# The Czech and Slovak Republics: The Process of Divergence

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The first two years of the Czecho-Slovak economic reform, begun in 1990, led to a sharp decrease in industrial production and rising unemployment. Expansion of foreign trade thanks to massive devaluations could not overcome the decline in other components of demand. At the outset, the reform was implemented federally, with no major difference between the economic policies of the two republics. Although most aspects of economic decline were quite similar, economic contraction seems to have been more severe in the Slovak Republic, whereas the Czech government has been applauding signs of economic recovery since 1992.

From the first quarter of 1992 the gap in economic performance has been widening, and one can identify changes both in economic policies and performance. The relatively prudent policies of the Czech government have been accompanied by positive macroeconomic responses. On the other hand, despite mild stimulative attempts, demand in the Slovak Republic is still falling. Another problem, not discussed in this article, is differences in the emerging institutional frameworks. In particular, the faltering process of privatisation in the Slovak Republic may lead to economic rigidities preventing a fundamental transformation of the economy.

While 'Czechoslovakia provides a unique example of a country that became underdeveloped as a result of an externally imposed system' (Dyba & Svejnar, 1991), recent Czech and Slovak economic development is strongly influenced by diverging expectations. In this article we provide an evaluation of the process of economic divergence based on macroeconomic data. We discuss particular issues in the following order: aggregate demand and supply, monetary policy, fiscal policy and prices.

## Aggregate Demand

Aggregate demand has been showing distinct signs of recovery in the Czech Republic, while the Slovak picture seems less clear. We focus on the retail market and household sectors first, and then on the productive sphere.

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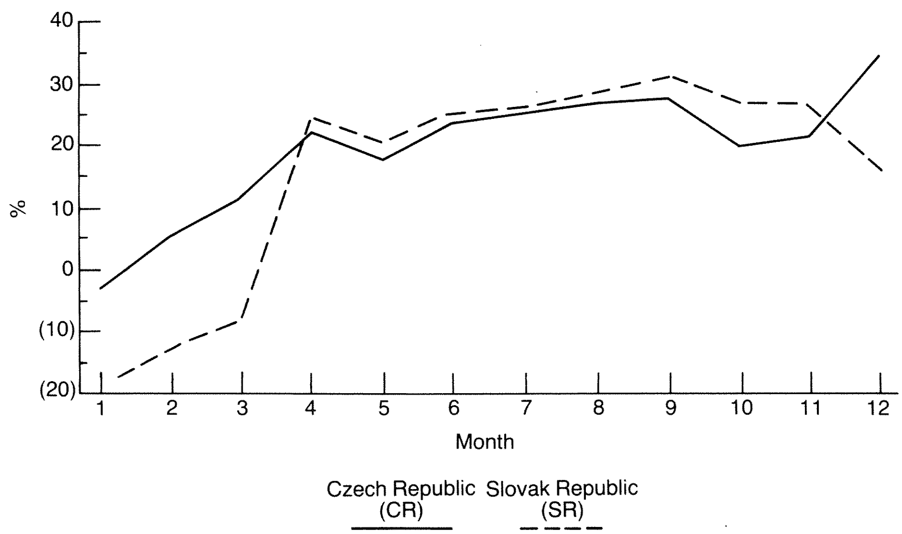


**Figure 1.** Real retail sales, 1992. Change compared with the same month of the preceding year.

*Retail Market and Consumer Demand*

In the Slovak Republic, consumers have been relatively pessimistic, with minimal expectations of an increase in living standards in the near future. Several opinion polls showed widespread pessimism about economic prospects under both the Čarnogurský and Mečiar governments. Initially, expectations in the Czech Republic were not particularly optimistic.

Real retail sales in both republics in 1992 are shown in Figure 1. While Czech households became more willing to spend after January and have been spending since then, Slovak consumer demand remained falling, with no sign of recovery till April. From May, the recovery of Slovak retail sales was similar to Czech sales. Slovak retail sales started to grow, however, from a lower base in 1991. Comparing 1991 and 1992, Czech real retail sales rose by 20% and Slovak sales by 15%. In the Czech Republic, increasing consumer demand has been accompanied by an increasing rate of saving, whereas Slovak household bank deposits were decreasing.[1] From January to November, the rate of saving in the Czech Republic averaged 5.3% but was only 1% in the Slovak Republic.

From Figure 2 one can observe that the growth of nominal income and nominal expenditure was higher in the Czech Republic in the first 11 months of 1992. The rise in Czech nominal income totalled 20.4%, and in expenditure 19.6%. Slovak income and expenditure increased 13.5% and 14.6% respectively. Both republics show expenditure closely linked to nominal income, which might be explained by the fact that about half the population did not save out of current income during 1992. It may also reflect the low level of inflationary expectations.

An interesting issue is the structure of nominal income in the Czech and the Slovak Republics. While nominal wages grew from January to September 1992 by 22.9% and 19.8% respectively, compared with the same period of 1991, other incomes grew by 60.4% and 39% respectively. In absolute terms the latter was 124.3 billion Crowns and 24 billion Crowns in the two republics.[2] Some 55.1% (68.5

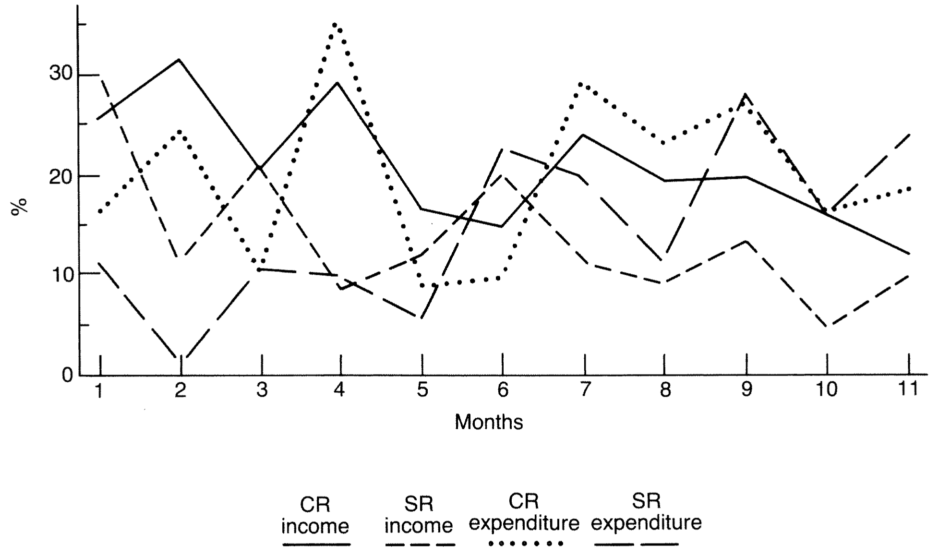


**Figure 2.** Nominal income and expenditure, 1992 (% change on previous month).

billion Crowns) of 'other income' in the Czech Republic should be attributed to various sorts of business income. The corresponding figure for the Slovak Republic is clearly much smaller, which implies a lower level of undisclosed activity in Slovakia.

### *Foreign Trade*

Devaluations in 1990 helped boost exports and curb imports. Table 1 shows that in the first 10 months of 1991 the Czech Republic ran a balance of trade surplus and the Slovak Republic ran a deficit of similar size as a fraction of GDP (the ratio of which is roughly 2:1).

In 1992 the situation was reversed. Czech imports exceeded exports, while Slovak foreign trade was approximately balanced each month. The monthly balance of trade is shown in Figure 3, where the Czech Republic is seen to be in deficit from April.[3] A possible explanation for the Czech deficit is economic recovery: rising Czech income boosting imports. On the other hand, a small surplus in the Slovak balance of trade in January–August 1992 was due to a fall in imports, which were at 86.5% of the level in January–August 1991. Preliminary data show that the Czech balance of trade for 1992 had a deficit of 23 billion Crowns, whereas the Slovak balance of trade had a deficit of 2 billion Crowns.

**Table 1.** Balance of Trade, (billion Kcs, fco)

| | 1991 (1–10) | 1992 (1–10) |
|---|---|---|
| CR | 23.13 | – 3.24 |
| SR | – 9.61 | – 0.81 |

*Source*: Federal Statistical Office

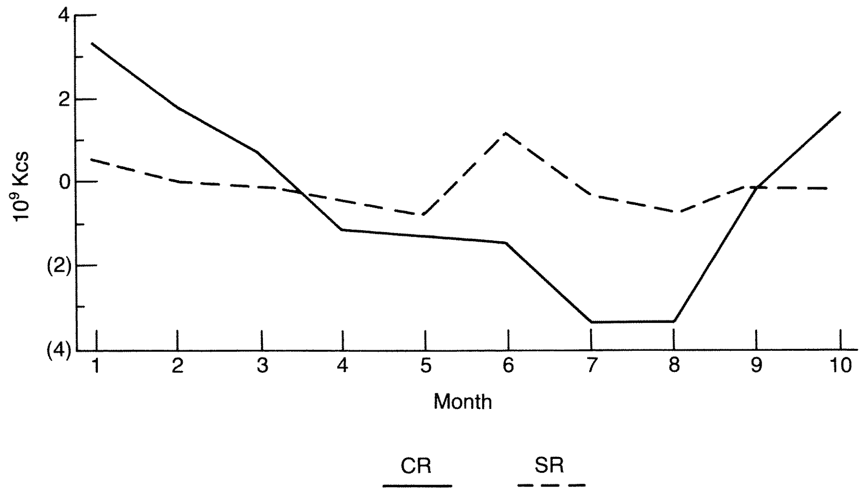


**Figure 3.** Balance of trade, 1992 (billion Kcs, fco).

In 1992 Czech exports to Slovakia were approximately 25% of total Czech exports, and declined by 17%. Slovak exports to the Czech Republic were about 40% of Slovak exports, and decreased by 20%. Combined bilateral trade was roughly 25% of Federal GDP, and Slovakia had a deficit of at least 10 billion Kčs in trade with the Czech Republic, representing over 3% of Slovak GDP.[4] It is estimated that after the split the bilateral trade might decline by 10–30%.

### *Producers' Demand and Production Expectations*

Measuring producers' demand in a post-communist economy is problematical; traditional measures of demand are either unreliable under current conditions (profit, inventories) or difficult to obtain on an aggregated basis (utilisation of production capacities, retained earnings). For example, firms which are still state-owned and await privatisation usually do not attempt to generate taxable profit.[5] Instead, management tries to increase its perks and use earnings for consumption such as business trips abroad, upgrading company cars, or excessive computerisation. Until state-owned firms and state-owned joint stock companies find real owners, this type of behaviour is likely to continue.

Data on expected production provide insight into business confidence, and regular sample reviews (*Konjunkturální průzkum* . . ., 1992) suggest that in the fourth quarter of 1992 and the first months of 1993 tendencies[6] towards rising demand in both republics should continue. Approximately 71% of construction firms and more than 75% of industrial firms believed the economic situation had stabilised. Almost one-fifth of respondents expected an improvement in their position on the market during the last quarter of 1992 (see Figure 4). Note that the figures show changes compared with the preceding quarter. Separate figures by republic (Table 2) are also informative. While Czech industrial firms are more pessimistic about the decline in external demand (by 1%), they are more optimistic about both total demand and external demand in that more answer 'better' than 'stable' (by 19.5% and 9.5% respectively).

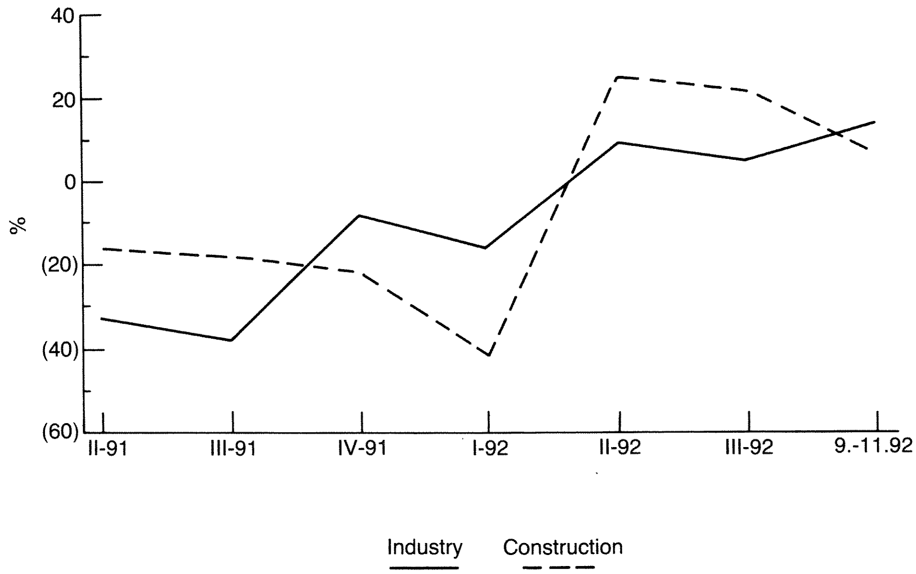


**Figure 4.** Production expectations, Czecho-Slovakia (CSFR)—industrial and construction firms.

With respect to production, more than 55% of firms in the Czech Republic expected an increase in output, whereas less than one-third of Slovak firms expected an increase in output, and this from a lower baseline in Slovakia. Nearly half of Slovak firms expected stable output (47%), which means continued underutilisation of capacity. On the other hand, even those which expected stable output in the Czech Republic (28%) assumed a relatively higher base level.

## Aggregate Supply

At this stage in the economic reform process it is rather difficult to make generalisations about the supply side of the economy. Gross domestic product is not growing substantially and the quality of official data is often dubious. Nevertheless, one can make an important generalisation about the speed of supply-side adjustment:

**Table 2.** Expected Demand in Industry, September–November 1992

| | | 'Worse' | 'Stable' | 'Better' | Balance of 'better' minus 'worse' |
|---|---|---|---|---|---|
| Total Demand | CSFR | 9.3 | 58.1 | 32.6 | 23.3 |
| | CR | 9.5 | 51.1 | 39.4 | 29.9 |
| | SR | 8.9 | 71.2 | 19.9 | 11.0 |
| External Demand | CSFR | 5.7 | 72.5 | 21.8 | 16.1 |
| | CR | 6.0 | 69.0 | 25.0 | 19.0 |
| | SR | 5.0 | 79.5 | 15.5 | 10.5 |

*Source*: Federal Statistical Office.

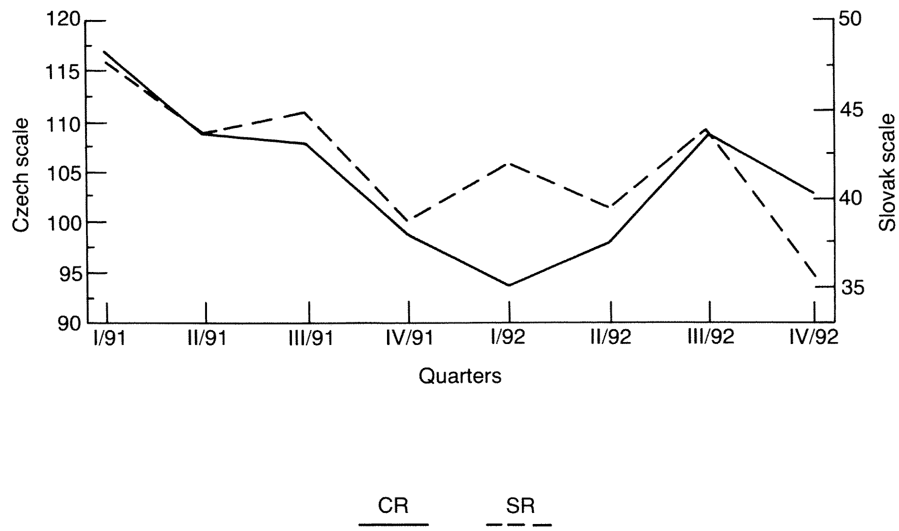


**Figure 5.** Gross Domestic Product, 1991–92 (billion Kcs, 1984 prices).

state-owned enterprises will adjust more slowly than the private sector. Accordingly, to the extent that Slovak privatisation is slower, the Slovak economy will remain less flexible. Nevertheless, a limited supply-side adjustment in Slovakia should result from the first round of Voucher Privatisation. In the medium term, the Slovak economy could benefit from lower wages, a slack labour market or a significant devaluation of the Slovak currency, which might be expected soon after the currency union split.[7] The Czech labour force and management are somewhat more skilled than their Slovak counterparts and the Czechs have been more successful in attracting foreign investment. In 1992 approximately 90% of all foreign direct investment in the former federation went into the Czech Republic.

### *Gross Domestic Product*

It is difficult to estimate gross domestic product for several reasons. First, private businesses have a strong incentive to conceal their activities, as this enhances their possibilities for tax evasion. Second, there is a growing underground economy, estimates of which range from 5% to 20% of GDP.[8] Also, some economists question the general appropriateness of the current statistical procedures used for estimating national accounts.

Figure 5 shows that the development of gross domestic product (in 1984 prices) was similar in both republics. After a steep decline in 1991, output was relatively stable in the first and second quarters of 1992 (note separate scales by republic). Czech GDP in the third quarter of 1992 was 13% lower than in the first quarter of 1991 (15.5 billion Crowns), and Slovak GDP was 8.4% lower (4 billion Crowns). Data on the fourth quarter of 1992 are preliminary.

Because changes in supply are inevitably slower than changes in demand, a positive supply response was unlikely in 1992. Furthermore, given general uncertainty about the course of future developments, including changes in the tax system, inflation and interest rates, significant supply changes would have been unlikely. Accordingly, it is difficult to explain the increase in Slovak GDP in the first quarter

**Table 3.** The Role of Private Entrepreneurs (% of final sales), 1992

| | January–March | | January–June | |
|---|---|---|---|---|
| | CR | SR | CR | SR |
| Industry | 7.3 | 2.8 | 26.8 | 4.3 |
| Construction | 39.9 | 19.5 | 47.7 | 20.6 |
| Retail Trade and Services | 54.4 | 46.2 | 61.1 | 59.7 |

*Source*: Federal Statistical Office.

of 1992, especially since this was not accompanied by growth in industrial production.

### *Privatisation*

In both republics privatisation of small assets is nearly complete and it is unlikely that either government would move to reverse the process. Large-scale privatisation is progressing more slowly in the Slovak Republic, particularly because of changing rules for privatisation after the June 1992 elections. The new Slovak government has stated that more attention should be paid to standard methods for privatising large assets: the relative importance of direct sales should increase, with a decline in the use of the voucher scheme.[9] According to the priorities of the new government, budget revenue will have precedence over the speed of the privatisation process. Also, the Slovak government has indicated its desire to speed up sales to foreigners, and has identified enterprises it hopes to sell.

One measure of the relative speed of the mass privatisation process is the share of private firms in sales, shown in Table 3. All figures show a significantly lower share of private firm involvement in Slovakia; the gap is narrowing in retail trade but widening in both industry and construction. While Czech private firms provide one-half of all construction works and more than one-quarter of industrial output, the figures for Slovakia are 20% and 4% respectively.

Table 4 shows the share of industrial production in firms with more than 25 employees according to property type in August 1992. Once again, the role of state ownership is greater and the role of foreign direct investment is smaller in the Slovak Republic. Medium and large private firms have a share in output more than six times larger in the Czech Republic.[10]

**Table 4.** Industrial production, firms with more than 25 employees, August 1992 (%)

| Form of ownership | CSFR | CR | SR |
|---|---|---|---|
| Private | 10.5 | 13.2 | 2.1 |
| State-owned | 83.9 | 79.7 | 94.3 |
| Foreign-owned | 3.3 | 4.0 | 1.5 |
| Cooperatives | 1.5 | 1.5 | 1.6 |
| Other | 0.8 | 1.6 | 0.5 |
| Total | 100.0 | 100.0 | 100.0 |

*Source*: Federal Statistical Office

**Table 5.** Number of Unemployed and Number of Vacancies (thousands, end of month, 1992)

| | Czech Republic | | Slovak Republic | |
|---|---|---|---|---|
| Month | Unemployed | Vacancies | Unemployed | Vacancies |
| I | 231 | 53 | 319 | 10 |
| II | 218 | 60 | 319 | 10 |
| III | 195 | 66 | 307 | 10 |
| IV | 165 | 72 | 296 | 12 |
| V | 150 | 78 | 283 | 13 |
| VI | 142 | 85 | 282 | 13 |
| VII | 140 | 89 | 279 | 14 |
| VIII | 139 | 94 | 273 | 15 |
| IX | 137 | 89 | 266 | 16 |
| X | 131 | 85 | 261 | 16 |
| XI | 129 | 81 | 258 | 16 |
| XII | 135 | 80 | 260 | 16 |

*Source*: State Bank of Czecho-Slovakia; *Hospodářské noviny*.

*Labour Market*

Conditions on the labour market have been closely monitored since 1990, when unemployment started to rise in both republics. In 1991 both the rate of unemployment and the total number of unemployed increased more rapidly in the Slovak Republic. In 1992 unemployment declined in both republics. Nevertheless, the total number of unemployed and the rate of unemployment remained much higher in Slovakia (see Table 5).

The principal explanation for the declining number of unemployed people in both republics might be a reluctance on the part of the management of state-owned enterprises to sack people. Since output is falling, however, low rates of unemployment are accompanied by decreasing productivity of the state sector. There is a significant difference in job creation between republics, which is shown in the rising number of vacancies.[11]

The difference between the total number of unemployed less vacancies is shown in Figure 6, as this is a useful indicator of the degree of slack in the labour market. In the Czech Republic this indicator has decreased from 178 000 to 55 000. In the Slovak Republic the decline was more modest, from 309 000 to 244 000. There were less than two registered unemployed per vacancy in the Czech Republic in December, whereas in Slovakia there were more than 16 unemployed per vacancy. As yet, the duration of unemployment has not been a problem and many individuals (47% in the Czech Republic) were able to find a new job within three months, while less than 20% of the jobless had been registered for more than one year.

Over the same period, the unemployment rate (Figure 7) went from 4.3% to 2.6% in the Czech Republic and from 12.7% to 10.4% in the Slovak Republic. Regional differences in unemployment are modest in the Czech Republic: in December in Prague the rate of unemployment dropped to 0.32%, signalling significant excess demand on the labour market, whereas the worst situation is in Northern Moravia, with 3.98% unemployment, and the district with the greatest unemployment has 6% unemployed. In Eastern Slovakia unemployment was 12.5% and in the Trebišov district it reached 19.3%.

There are several possible explanations for differences in the rate of unemploy-

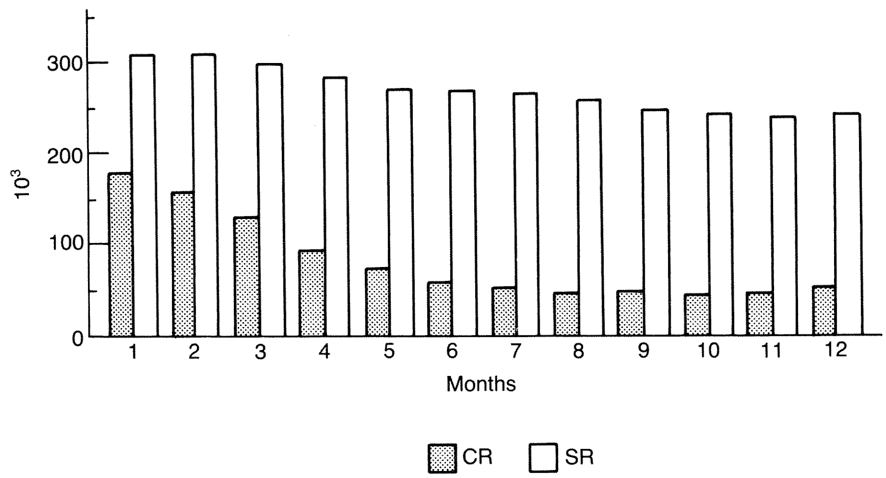


**Figure 6.** Labour market development, 1992—unemployed minus vacancies (in thousands).

ment. First, more rapid and widespread privatisation in the Czech Republic, particularly small-scale privatisation, may have created more employment in the Czech economy; and Prague remains the major tourist and business centre, with a striking degree of excess demand for labour. Second, there are claims that the Slovak authorities were not technically prepared for massive unemployment; for example, almost 20,000 'assistant' jobs were created for university and high school graduates in the Czech Republic in 1992, whereas in the Slovak Republic almost no such jobs were created. Third, lower aggregate demand and structural adjustment are more pronounced in Slovakia. For example, weapons producers were concentrated in Eastern Slovakia, and these regions are the most depressed. Moreover, these producers were accustomed to selling on less competitive markets, which adversely affects their overall competitiveness. Fourth, Slovakia has attracted only about 10% of foreign direct investment in the former federation. Fifth, areas close to West

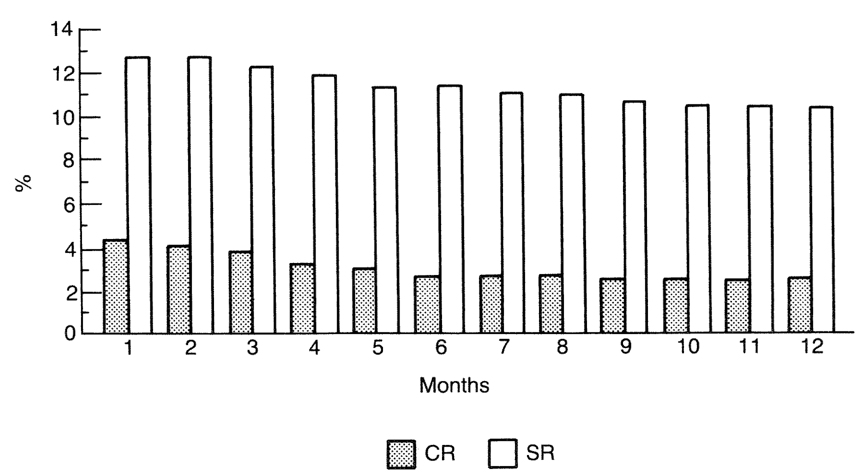


**Figure 7.** Labour market development, 1992—rate of unemployment (%).

Germany and Austria have benefited from job opportunities abroad, with thousands of Czechs resident in towns close to the border commuting to work abroad, whereas Slovakia is disadvantageously located in this respect.

## Monetary Policy

Monetary policy is constrained by the need to maintain the exchange rate peg as part of the economic reform package.[12] Standard monetary indicators such as M2 give a rather blurred picture of monetary policy, which may be influenced by discretionary decisions of the Central Bank or by the privatisation process.[13]

### *Commercial Banks*

It is important to note that Slovak banks have been relying on Central Bank discount loans much more than Czech banks: Central Bank discount loans to Slovak banks increased from 23 billion Kčs on 1 January 1992 to 24 billion Kčs on 30 September, whereas Czech banks lowered their dependence on Central Bank resources from 19 billion to 16.5 billion Kčs over the same period. The decline in their own resources has made Slovak banks front runners in auctions for discount loans, as these were the only reliable source of external liabilities.[14] A limited amount of discount loans with one and three months maturity were auctioned weekly by the State Bank, with the resulting rate of interest termed the 'refinancing rate', which replaced the official discount rate as the leading interest rate indicator in the banking sector. At the end of 1992 the refinancing rate reached 21%, exerting upward pressure on other market rates, whereas the official discount rate remained at 8% from September 1992 until January 1993, when it was increased to 9.5%.[15]

There are no data on net redistribution between republics on the interbank market. Nevertheless, the net transfer from the Czech to the Slovak Republic is estimated to be at least 4 billion Kčs. In the course of 1992 the Central Bank attempted to limit discount loans in the hope that free reserves of the commercial banks would be traded on the interbank market. There was, however, a reluctance to lend to Slovak banks, since the split-up of the federation was seen as inevitable. The lack of cooperation was not unforeseeable, particularly because both banking systems were built as national networks from the outset.

As a result of the division of the assets and liabilities of the State Bank of Czechoslovakia, Slovakia owes the Czech Republic 23 billion Crowns.[16] The Slovak government agreed to repay this amount in instalments, but no repayment scheme has been agreed.

The impact of the new commercial banks on the supply of credit and the quality of bank services has been rather negligible in both republics, and only a few new banks were established in the Slovak Republic. Most foreign banks concentrated on activities in the Czech Republic.

### *Total Deposits*

Possibly the most striking fact is the development of household and firms' deposits in domestic currency: Czech deposits rose by one-fifth, while Slovak deposits have not been increasing (see Figure 8). Historically, increases in household savings have been lower in the Slovak Republic, but the lack of new deposits caused problems for Slovak commercial banks. Moreover, the rate of household saving was three times

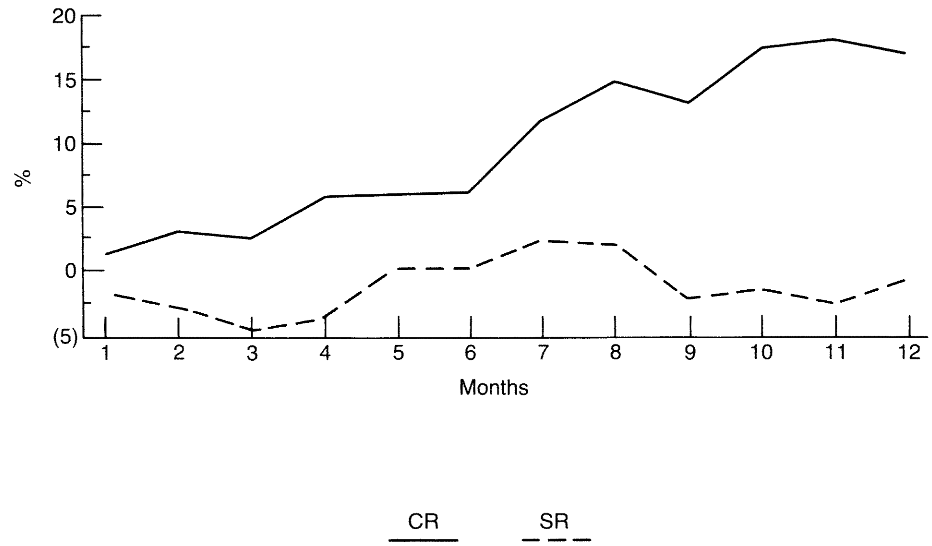


**Figure 8.** Total deposits, 1992 (% change compared with December 1991).

higher in the Czech Republic than in Slovakia. While the Czech rate averaged almost 7% from May 1992, the Slovak rate dropped from its peak of 6.3% in February to 2.2% in September 1992. To an important extent, this can be attributed to widespread fears of devaluation of the Slovak currency.

On the other hand, there are no signs of extensive withdrawals from Slovak banks or massive deposits in Czech institutions. Instead, there was a sharp decline in household deposits in Czech savings banks in September and December; enterprise deposits remained virtually unchanged.[17] Also, according to daily data on the major banks, the process of deposit outflow from the Slovak to the Czech Republic was negligible. Slovak commercial banks have offered a somewhat higher average rate of interest on deposits than Czech banks. In November 1992 the spread between loan and deposit rates was approximately 1 percentage point higher in the Czech Republic, at 6.9 and 5.7 points respectively.

There are three possible explanations for this behaviour. First, Slovak households exchanged almost all of their official allocation of foreign currency for 1992 (7500 Kčs, or about US$ 275), presumably in expectation of devaluation of the future Slovak currency. This can be contrasted to Czech households, which indicated their confidence in the currency by exchanging only about half of their allocation. For 1992, in absolute terms, Czech households saved more in Czechoslovak crowns than in foreign currency (14.8 billion Kčs compared to 6.4 billion Kčs). While no exact figures are available for Slovak households, the trend seems to be the opposite. Second, at the end of 1992 and beginning of 1993 Slovaks were transferring their savings to Austria and Germany and hoarding convertible currencies. Third, lower Slovak savings might be linked to higher cash balances and hoarding of goods purchased on the better-supplied Czech durable goods market.

*Currency Emission*

Until 8 February 1993 there was a single currency circulating in both republics.

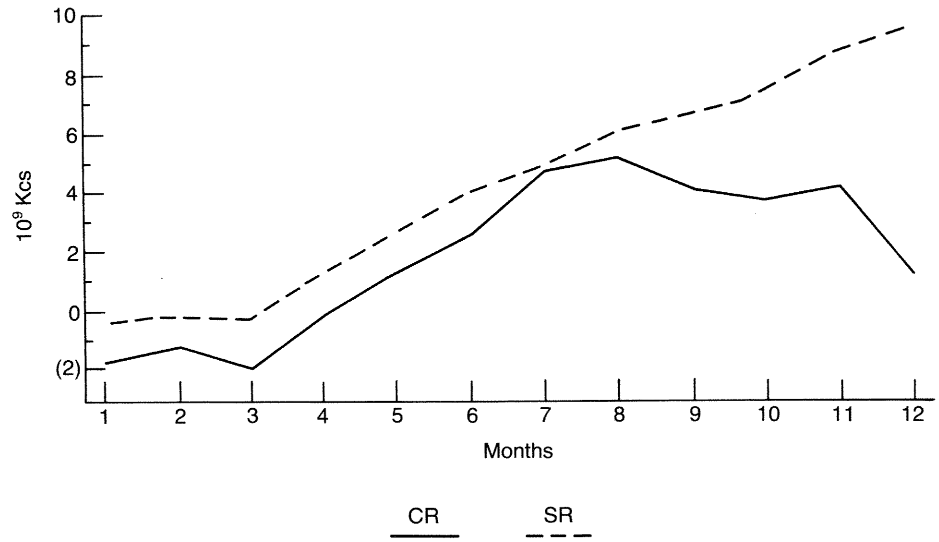


**Figure 9.** Currency emission, 1992 (change compared with 31 December 1991; billion Kčs).

Currency emission by republic is shown in Figure 9. One can see that emission was faster in the Slovak Republic from January to December 1992, whereas the population and economy of the Slovak Republic is roughly one-third of the federation.[18]

Increasing tax evasion and the shadow economy clearly contributed to the increase in cash balances, as well as requirements for cash payments among private partners. Another possible explanation for Slovak demand for cash balances might be the aforementioned hoarding of consumption goods, given Slovak expectations of devaluation. An alternative hypothesis would be that, given a favourable black market exchange rate in Vienna, Slovak citizens would buy foreign currencies abroad and deposit them in domestic (Czech) banks. Such an operation would have shown an expected profit of about 20% if one believed the 'conventional wisdom' that the Slovak currency would be devalued by approximately one-third in the first quarter of 1993.

### *Loans*

Slovak monetary policy was somewhat expansionary, owing to both the greater volume of discount loans to commercial banks and the behaviour of banks themselves (see Figure 10). By August 1992 total loans had risen by almost 10% in the Czech Republic and by 17% in the Slovak Republic, compared with December 1991, but the difference narrowed because of an increase in loans for large-scale privatisation in the Czech Republic in the last quarter and a growing lack of reserves in Slovak banks.

Why are Slovak banks prone to less restrictive credit policies than Czech banks? One explanation may be involvement of the Slovak government, which is linked to its intention to retain state ownership of 51% of commercial bank shares, even after privatisation. Another explanation was the signal sent by the Slovak government that troubled firms, particularly in distressed areas, would be bailed out. A similar signal

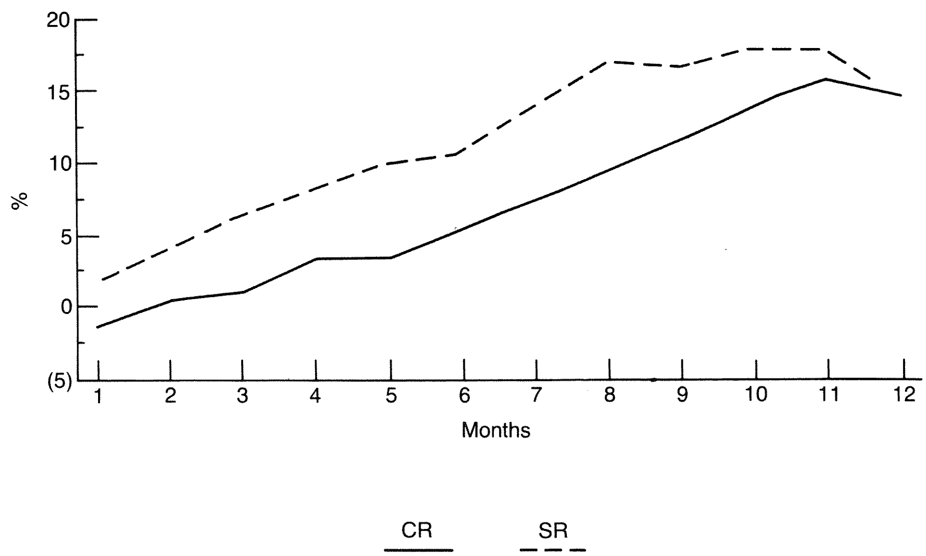


**Figure 10.** Total loans, 1992 (% change compared with 31 December 1991).

was given by the Czech government by postponing the bankruptcy law, which may have contributed to an increase in loans provided by Czech commercial banks at the end of 1992. Firms that were previously rated as unreliable risks obtained new loans, particularly with respect to sizeable clients whom large banks had inherited from the monobank system.[19]

### *Payment Arrears*

The 'payment inability' of Czechoslovak firms increased dramatically in 1990 and 1991. In 1992 payment arrears declined significantly for Czech firms, but only slightly for Slovak firms (see Table 6). Payment arrears of Czech firms peaked in the fourth quarter of 1991, and they decreased by one fifth in the third quarter of 1992. Payment arrears of Slovak firms were stable during 1992.

In the short run, less prudent credit policy by banks may contribute to lower payment arrears, particularly if loans are obtained by firms previously considered poor risks. In the medium and long run, however, the opposite result would occur because loose credit policies lower the credibility of the entire reform programme.

In August 1992 only one-quarter of industrial firms did not report any problems caused by payment arrears, whereas 54% of construction firms reported no problems. A general tendency towards an improvement of solvency was indicated by the fact that about one-half of industrial firms surveyed expected to improve their own

**Table 6.** Payment Arrears in 1991 and first three quarters of 1992 (end of quarter, billion Kčs, all firms)

| | I | II | III | IV | I | II | III |
|---|---|---|---|---|---|---|---|
| CR | 55.6 | 88.8 | 100.2 | 113.2 | 107.8 | 109.6 | 94.2 |
| SR | 23.0 | 34.6 | 46.9 | 61.1 | 62.4 | NA | 60.2 |

*Source*: Czech Ministry of Economy and Czech National Bank.

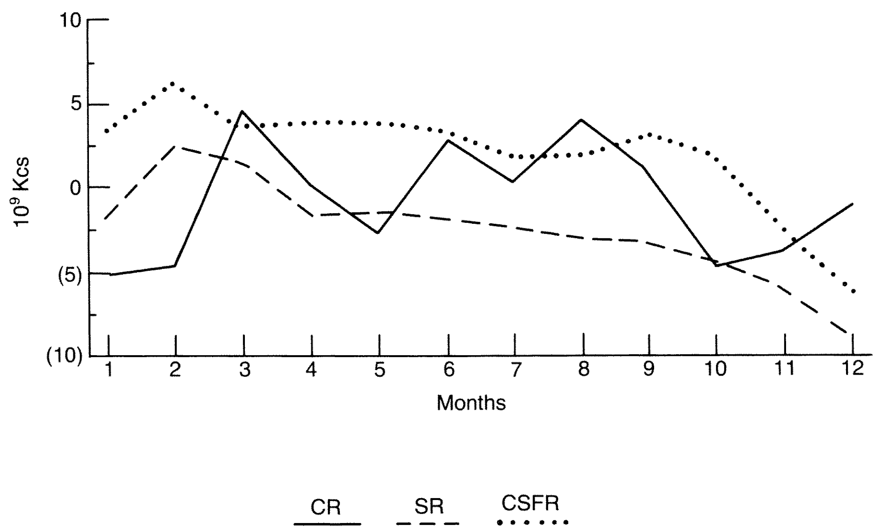


**Figure 11.** Budget deficits, 1992 (Czech Republic, Slovak Republic and Federation).

financial situation in the last quarter of 1992, whereas worsening solvency was considered a likely outcome by approximately 10% of respondents.

## Fiscal Policy

In the former federation there were three government budgets, one federal and two republic.[20] The majority of revenues went into the federal budget, and were redistributed to the republics. Federal revenue relied heavily on the turnover tax, and republic budgets were based on incomes from corporations under republic control, and partly on taxes paid by households. Public services were financed by republic budgets (45%) and local budgets (35%). Federal expenditure (20%) was primarily to finance federal functions and the executive power of the federation. Roughly half of republic needs were covered by transfers from the federal budget, and these transfers were negotiated separately for each republic.[21]

In 1990 the guiding principles of 'independence' and 'self-sufficiency' of respective budgets were applied, with transfers minimised. The federation was responsible for defence, foreign policy, monetary policy, legislation, and some infrastructure—such as railways and telecommunications. All other functions were devolved to the republic level. Accordingly, information from the 1990 consolidated budget is not very informative, since decisive changes were made in the budgets of the individual republics, including differing surplus or deficit positions (see Figure 11).[22]

Nevertheless, one can identify a few general tendencies. While the federal budget had a relatively stable surplus in the first three quarters of 1992, mainly thanks to a relatively stable tax base, both republic budgets were frequently in deficit. The Slovak budget had a modest deficit in April 1992 and declined thereafter. At the end of the year all three were in deficit: the federal budget for 1992 had a predictable but modest deficit; the Czech budget ended up with a small deficit of 0.5% of GDP; and the Slovak deficit was almost 6% of GDP. Low profits and constant retail sales do not offer much hope for a balanced Slovak budget in the near future. Moreover, an important source for concern in Slovakia will be the loss of transfers from the federation. Although official statistics are sketchy, conservative estimates are that the federal budget redistributed approximately 3% of Czech GDP to Slovakia, which comprised about 6% of Slovak GDP.

In both republics the end-year budget results are the consequence of tax collection and spending policies in the last few months of 1992, including difficulties with tax collection. For example, in the Czech Republic turnover tax collections were 7.3 billion Kčs below projections (total revenues 32.8 billion Kčs) and profit tax collections from state-owned enterprises were 2.2 billion Kčs below expectation (total revenues 29.8 billion Kčs). The situation in the Slovak Republic is probably similar. Nevertheless, budgets have been kept relatively balanced through prudent policies and expenditure cuts. In the case of the Slovak Republic, in particular, this behaviour is in clear contradiction to pre-election promises: no fiscal spree has happened in Slovakia.

Generally, the budgets of local authorities in 1992 were in surplus, totalling 10.8 billion Kčs on 31 August 1992. After double-digit inflation in 1991 and significant inflationary expectations for 1992 (about 20%), subsidies from central budgets to local budgets were indexed. However, inflation in 1992 was close to 10% and expenditure of local authorities was lower. According to a November announcement, the Czech government cut subsidies to local authorities by 6 billion Kčs and a similar measure was prepared in the Slovak Republic.

Why are tax collections lower than expected? The main reason is a loosening of state control over the whole economy. Lack of control over state-owned enterprises has led to a decline in tax revenue, since these companies are not concerned with maximising profit, as discussed above. There is evidence of massive tax evasion by retail traders, estimated at 20% of regular tax revenue. Tax discipline is generally low in all sectors and the introduction of the VAT was not particularly well prepared. It is unclear whether introduction of value added tax will bring in more revenue: the experience of the first few weeks of 1993 has shown problems with tax enforcement in both republics and an unfortunate impact on trade between them.

Prudent fiscal policy may require additional expenditure cuts, and this has been clearly recognised by republic ministers of finance. Approximately 70% of expenditure goes to the ministries of education, health and social affairs, but only 30% of expenditure is considered inflexible commitments. There is little scope for tax increases, particularly because small and medium sized businesses were badly affected by new health and social insurance payments.

### *Government Paper*

In 1992 the Czech Republic issued short-term treasury bills five times; the Slovak government 15 times; and the Federal government seven times. Since the deficit of the Czech Republic has been relatively low, there were few issues of smaller amounts, which generally encountered excess demand at pre-set interest rates.[23] The higher frequency of issue of Slovak treasury bills was accompanied by a substantial excess supply on the market, ranging from 60% to 90%. Up to the end of November 1992, in six cases (the first on 12 June) the Central Bank (SBČS) felt obligated to buy Slovak treasury bills and in five cases it bought the total issue, primarily because the Slovak Ministry of Finance rejected prices offered by commercial banks.

The Central Bank purchased a total of 16 billion Kčs (47%) of all bills issued by the Slovak Ministry of Finance in 1992, whereas the Central Bank did not have to

**Table 7.** Treasury bills held by banks, 30 September 1992

| Banks | billion Kčs |
|---|---|
| Czech commercial banks holdings of Slovak treasury bills | 5.2 |
| Slovak commercial banks holdings of Czech treasury bills | 0.6 |
| SBČS holding of Slovak Treasury bills | 0.3 |
| SBČS holding of Czech Treasury bills | 0.05 |

purchase Czech treasury bills.[24] Additionally, Czech commercial banks purchased more Slovak treasury bills than Slovak commercial banks purchased Czech treasury bills (see Table 7). There are signs, however, that from May 1992 Czech commercial banks were less willing to buy new Slovak paper and that holdings of Slovak treasury bills in the portfolios of Czech banks have been decreasing steadily since that time.

The average yield to maturity on the primary market of one-month treasury bills of the Czech Ministry of Finance decreased from 10.7% to 6.45% in the course of 1992. From mid July the yields to maturity on Slovak treasury bills were significantly higher than on Czech bills (see Figure 12). The market-determined spread between Czech and Slovak treasury bills would probably have been still wider were it not for Central Bank intervention at an agreed (non-market) price.

Emissions of Slovak treasury bills in January 1993 yielded on average between 17.3% and 19%, whereas Czech paper yielded between 9% and 10.7%, the difference being primarily due to the impending split and expected devaluation of the Slovak currency. Slovak commercial banks also lack liquidity with which to purchase government paper. Additionally, secondary market trading provides some insight into investor confidence, although trading is infrequent. The last two Czech issues in November traded at between 7.0% and 9.75%, whereas Slovak paper traded at between 8.625% and 12.0%. The risk liquidity premium *vis-à-vis* short-term

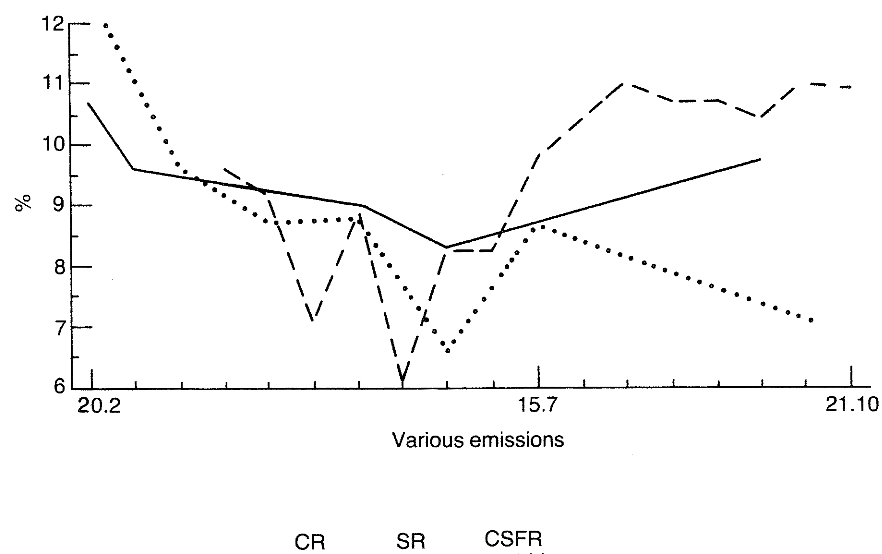


**Figure 12.** Yields to maturity of treasury bills, (%) 1992.

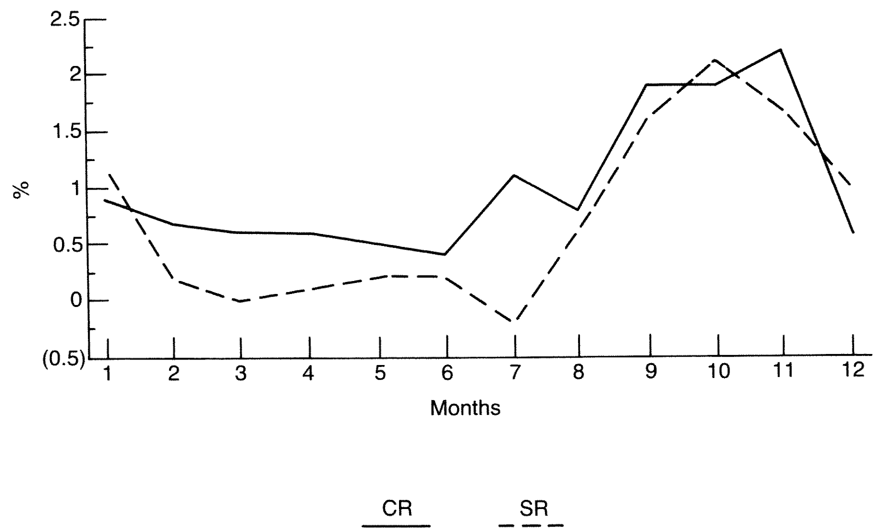


**Figure 13.** Consumer prices, 1992 (% change on previous month).

Central Bank bills (at 8%) seems to be approximately 3% for Slovak paper and 1.7% for Czech paper.

## Prices

*Consumer Prices*

From December 1991 to December 1992 consumer prices in the Czech Republic increased by 12.7%, compared with 9% in the Slovak Republic (see Figure 13).[25] Lower inflation in Slovakia occurred despite somewhat more expansionary fiscal and monetary policies. There are several possible explanations for this paradox. In 1991 some economists argued that faster inflation was caused by the higher degree of monopoly power possessed by Slovak producers and distribution networks. While this claim may still be valid, it could have been offset either by lower demand or by efforts to preserve subsidies to selected goods and (public) services in the Slovak Republic. We have shown above that demand is relatively depressed in Slovakia compared with the Czech Republic, particularly in the retail trade and construction sectors and even in industrial production. Given production capacities and the fall in aggregate demand, one might assume that Slovakia is experiencing Keynesian-type deflationary depression.

During 1991 the Czech government cut several types of subsidies, and liberalised 95% of all prices or, at least, significantly relaxed price control. On the other hand, the Slovak government preserved some subsidies, such as to public transport, paid medical services and housing. Moreover, the Slovak government has merely postponed final price liberalisation and resulting inflationary pressures. For example, Slovak subsidies for public transport are approximately 2.7 billion Kčs, compared with 1.5 billion Kčs in the Czech Republic, so that per capita subsidisation is almost four times higher.

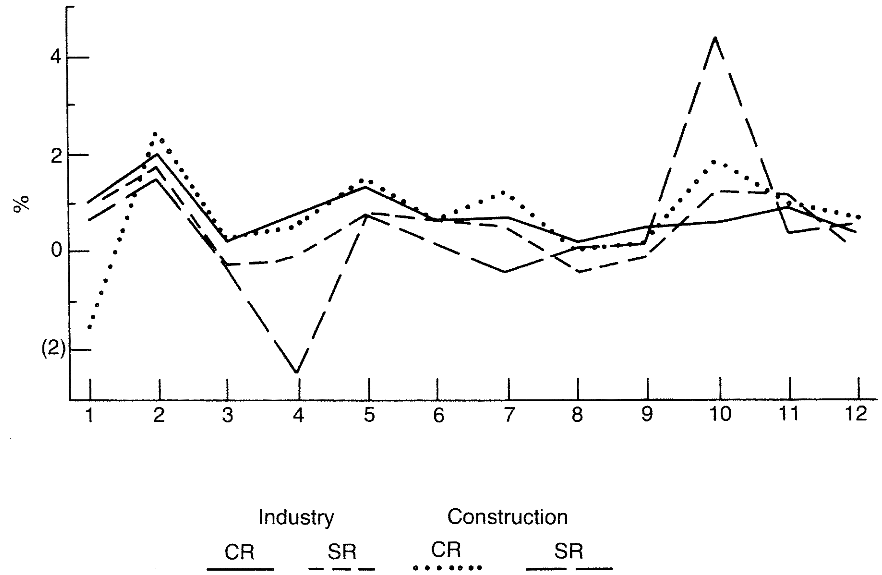


**Figure 14.** Producers' prices, 1992 (% change on previous month).

*Producer Prices*

Producer prices are effectively free in both republics,[26] whereas consumer prices are subject to different degrees of administrative controls in the two republics. Nevertheless, a somewhat similar picture is shown by price indices for industry and construction (see Figure 14). Accordingly, the major determinant of price movements should be demand, rather than administrative measures. While prices in industry as a whole went up by 9.3% from January to December 1992 in the Czech Republic, prices in industry increased only 6.1% in Slovakia. Similarly, prices in construction increased 8.8% and 5.5% respectively over the same period. Note that until September 1992 construction prices showed no significant change.

## Policy Implications

We have shown that economic policies and outcomes are already diverging between the Czech and Slovak Republics. After two years of reform-induced recession, the performance of the Czech economy is improving, to a large extent as the result of the emerging private sector. In Slovakia, however, economic performance is stagnant, and the prospects for improvement are poor. Furthermore, the Slovak government advocates continued state involvement in the economy, which caused it to slow privatisation and preserve 51% state ownership in commercial banks.

Relative to Slovakia, the Czech Republic performed better in 1992 with respect to retail sales, savings, unemployment, government finances, expansion of credit and the overall general expectations of the population. Economic difficulties in Slovakia will be exacerbated by the loss of direct and implicit transfers from the Czech Republic, which may have been greater than 10% of Slovak GDP.[27] Populist political pressures may encourage the Slovak government to relax macroeconomic policy further, and devaluation is anticipated, which will further increase inflationary pressures.[28]

For the Czechs, the once-and-for-all costs of separation should be more than offset by an end to subsidies to Slovakia, which were at least 5% of Czech GDP. Moreover, the time-consuming process of continuing negotiations with the Slovaks will cease to consume the energies of key policy makers.

Considering the economic performance and prospects outlined above, one has to question the factors motivating the Slovak government to seek independence. The costs of separation outlined in this article may well be lower than the consequences of the loss of direction and coherence in economic policy making. The new government will learn about macroeconomics through experimentation—one can only hope that its learning-by-doing will not be too expensive for the Slovak people.

## Notes

1. A possible, although unobservable, explanation would be Slovak households hoarding goods from the better supplied Czech market. Alternatively, Slovak households might be holding cash balances, probably in foreign currency, or transferring assets abroad.
2. Data on 'other incomes' for Slovakia are available until July 1992; attempts to further divide 'other incomes' would be speculative.
3. The balance of payments of the Czech Republic was probably in surplus thanks to an inflow of foreign direct investment, but separate statistics are unavailable.
4. *Financial Times*, 16 February 1993.
5. At 30 September 1992 a total of 506 firms under the Ministry of Industry showed a loss. Almost two-thirds of them had a sufficient amount of liquid assets including cash, bills of exchange and liquid liabilities.
6. A total of 928 industrial and 264 construction firms answered the question: 'what do you expect about demand for your products in the next quarter compared to this quarter?' Evaluation is conducted as the difference between the answer 'worse' and the answer 'better'. The cross-section sample research described above was conducted at the beginning of September 1992.
7. On 18 February 1993 the Slovak government refused to accept IMF preconditions for a loan to supplement the depleted reserves of the Slovak Central Bank: a significant devaluation and a floating exchange rate.
8. No estimates are available as to the relative size of the shadow economies in the two republics, although data on 'other incomes', discussed above, would imply a larger shadow economy in the Czech Republic.
9. For a more detailed discussion of the voucher scheme, see Charap & Nivet, 1991.
10. Statistical difficulties may overstate the difference between republics, since there are signs that the Slovak authorities are less adept at collecting data about private and privatised enterprises.
11. For example, there was no increase in the number of unemployed in September when new graduates entered the labour market in the Czech Republic, and only a slight decrease in vacancies. The willingness of enterprises to retain employees may be influenced by signals of continued government intervention in both republics on behalf of troubled firms. This is discussed in more detail in the section devoted to monetary policy.
12. On 1 January 1991 the currency became convertible for most current account transactions and the exchange rate was fixed against a basket of currencies (see Charap & Dyba, 1991).
13. Bulíř (1992) shows that the choice of privatisation methods can have a significant impact on both loan and deposit growth. For example, the amount of money lent by commercial banks for loans financing privatisation doubled over the period from January to September 1992. Privatisation loans are usually collateralised by the property itself.
14. See Bulíř (1993) for a detailed discussion of discount policy manoeuvres in 1992.

15. The monetary target of the central bank was the level of non-borrowed (free) reserves and not the rate of interest, with the underlying assumption that the refinancing rate had a limited impact on market interest rates.
16. After 1989 some Central Bank liabilities came from required reserves deposited by Czech commercial banks.
17. One would assume that enterprises considering a possible devaluation would move their deposits out of Slovak commercial banks or hoard imports. To date, there are insufficient data to support this assumption.
18. The latest data on currency emission may be biased owing to diverging expectations. In the last 10 days of December, households started to deposit their cash balances in banks to facilitate conversion to new national currencies. The sharp decline in cash balances continued in January 1993, and before the currency split cash balances were about 50% (55 billion Crowns) lower than their peak.
19. For example, the major commercial bank, Komerčni Banka, has become more involved in two troubled companies: Škoda Plzen and Tatra Koprivnice. The financial situation of both heavy industry giants was previously viewed as hopeless.
20. For a discussion of budgetary questions, see Kočarnik, 1992.
21. There were signs that the system was becoming unworkable even in the late 1980s.
22. This information should be evaluated with a degree of scepticism, however, because it is affected by weekly fluctuations.
23. For example, at the auction of 17 September 1992 there was an excess demand of 24% at offered interest rates.
24. The share of government paper held by the Central Bank is limited by law to 5% of revenue in the previous year. Czech bills have been bought mainly for the sake of open market operations.
25. For the federation, consumer prices increased by 11.1% in 1992, which was slightly higher than the goal of 10% set by the Central Bank.
26. A few prices remain controlled, primarily hard and soft coal and certain steel products. Price regulation is supposedly the same for both republics.
27. As discussed above, fiscal transfers were probably over 6%; the trade deficit was more than 3%; and there are significant implicit transfers, including subsidised finance of the budget deficit.
28. Some observers expect re-introduction of foreign exchange controls in Slovakia, representing a significant reverse in the reform. In February 1993, for example, the Slovak government decided to re-impose an import surcharge, which had been abolished on the federal level two months earlier. Also, the Slovak government decided to stop publishing reserves and foreign exchange interventions on a regular basis.

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## Appendix

**Table A.1.** Foreign Exchange Reserves (all banks, including central bank; $US billion, end of quarter)

| | I | II | III | IV |
|---|---|---|---|---|
| 1991 | 1.4 | 1.7 | 2.3 | 3.3 |
| 1992 | 3.8 | 4.9 | 5.5 | 4.3 |

*Source*: Czech National Bank.

**Table A.2.** Exchange Rate (Kčs/ $, end of month)

| | 1992 | | |
|---|---|---|---|
| | Official | Parallel | Premium (%) |
| 1 | 28.4 | 30.1 | 6.0 |
| 2 | 28.8 | 30.2 | 4.9 |
| 3 | 29.2 | 30.2 | 3.4 |
| 4 | 29.1 | 29.8 | 2.4 |
| 5 | 28.8 | 29.4 | 2.1 |
| 6 | 28.4 | 30.4 | 7.0 |
| 7 | 27.6 | 29.2 | 5.8 |
| 8 | 27.3 | 28.8 | 5.5 |
| 9 | 27.2 | 29.4 | 8.1 |
| 10 | 27.4 | 29.6 | 8.0 |
| 11 | 28.5 | 31.4 | 10.2 |
| 12 | 28.6 | 31.3 | 9.4 |
| | 1993 | | |
| 1 | 28.9 | 51.6 | 78.5 |

*Source*: Czech National Bank.

**Table A.3.** Selected Macroeconomic Indicators, CSFR

| | 1989 | 1990 | 1991 | 1992 |
|---|---|---|---|---|
| Nominal GDP[a] | 795.5 | 811.3 | 977.8 | 1059.9 |
| Real GDP[b] | 732.6 | 719.8 | 611.4 | 564.2 |
| GNP deflator[c] | 1.2 | 8.7 | 61.1 | 11.0 |
| Private consumption[b,c] | 2.8 | 2.9 | − 24.0 | 6.0 |
| Public consumption[b,c] | 7.6 | − 1.2 | − 17.2 | − 11.5 |
| Gross fixed capital[b,c] | 3.2 | 2.6 | − 31.8 | − 0.2 |
| Exchange rate (Kčs/$)[e] | 15.1 | 18.3 | 29.5 | 28.3 |
| Real effective exchange rate (1985 = 100) | 70.9 | 54.2 | 51.8 | 55.0 |
| Current account[d] | 0.4 | − 1.1 | 0.4 | 1.0 |
| External debt[d] (Gross) | 7.9 | 8.1 | 9.4 | 9.6 |
| M2[c] | 4.4 | 3.7 | 27.3 | 25.3 |

*Source*: SBCS, Czech National Bank and Federal Statistical Office
*Notes*:
[a] billion Kčs
[b] billion Kčs, 1984 prices
[c] % change
[d] billion US$
[e] annual average