With regard to macroeconomic stabilisation policies it might indeed be called a relative success. On the other hand there was a huge decrease in GDP (especially in industrial production), a decrease in labour productivity, while the many unsolved problems still exist at the microeconomic level.

In the case of the Czech Republic one advantage over the other Central and Eastern European Countries should be emphasised. It has a relatively long history of capitalist

development and industrial traditions which has created the possibility of an easier and less costly transition than is the case with the other post-communist countries. On the other hand, the liquidation of the private sector was more complete than in Hungary or Poland; in this context the recreation of the private sector with the support of newly-born private firms and the privatisation of state property has become the transition's cornerstone.

### **The transformation strategy of the Czechoslovak Government and, later, of the Czech government**

The transitional strategy of the Czechoslovak (and the Czech) government was originally based on the liberal theoretical concept, but given the actual circumstances many practical solutions have been more pragmatic and have not simply respected the liberal theoretical background. The complex problems of restructuring the national economy and the limited degree of market development attained thus far have not permitted the „laissez-faire“ approach which has prevailed in the theoretical justifications of the economic policy in Czechoslovakia since 1991. Indeed a scarcely identifiable mix of state corporatism, social market economy and quasi reactive (ad hoc) policies (usually in the eleventh hour, that is, under extreme pressure) as a response to the social and political pressures has been the reality. There are, however, some signs of a more deliberate and active approach in export promotion (the creation of the Export Guarantee and Insurance Agency - EGAP) and the restructuring of the coal industry. Even some principles of the future agricultural policy have been laid down.

The Czechoslovak government decided to implement restrictive monetary and fiscal macroeconomic policies. Under the conditions of the supposedly low responsiveness of state-owned enterprises, whose reactions were scarcely predictable and lacking adequate institutional frameworks, the government pragmatically linked instruments of traditional macroeconomic stabilisation policy with instruments of incomes policy. An important role in the stabilisation policy was played by the rather „overshot“ devaluation of the Czechoslovak crown, where the nominal exchange rate played the role of „nominal anchor“. The devaluation of the Czechoslovak crown was a necessary prerequisite for the liberalisation of the current account, connected as it was with the so-called internal convertibility of the Czechoslovak crown.

Fiscal policy had a crucial role in the government's anti-inflationary policy restraining aggregate demand. All the government budgets were conceived as balanced, and the aim of reducing the role of government in the economy was observed in reducing the ratio of government budget to GDP.

In 1990 the CSFR government budget ended up with a minor surplus, in 1991, its deficit did not surpass 1.1% of GDP and in 1992, 0.8% (0.5% for the Czech Republic). Unlike in Poland and Hungary, the proceeds of privatisation have been kept mostly outside the government budget. During the period 1990-1992 the ratio of budget receipts to GDP decreased from 57-58% to about 53-54% (for the Czech Republic it should decrease in 1993 to 51%).

With the exception of foreign borrowing the government did not resort to any financing outside the banking sector. The Central Bank has been independent of any instructions given by the central government, and its primary objective was the stabilisation of domestic currency. The central bank was forbidden by law to cover budget deficits by direct credits to the government. Net credit to the government of

CSFR from the domestic banking sector increased from an almost negligible figure in 1990 to a level representing almost 7% of GDP in 1992. The gross debts (domestic and foreign) of the central government of the Czech Republic can be estimated at about 22% of GDP at the end of 1992 (a financial settlement between the Czech and the Slovak Republics has not yet been reached). The debt service of the Czech government is expected to be about 4% of budget receipts in 1993. [cf. Hájek, Klacek 1993].

In January 1993 a new tax system based on VAT and fully compatible with EC standards was introduced, aiming at broadening the tax base, removing distortions in the old system and making fiscal operation more efficient and transparent. A new social security system (with Health Care Fund, Social Security Fund and Employment Fund independent of the budget) and local budget reforms were introduced as well. Despite these enormous systemic changes in the tax system, the balanced budget for 1993 was achieved with even a small surplus.

The relative success which has been achieved thus far in the field of macroeconomic stabilisation is clearly visible. In spite of the immediate liberalisation of 95% of all prices and the subsidy cuts under conditions of an extremely monopolised post-socialist economy creating a one-off, bubble-like increase in price levels at the very beginning of 1991, the monthly consumer price increases from then until the end of 1992 did not surpass 2%. In 1992 the annual inflation rate reached 11.1% (measured by CPI), which is the lowest figure among all the post-communist countries. A slightly higher rate of inflation in 1993 - about 18.2 - reflects the price level increase due to the introduction of the new tax system based on VAT in January 1993, with a similar one-off, bubble-like increase in price levels at the beginning of the year, followed by moderate price increases up to the end of the year. Low inflationary expectations had favourable impacts on the economy's entrepreneurial climate as well as on rational consumer and saving-behavioural patterns in the household sector.

The external stabilisation of the economy has been reflected in the exchange rate of the Czechoslovak crown which, after the massive devaluation in the end of 1990 (by nearly 100%), remained stable until the beginning of 1993. This stability has been maintained in spite of the widening scope of internal convertibility, the balance of payments and the foreign exchange reserves fluctuations at the end of 1992, which were caused by the expected split of Czechoslovakia. In mid-1992 and prior to these fluctuations, the external reserves reached the highest level of the post-war period. After the split of Czechoslovakia in January 1993, foreign reserves declined amid devaluation speculations. But soon after the dissolution of the federal state and the common currency, the foreign reserves again reached the highest level since 1992. By the end of 1993 the foreign reserves of the Czech National Bank reached \$ 3.8 billion and foreign reserves of the entire Czech banking system reached \$ 6.2 billion.

Some progress - but far less impressive - was achieved within microeconomic restructuring. But due to the large share of state-owned enterprises in GDP formation, the mobility of production factors has thus far been limited. This may be quite clearly observed in the labour market, and is expressed by a very low unemployment rate. However, a satisfactory explanation of these phenomena may only be found at the microeconomic level.

In 1990, the central planning system of the administrative allocation of capital and labour was abolished, but efficient market allocative mechanisms have only emerged

slowly, and may not be sufficient in themselves to rectify the huge structural deformations created by the communist economic system in a comparatively short time span. To a certain extent the Czech economy inhabits a systemic vacuum which, in a reactive and unsystematic way, is filled by government intervention.

After 1989, the natural structure of „entitlements“ characteristic of the Soviet-type economy in Czechoslovakia was weakened and their regulatory ability comparatively diminished. However, the regulatory capacity of central planning was very limited and inefficient, even during the communist regime. Thus L. Mlčoch may be quite right when he states in his background study that the „abolition of the planning system has passed almost without notice“ [Mlčoch 1993: 4]. Nevertheless new legal structures of property rights are emerging hesitantly and are accompanied by many problems, and the regulatory and allocative capacities of market forces have thus far remained quite weak. The markets in the Czech Republic are heavily monopolised and inefficient.

The structural development and modernisation at the microlevel has lagged behind considerably (especially in manufacturing). The industrial structure is changing very slowly while, in fact, the position of primary and low value-added industries has been strengthened. More than 30% of industrial output is still produced in enterprises with over 5 000 employees, reflecting a bias towards large-size companies as a legacy of the Soviet-type economy. Due to a relatively low competition for output in the markets of developed economies, the share of high value-added products in Czech exports decreased during the necessary shift from the CMEA market to Western markets. Nevertheless the reorientation of exports should be considered quite successful.

Changes at the microeconomic level have, until now, not been significant enough to serve as a firm basis for sustainable macroeconomic stability. The creation of strong microeconomic roots for medium-term macroeconomic stabilisation requires at least 3-4 more years. For this reason, even the positive results of the macroeconomic stabilisation policy may not be tenable in the medium run without successful restructuring at the microlevel and responding changes in market agents' behaviour.

### Transformational recession<sup>2</sup> in the Czech Republic

The implementation of a radical economic program aiming at a transition from the Soviet-type economy to a market one, the stabilisation of macroeconomic policies and the collapse of intra-CMEA trade were followed by a steep decline in economic activity from 1990 to 1992 (measured by real GDP and industrial production). However, this development was preceded by a decade of economic stagnation [Klacek, Hájek 1989].

This economic decline or „transformational recession“ is a unique and, to a considerable extent, an unavoidable phenomenon - „an atypical one-off downward adjustment of output on the way from a singularly wasteful, closed economy to a more efficient, open one“ [Winiecki 1993: 7]. It is a multi-causal phenomenon created by a vast number of interrelated factors and external shocks. The depth of the transformational recession also depends, however, on the overall transformation strategy and the nature of economic policy.

<sup>2</sup>) A formulation employed by J. Kornai to describe the principal difference between the classical cyclical recession in a standard market economy and the one-off recession created by transitional process from the Soviet-type economy to a market one [Kornai 1993: 3].

In 1990, the real GDP of the Czech Republic decreased by 1.2% over the previous year, by 14.2% in 1991 and by a further 7.1% in 1992. This economic decline continued through the first half of 1993, while in the third quarter some faint signals of recovery appeared. This economic decline has been far greater in industrial production, where during the period 1989-1992 the output decreased by 32% [Novotný 1993]. However, the decrease in industrial output is not so large if measured in value-added terms [cf. Nachtigal 1993].

A detailed analysis reveals that during the 1991-1992 period, all elements of aggregate demand declined. The fall in domestic aggregate demand (the sharpest reduction in investments into fixed assets being followed by a reduction in private consumption) was accompanied by the dramatic collapse of the CMEA market (compensated partly by increasing exports to the West European markets, especially to the EC). The sharp transformational recession in the 1990-1992 period, representing on a compound basis more than 22% of GDP, was not, however, accompanied by a corresponding decline in employment. A very low rate of unemployment has been a specific feature of the Czech economy as compared to other economies in transition as well as to developed market economies. This striking difference between the tendencies in the development of output and unemployment cannot, however, last for long and may be explained mainly by the slow restructuring at the microlevel.

The main reasons for the depressed aggregate demand and supply in 1991 were a price jump following price liberalisation in January 1, 1991, the massive devaluation of Czechoslovak crown, and the collapse of the CMEA trade system. These shocks took place within the framework of a tight fiscal and monetary policy aiming at curbing inflationary pressures. Fiscal and monetary restrictions were somewhat heavy-handed given the conditions of high price increases, creating in this way an additional recessionary pressure.

The aggregate demand declined by 22.3% in 1991, private consumption fell by approximately the same amount, and gross fixed capital formation was reduced by almost one third. Aggregate exports fell by 8.2%, but there was a rapid increase in the export of services. Due to the devaluation of the Czechoslovak crown, and an overall decline in economic activity, demand for imports decreased, resulting in a surplus in the current account of the balance of payments.

In the second half of 1992 and in 1993 the co-existence of both the symptoms of recession and some signs of economic recovery become visible. Industrial output fell by 10.6%, (large state-owned enterprises experienced a further decrease in output, while in smaller ones and in the private sector the output rose). In 1992, output in construction increased by 22.0% (this being due mostly to contracts abroad). The upturn in economic activity was located in the private sector, but because of its low share in GDP formation thus far its dynamics were overbalanced by declining trends in the state sector. In 1993, the GDP stagnated, while industrial production decreased further (preliminary data shows a decrease of about 5% with some decrease in construction as well).

The transformational recession is a complex phenomenon in which aggregate demand and supply factors are intertwined. There is no simple aggregate demand stimulation solution because of the very rigid and highly monopolised economic structures in a majority of the state-owned enterprises, which do not respond in a standard manner to increasing aggregate demand. Under these conditions, demand

management of the traditional neokynesian kind would have inflationary effects and very limited positive effect on aggregate supply.

### **Inflation**

The low inflation rate which is now more or less under control is, apart from the stable exchange rate, the most outstanding feature of the Czech economy when seen in comparison to other Central and East European post-communist economies.

These results were achieved mainly through a restrictive fiscal policy and through an income policy based on tripartite bargaining between government, employers and trade unions. In 1991 the stabilisation of macroeconomic policies succeeded in preventing the one-off price level jump which followed the liberalisation of almost all prices from triggering off an inflationary process. As markets and especially the labour market can hardly be considered to function efficiently during the transitional period, an income policy was temporarily employed to provide a stabilising anchor above and beyond the exchange rate, but its effects and even the necessity of its implementation have sometimes been questioned.

The overall indexation of wages based on tripartite agreement resulted in a 16.4% rise in money wage, but a 24% decrease in the real wage rate, this being due to a high initial price level increase in 1991 (see table 1). In 1992 the wage regulation was partly relaxed and in 1993 it was removed (but from May 1993 the government sought to reintroduce it in response to a large increase in money wages, especially in state-owned enterprises; finally it was reintroduced in July 1993). In 1993 wage regulation became the subject of fierce debates inside the tripartite, with trade unions, employer's associations and commercial banks expressing their disapproval of it.

The pressure exerted on prices by the money wage increase was already present in 1992, when the unit labour costs increased 2.5 times faster than consumer prices (see table 2). These pressures have continued in 1993, and could probably weaken the competitiveness of Czech exports and even domestically consumed goods in relation to imports because of their impacts on costs and the real appreciation of the Czech crown.

Table 1. GDP, Productivity and Wages in the Czech Republic  
(Annual per cent change)

	1990	1991	1992
Real GDP	-1.2	-14.2	-7.1
Employment	-0.2	-7.0	-3.0
Productivity of Labour	-1.0	-7.7	-4.2
Money Wage Rate	3.5	16.4	22.2
Real Wage Rate	-5.8	-23.9	9.7

Source: Statistical Yearbook of CSFR 1992 and Reports of the Czech Statistical Office.

### **The results of privatisation efforts**

At the end of 1991 the share of the private sector was about 8.4% of GDP and 10% of employment. But the situation changed dramatically during 1992 and the first half of 1993. According to Czech National Bank estimates, 32% of GDP was produced in the private sector in the first quarter and 44% in the third quarter of 1993 (including

enterprises privatised through the voucher privatisation in the first wave of large-scale privatisation) [see CNB Report 1993: 12].

Taking this into account, we can view the privatisation process in the Czech Republic as having been quite successful; however, some problems connected with the large-scale privatisation remain. The result of the first wave of large-scale privatisation has been more or less formal privatisation (or commercialisation). Efficient property rights structures (especially on the basis of the voucher scheme) may only evolve gradually, and even this evolution may present some dangers (even the possibility of a breakdown in the newly-born capital markets and the denationalisation of some enterprises privatised using the voucher method have been stressed by some authors) [see Mlčoch 1993; Sojka 1992].

„In relation to the privatisation process, there is frequently a „privatisation paralysis“, wherein expectations, and often time and energy-consuming negotiations related to the change in property rights, cause postponement of decision-making in employment, capacity utilisation and investment, or other questions about company restructuring“ [Charap, Zemplinerová 1993: 20].

In Czechoslovakia, about 437 privatisation investment funds (PIF), which invested investment points on behalf of individual citizens, have been established in the voucher privatisation process, and 72 per cent of investment points were invested by the PIFs, with important and sometimes still uncertain consequences for property rights structures [see J. Havel 1993, and Sojka 1992].

If we wish to assess the outcomes of privatisation efforts in the Czech Republic, some of the significant, as yet unresolved problems and risks should once again be stressed:

- in its initial stages, voucher privatisation has had the character of a relatively formal privatisation (or commercialisation). As we have just mentioned, an efficient property rights structure may only develop gradually on this basis; in this way voucher privatisation could lead to a significant postponement of restructuring enterprises, thus protracting the inefficient use of „frozen“ resources;
- the restructuring of state-owned enterprises was deliberately left to future private owners (which, in some cases, may lead to the necessity of government support in restructuring them after privatisation and even to the danger of denationalisation). The relaxation of government governance created a situation in which state-owned enterprises have operated in a special environment characterised as a „no-man’s land“, an environment between state and private control, which has adverse effects on investment and restructuring processes and causes uncertainty with respect to privatisation. This situation creates favourable conditions for wild privatisation and thus leads to a loss of assets;
- there is considerable uncertainty as to the behaviour of the largest PIFs, with the possible risks of a capital drain of the newly privatised enterprises, the petrification of monopolistic structures and significant difficulties for the capital market which may arise from the necessity of adjusting PIFs’ asset holdings and management to the new legal requirements. The largest PIFs experience serious difficulties in executing their property rights over the management and financial restructuring of enterprises in their portfolios.

Due to the shape of the privatisation strategy, in which an important role is played by the non-standard voucher method, the transition from formal private ownership to real governance of firms remains a significant problem, and one which is linked to some significant risks (in the short and medium run, there is the problem of the fragmentation of shareholdings as well as uncertainty as to the behaviour of the 16 decisive PIFs and developments in newly-created capital markets).

### Unemployment

The present tendencies encountered in unemployment data (a relatively modest increase in 1991, a decrease in 1992 and a moderate increase in 1993) are the result of the very specific conditions existing in the present stage of the transition process in the Czech national economy. The situation in the labour market and the rate of unemployment are the outcome of a number of mutually intertwined factors. The most important of these being:

- 1) The „pre-privatisation syndrome“ - a behavioural pattern encountered frequently in state-owned enterprises. In this sector, even under changing conditions, we can observe a tendency towards an increase in social over-employment in 1991-1992. Large enterprises with more than 1000 employees have, until now, had the decisive share in output - over 70% in 1992 [Hájek 1992].
- 2) The absent disciplining of enterprises through bankruptcies until April 1993.
- 3) The changes in institutional conditions for granting unemployment benefits.
- 4) The high devaluation of the Czechoslovak crown at the end of 1990 creating suitable conditions for competitiveness, mostly in traditional industries, and helping reorientate Czechoslovak foreign trade to Western markets.
- 5) The increasing economic activity in the private sector, especially in services, construction and transport.
- 6) The growing efficiency of labour offices and active employment policies alleviating the situation, especially for young people.
- 7) The migration for jobs abroad (especially in Western Bohemia).

Due to all the above mentioned factors, unemployment has, until now, been quite low in the Czech Republic; however, some important regional differences exist. As empirical data show, unemployment tends to increase from the western regions to the eastern regions of the Czech Republic. The parts hit hardest by unemployment are Northern and Southern Moravia, with respective unemployment rates of 4.57% and 2.93%, as well as Northern Bohemia with 3.11%. In Prague, the rate of unemployment is about 0.24% while in all other Bohemian regions it moves between 1.89 and 2.76%. These unemployment data are from June 30, 1993, when the unemployment rate in the Czech Republic reached 2.63%. At the end of 1993 the unemployment rate reached 3.2%.

As usual, districts with markedly one-sided production structures are hit hardest, especially the „one-factory regions“ in Northern Moravia, where a rapid increase in unemployment can be expected in the near future (Vsetín and Šumperk districts with an expected unemployment rate of over 15%). In parts of Northern Bohemia and Northern Moravia Gypsy unemployment may become a particularly difficult problem to solve due to their low skills (the Gypsy share in unemployment was 5.6% in 1992).

## Foreign trade reorientation

During the first phase of the transformation processes a radical adjustment of trade, services and capital flows began to materialise. This process should implement the shift from the distorted structures, which arose under the Soviet-type economy framework, to standard market-determined patterns of trade and capital flows, reflecting underlying comparative advantages.

As expected, the low competitiveness of higher value-added Czechoslovak goods saw the share of relatively higher value-added products in total Czech exports continue to diminish over the period 1989-1992. The share of finished products fell to about 1/3 and a dramatic decrease occurred in the share of machinery and transport equipment, from 47% in 1989 to 25% in 1992 [see Hrnčíř 1993]. At the same time, however, an encouraging trend in exports to the developed market economies began to evolve as a result of the steady increase in finished products since 1990.

## Possible future developments

The macroeconomic performance of the Czech economy will depend heavily on the results of microeconomic transition. We expect that the major unresolved problems connected with restructuring and adjustment at the microlevel will be met with adequate solutions, and that around 1995-1997 rational market behaviour of firms and households will prevail. The timing of the „break-even point“, the point at which the private sector, based on newly-born private firms and real privatisation connected with standard rational market behaviour, will prevail, is an important dimension co-determined by the nature of government economic policy and its priorities.

No simple „laissez-faire“ versus interventionist (or liberal versus keynesian) options exist in the transitional economy. The development path, with its potential and required solutions, is very narrow, allowing the government two realistic options: to continue the macroeconomic stabilisation policy at the macrolevel, combined with „reactive“ supply-side microeconomic measures of a somewhat ad hoc character, or to integrate the macroeconomic stabilisation policy with „active“ supply-side microeconomic policies (industrial and regional), aiming at deliberate restructuring and modernisation at the enterprise and regional levels.

The results of these two approaches may differ only in the medium and longer run (the elaboration of comprehensive industrial and regional policies and programmes is time-consuming). We suppose that the active pro-market approach could shorten the transitional process and minimise the inevitable social costs (unemployment, loss of resources, poverty) and risks, thus creating space for greater political and social stability.

In the case of the „reactive“ approach, the break-even point may be delayed until 1997-1998, so that growth rates up to the year 2000 will be lower and regional disequilibrium higher, as will the unemployment rate. In the short and medium term, on the other hand, there may be smaller government budget deficits and a slightly lower rate of inflation.

The „active“ approach may be connected with a more rapid but more even economic development, a lower rate of unemployment, a slightly higher rate of inflation not exceeding 10%, and lower regional differences. On the other hand, government budget deficits may rise to 4-5% of GDP, net exports of goods may be more negative and

foreign borrowing may be used to finance some infrastructural projects (telecommunications, transport networks etc.).

Successful development is greatly determined by adjustment processes at the microeconomic level which should be, in the systemic vacuum existing in the initial phases of transition, linked to a number of supply-side microeconomic policies. These policies should aim for structural adjustment at enterprise, industry and regional levels, and should solve the problems of enterprise restructuring in their financial, organisational and real dimensions.

The restructuring, modernisation and demonopolisation of the Czech economy is critically dependent upon overcoming the entrance barriers to new firms and the exit barriers of firms which exist in our industrial structures.

On the one hand, the microeconomic supply-side policies envisaged may have the character of „picking up the winners“, and, as such, should be connected with a comprehensive system of policies supporting small and medium firms, the elaboration of technological policy and the creation of economic tools to help them materialise. On the other, they should embrace „selecting the losers“ policies aiming at restructuring or weeding out inefficient state-owned enterprises (especially in the initial phase of transition) or helping to restructure large privatised enterprises and industries in crisis. The „selecting of losers“ policy should involve a clear demarcation of border-lines between the private and public sectors, as well as the execution of property rights in the public sector by the respective government agencies. The creation of a comprehensive pro-export and agricultural policy, the foundations of which are being laid at present, is recommended.

#### *The GDP and aggregate demand components*

In the short and medium run real GDP is forecast to grow rather slowly as the effects of privatisation on restructuring require time to identify, and the majority of privatised enterprises will only gradually improve their performance. The dynamics of the small and medium private firms are high, but their share is not large enough to have a decisive impact on the dynamics of industrial output. Even in developed market economies growth rate expectations are not very optimistic for the next two years. According to the analysis presented above we expect growth rates of 1.41% in 1994 and 2.62% in 1995. In the longer run - in the period 1996-2000, 2.9-3% and in the period 2001-2005, growth rates of about 2.8% are forecast. Higher growth rates are estimated on the assumption of the prevailing efficient behaviour of firms at the microlevel, increasing efficiency of economic resources on the basis of restructuring, sufficient foreign capital inflow and an absence of internal or external shocks. The growth rates of GDP were estimated with the help of macroeconomic calculations, based on the social accounting matrix determined by a simple computable general equilibrium model [see the Annex of the report „The Czech Republic in 2005: Economic Scenario“, prepared by J. Hutař].

In the gross value added by sectors, a certain decrease in the shares of manufacturing and agriculture, and an increase in the share of construction and services are forecast, as table 2 shows.

Table 2. Gross Value Added by Sectors

	1992	2000	2005
Mining and quarrying	2.8	1.3	1.1
Manufacturing	50.4	45.4	43.2
Construction	8.4	15.0	19.1
Agriculture and forestry	5.1	2.7	2.3
Services	33.3	35.6	34.3
Total	100.0	100.0	100.0

Source: Czech Statistical Office and own calculations based on BS written by Nachtigal, Klacek and Hájek, and on the Computable General equilibrium model application by J. Hutař in the Annex.

### *Inflation*

Single digit inflation will remain one of the most important macroeconomic goals. After 1993, inflation is forecast to be single digit, in spite of some relaxation in monetary and fiscal policies. For 1994 an inflation rate of about 9% is expected.

The average yearly rates of inflation for the period 1992-2000 are forecast to hit around 7.6% (measured by CPI) or 6.1% (measured by PPI) and, for the period 2001-2005, about 6% (CPI) or 5.5% (PPI), as shown in table 20.

### *The Labour Market*

The present tendencies encountered in the labour market in the Czech Republic, with its comparatively low unemployment rate, are a result of the specific conditions of the current phase of the transitional process. The privatisation process should bring about the first wave of enterprise restructuring in the second half of 1993 or, more probably, in 1994. Some effects of the law on bankruptcies can be expected in 1994.

In the medium run, liquidations and restructuring connected with limiting social overemployment will increase the labour supply and create regional problems. These developments will bring about some positive effects on the labour force's mobility. The first effects are to be expected in light industry in North-eastern Bohemia and some parts of Northern Moravia as well as in agricultural regions. In the second half of the 90s, branches of heavy industry may be hit, with adverse effects concentrated in Northern Moravia (in coal mining, iron and steel production).

The tendencies in the development of the labour market will depend on the inflow of foreign capital (mainly from Germany and the other EC countries) and on the continuing development of the small and medium-scale private sector. An active employment policy will become a very important factor in curbing unemployment, especially at the regional level.

Reconsidering all the major factors determining the developments in the labour market a most probable scenario presupposes an increase in unemployment from 1994, and a continuing increase in the unemployment rate over the next 2-3 years. A fall in GDP should be matched with a possibly delayed fall in employment in the economy as a whole. In the second half of 90s employment, unemployment and GDP should behave in a „standard way“, that is, similar to developed market economies.

In 1994, an unemployment rate of around 6-8% may be expected, with some pockets of unemployment with rates of around 15%. In the medium and long run we can reasonably expect some stabilisation of the unemployment rate, which could be maintained at the level of 5-6%. In case of an „active“ pro-market strategy an unemployment rate of around 4% could be deliberately maintained from 1996.

The employment structure will gradually approach the employment structures encountered in developed market economies. The share of private sector will outweigh the public sector from the mid 1990s, and around the year 2000 we can expect its share to constitute about 70% of the labour force. Employment in agriculture will decrease very rapidly and from the mid 1990s it may be halved. Employment in industry will also decrease, while at the same time employment in the service sector will increase significantly.

#### *Foreign trade*

A substantial percentage of Czech exports are resource-based, low value-added products and standard labour intensive and relatively low-skill manufactures. After the heavy devaluations of the Czechoslovak crown in 1990, iron-metallurgy, basic chemicals and similar intermediate products were able to find new export markets relatively quickly, as their competitiveness increased [see Hrnčíř 1993: 19, table 14]. The prospect of further increases in the export of these products are only modest, as in these branches international demand is weaker, the competition between developing countries particularly strong and all accompanied by strong pressures in favour of protectionism in response to overproduction and/or unemployment.

The existing patterns of the Czech exports can only change in the medium and long-run in connection with the restructuring of the Czech economy, which will bring about an upgrading of production and export structures. This process could create conditions for a recovery of the Czech Republic's share in world markets.

In the short-term the country will have to rely mostly on existing export patterns, with a bias for cheap labour and labour intensive, relatively standardised products. The advantages of low wages and cheap labour as the basis of the country's specialisation and competitiveness must, however be, qualified. The cost and price dimensions of competition are dominant for standardised products. For non-homogeneous, more sophisticated and higher, value-added products, factors such as goodwill, reliability and quality standards, advertising, after-sale service and the capacity to meet special consumer requirements are crucial. The incentives implied in „cheap labour“ are likely to promote a further shift towards lower value-added branches. Such a „regressive specialisation“ can have negative implications, including the risk of a brain drain and an increasing technological gap in relation to the standards of developed countries.

The actual short-term trade patterns differ considerably from the underlying comparative advantages of the country. The Czech Republic has a comparatively high level of human capital. Standards of education, skills and craftsmanship remain comparatively high and, associated with an industrial tradition and a continuing technical know-how, should form the basis for a comparative advantage in skill-intensive and advanced manufactures and services.

In order to exploit this comparative advantage a number of existing barriers must be overcome. Physical capital is obsolete, many firms are undercapitalised, marketing and management capabilities are underdeveloped, many trade and banking services are

either lacking or inefficient. The ability to validate the existing human capital and skills is dependent on the inflow of foreign physical capital and the transfer of Western technology and know-how.

#### *Foreign investments and foreign debt*

The increased inflow of foreign capital (implying the inflow of foreign technologies and know-how) is considered desirable and even necessary both to cope with the undercapitalization of domestic firms and to support both the balance of payments and the introduced internal currency convertibility.

During 1990-1992, Czechoslovakia succeeded in attracting the second largest volume of foreign direct investment (FDI) among the ex-CMEA countries after Hungary (\$ 2,122 million). A substantial part of these funds was used just to acquire existing property. (A more detailed analysis of FDI in CSFR is contained in [Hrnčíř 1993].) Investments in physical capital and technologies are only expected to gain momentum after 1993.

In the coming period an increasing inflow of FDI in the Czech economy can be forecasted. This inflow will generate increasing imports of equipment and technologies, and, at the same time, should enable the balance of payments to be maintained in equilibrium, thus correcting the likely deficits on the current account.

The gross foreign debt of the CSFR amounted to \$9.5 billion at the end of 1992. The gross foreign debt of the Czech Republic after the split of the federation (at the end of January 1993) amounted to \$8.5 billion. The share of short term debt increased from 57% to 61%, resulting in an increased liquidity of the country. It is forecast that gross foreign debt will fluctuate between \$7-8 billion over the forecasted period.

#### *Microeconomic restructuring and modernisation*

The restructuring activities of governmental economic policy should focus on creating suitable conditions for the exit of unviable enterprises (in the public sector via executing property rights, and in the private sector on the basis of the bankruptcy law and its execution. A more flexible court system is necessary).

An ever-growing part of investment, linked with restructuring and adjustment, will be carried out by private firms, including joint-venture companies. It would be unwise for the government to abandon investment decisions in specific areas and withdraw its active influence. Private investment should be promoted in all cases where technological, structural, regional and ecological aspects are involved.

After the first three years of transformation, it has become obvious that the adjustment problems are of such magnitude that it would be an illusion to believe that their solution can be left solely to market forces. The market is still only emerging and segments essential to implement structural changes (capital market, housing and labour markets) are only now beginning to develop. This certainly should not be interpreted as an appeal to return to the discredited forms of structural policy of the past (based on central planning). Rather it is an appeal not to neglect the experiences of other transforming economies [Slay 1993, Landesmann 1993].

A certain balancing between the idea that emerging markets themselves could and would solve major structural obstacles and the practical necessity of solving socially urgent problems linked with restructuring has led to a situation in which certain areas of

structural policy are „underdeveloped“ in comparison to others. As mentioned above, technological policies, export promotion, a clear vision of the position of various sectors, industries and large enterprises should be included under this heading.

Depending on the development of external factors (the prospect of an economic upturn in the world economy in general and in Western Europe in particular, linked with a broader opening of the West European markets to Czech exports) and on the trends in the internal conditions (progress in large-scale privatisation, restoration of economic and investment activities, success in the implementation of a clearly defined structural policy) one could examine the perspectives of structural changes in the Czech industry.

Significant structural shifts at the macroeconomic level can be predicted relatively easily. Some of them started as early as 1989. It is reasonable to assume that agriculture's contribution to GDP will diminish, as this sector continues to employ more manpower than is the case in the developed West European countries (8.3% in 1992). The share of industry in GDP will no doubt also diminish. In 1990 it amounted to 63,0% and, alongside construction, contributed 74,3% in national income formation. At the same time, one can certainly expect a further increase in the share of the service sector in GDP.

A much more complex problem concerns the nature of the structural changes in industry in the period mentioned.

Existing predictions of structural changes in industry cover the period until 1995 and are based on a set of limiting qualifications. One of these forecasts prepared in 1991 is based on two assumptions : 1. radical economic reform will continue and 2. exports to Eastern Europe will be restored [Zeman 1992]. Four scenarios of feasible development were elaborated covering the period to the middle of the 90s. Concerning the feasible structural changes in industry the study comes to an interesting conclusion, suggesting that „it would not be possible to maintain the present over-employment in industry“. It can be expected, the study continues, that the emergence of rational economic behaviour on the side of enterprises during the transformation period will produce significant changes in the structure of industrial production and employment. The most dramatic change would affect the share of non-electrical machinery and mining in the total volume of industrial production, mainly to the advantage of some light industries. In spite of the general increase in labour productivity in all industries during the period analysed, it cannot be expected that labour productivity in Czech industry would approach the level of the developed market economies before 2005 [Zeman 1992].

Any prediction as to what changes the industrial structure of the Czech Republic might see in the period following 1995, could only be very general and highly speculative. As mentioned earlier, some conclusions could be drawn by comparing the domestic industrial structure with the structure arrived at by comparable West European countries towards the end of the 80s. Countries like Austria, Belgium, Denmark, Finland or Sweden could be selected as countries meeting this requirement.

There is no doubt that a large reduction in capacities and employment, not only in steel and engineering, but also in textiles and other light industries will have to be carried out. On the contrary, expansion of capacities and employment in industries like foodstuffs, furniture, printing and professional goods can be predicted with a high degree of certainty.

We are fully aware that the industrial structure predicted is very sketchy. Similarly, the answer as to what the specific structure of manufacturing would most probably be by the end of this century can only be very general.

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