Macroeconomic Policy and Institutions in the Czechoslovak Transition: The Starting Point and First Steps

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The purpose of this chapter is to examine the institutional background of recent developments in Czechoslovakia and to suggest the design of future changes. The attempt of Czechoslovak reformers is to realize a rapid transition to a market economy. On the way to the market, though, several obstacles must be overcome.

One is usually interested in what is to be transformed, the timing of the process, and so forth. However, serious misunderstandings can evolve if the background of the previous institutional arrangements and macroeconomic performance is not understood. Such a description will be contained in the first part of this chapter, with special attention to the macroeconomic dimensions of a closed economy. The second part will address institutional changes and institutional prerequisites of a new macroeconomic policy. The third part is concerned with specific problems concerning monetary and fiscal policy in the transition.

BASIC CHARACTERISTICS OF A CENTRALLY PLANNED ECONOMY

It is not surprising that the monetary and fiscal systems of communist countries differ fundamentally from the corresponding arrangements in the West. What is usually referred to as the standard command system, including the basic communist concepts regarding the role of banks in the economy, first took shape in the Soviet Union during the early 1930s and then was introduced into the other eastern bloc countries when they came under communist control after World War II. The policy outlines were not altered significantly among the individual countries. Nevertheless, the fact that certain procedures or institutional arrangements were used, say, in Czechoslovakia or in the Soviet Union, does not mean that they were employed elsewhere. Although the Soviet Union was the prototype for the other eastern bloc countries, some elements of the Western economic culture have survived to a surprising degree in a number of these countries. Still, it is possible and beneficial to summarize basic principles concerning these topics that have a certain general validity.

Regardless of the country and possible reform attempts, the basic features of centrally planned economies remained intact for the last 40 years. Production targets, formulated mainly in physical terms, were embodied in the form of output plans. Designated governmental agencies specified for each enterprise, or group of enterprises, sources and quantities of basic inputs. Key prices were fixed by authorities, and wage rates and total payroll costs were also strictly controlled. Allocation of resources was determined by the central plan and not through the price system.[1] Private ownership of the means of production was destroyed, and financial markets and their instruments were abolished. Administrative measures, and not market adjustments, were used to correct disequilibria. Inconvertibility of the domestic currency derived necessarily from a system of centralized decision making since the planning model required that authorities retain a monopoly over foreign trade and foreign exchange. The inevitable result of inconvertibility is to isolate an economy from the rest of the world and to prevent the price system from transmitting relevant information.

Despite proclamations of Soviet economists in the early 1920s, the money and banking systems did not disappear. Also, taxes and the public economy were not replaced by direct material allocation. Fiscal and monetary authorities compiled their own one-year and five-year plans, but these were only complements to material plans. These institutions and their policies are hard to evaluate in Western dimensions. Since almost all basic planning was in real magnitudes, so-called material balances, the role of money was to provide a common denominator for aggregation.[2] Banks acted to ensure the smoothness of the planned path of economic expansion, regardless of profits or liquidity. The scope for a relatively independent monetary policy opened in Czechoslovakia after 1980, and even then, monetary authorities were under strong pressure from state authorities.

The position of fiscal authorities was even weaker because their aim was to provide a rigid set of public goods and administrative redistributions. Public goods proceeded from "implanted" values (free health and educational services, full employment, centralized social insurance, etc.)

rather than as the result of public choice. With respect to the decreased efficiency of socialist economies, both in absolute and comparative terms, the quality of these services has fallen.

FINANCIAL INSTITUTIONS

One can identify three central authorities in the socialist economies: the planning authority, the monetary authority, and the fiscal authority. The most influential of these is the planning authority, which is beyond the scope of this chapter. Let us start with the more important of the two remaining institutions: fiscal authority and the government budget.

Government Budget

From the beginning of socialist construction in the 1950s, almost all financial flows in the production sector, either related to the movement of final goods or to the flow of investment, were influenced by material output and input plans. Financial flows were not market determined; indeed, there were neither capital markets nor profit-maximizing commercial banks that could have allocated these scarce resources. Government institutions functioned without public control, and thus their instruments became "fuzzy" (Zieleniec 1990).

Instead, all major macroeconomic decisions—such as the division of current output between consumption and investment and allocative measures between industry and agriculture, or among industries, regions, and social groups—were embodied in the government budget. In the 1950s and 1960s, approximately 90 percent of the financial counterpart of the flow of real resources into investment was channelled through the budget. (Below we will show why this tight relationship disappeared in the 1970s and 1980s.) Also, a large proportion of consumption was channelled through the budget. The ratio of the government budget relative to net material product[3] grew steadily (a decrease of investment expenditures was offset by other expenses), and in Czechoslovakia in 1989, this proportion exceeded 70 percent, higher than in any Western country.

On the revenue side, the main resources were profit taxes and redistribution of depreciation, and only 10 to 12 percent of revenue was taxes paid by the population—numbers quite unusual by Western standards. These were popular measures, and wages could remain low. Moreover, the role of indirect taxes was steadily decreasing over time. The Ministry of Finance had no need to be afraid about funding sources, as the constitution enabled it to levy a new tax or increase the rate of an existing tax on state enterprises in order to balance its current budget. This was often done in the 1980s.

The position of the government budget resulted from two features. First, the channelling through the budget of the bulk of all investment in the 1950s enabled the reconstruction of heavy industry, and later, the concentration of resources into preferred industries. Second, the financing of a very large part of expenditures in so-called collective consumption, which included not only free education, health or other social services, but also enormous subsidies for food[4], housing, transportation, and so on, constituted a major use of funds.

This colossal burden, which led to hidden budget deficits in the 1980s, was above all an attempt to convince the population about the possibility of an improved standard of living and a successful way to communism. For political reasons, the built-in growth rate of expenditures into collective consumption offset the growth rate of expenditures into investment, environmental activities, and, in fact, led to a large capital deficit in the form of obsolete industry and infrastructure, pollution, and so on. Some economists therefore like to speak about the debt against capital, the so-called borrowing from the future. This debt is indeed impossible to express in exact monetary terms.

The accelerating rate of growth of expenditures for collective consumption (due to, for example, more expensive basic medical equipment, a higher share of retired population, or simply bureaucratic expenses) caused pressures on the budget balance in the 1970s and 1980s. But the Ministry of Finance never ran an open deficit and even when there where signs of it, the deficit was monetized: The expenditures were moved into the monobank's operations and these expenditures were covered by monobank's loans (Bulir 1990). Because political forces in the Communist Party preferred, for political reasons, expenditures for social purposes, this led finally to a decrease of financing for investment.

One can also see fundamental microeconomic issues connected with the public finance process. These issues, however, go far beyond the scope of this chapter. Some useful points can be found in Wiles (1979).

However, this accounting change did not mean a decentralization or even "marketization" of the investment process, as financial sources were simply channelled through the monobank rather than through the budget.

The Monobank

The particular form of banking organization developed originally in the Soviet Union combined in the state bank some attributes of a central bank with those functions of commercial banking that were relevant in a communist country. The main reasons for merging deposit and central banks into a monobank can be found in Wiles (1979: 312). The term "monobank" well describes this type of banking structure, even though the monobank was supplemented by a small number of specialized banks, including an "investment" bank, a savings bank, and a foreign trade bank. The important feature of the system was that all these banks were monopolies in their specific areas.

In specific terms, the monobank was the bank of issue. It managed foreign exchange reserves in close cooperation with and, in some cases, under the direction of the Ministry of Finance and the Ministry of Foreign Trade. The monobank was the sole source of short-term (and, in the 1970s and 1980s, also of long-term) credit, as the extension of direct interenterprise credit was forbidden.

Since control of credit was exercised directly, setting the credit limit for the economy and limits for individual branches, the monobank was not concerned with controlling the reserves of commercial banks or with open-market operations as central banks in Western countries are.

The monobank also served as the settlement and clearing center of the country (e.g., it had to solve liquidity problems of firms) and performed all the usual fiscal agency functions carried out by central banks in the West. Credit limits in the branches of the state bank were directly derived from plans of individual enterprises in material units, and firms were given credit or other resources for financing particular activities. Because payment flows and credit allocation were planned and tied to plan fulfillment, all such monobank operations involved an audit function to check conformity of payments to underlying authorization, called "control by the *koruna*."[5]

In addition, in the 1980s, the monobank in Czechoslovakia tried to provide a non-inflationary monetary policy.[6] This included credit targeting and a certain decentralization of direct credit allocation. Nevertheless, it is extreme to say that the credit rationing system was abandoned (Goodhart 1989: Chap. 7). However, during those attempts, the main problems connected with the monobank and with the impossibility of a tight monetary policy arose and became apparent: the "fuzzy" objective function of the monobank and the demonetization of the economy.

First, part of the problem stemmed from rules under which the monobank was established. Once the plan was accepted, the monobank's objectives were directed toward keeping the monetary variables in line with the projections that related changes in credit to the material targets. Money was put into circulation only to support the movement of goods.

The primary goal of the monobank was to financially secure the production process. Thus, the monobank was an adjuster, not a steerer. And it is well known that objectives promoting accommodative policy and anti-inflationary policy are contradictory.

Second, the separation of households from producers (no shares and no private capital ownership) led to different developments in the household and firm sectors. These included different price indices, different structures of commodities supplied to firm and household markets, different currency-demand deposit ratios, and even dissimilar responses to monetary impulses.[7] These features are sometimes described as a "hard" budget constraint within the household sector and a "soft" budget constraint within the producer sector. A soft budget constraint implies that liquidity is not the central aim of a socialist firm. Developments in the 1980s during tight monetary policy periods seem to confirm this statement: Many large firms have survived even in a permanent state of "payment incapability."

The consequences of such developments, which lasted over decades, are sometimes surprising: elimination of interest rates (the real interest rate was, in many cases, zero), relations between particular interest rates that appeared arbitrary, and non-homogeneous money supply. It was meaningless to sum up the currency in the hands of the public and the current accounts used by enterprises as they bore no significant connection to the development of aggregate indicators of economic performance. The same can be said about the exchange rate and the behavior of firms. Government budgets, directly via export subsidies, and the state bank, indirectly via a fixed exchange rate system, determined foreign trade.

MACROECONOMIC OR MICROECONOMIC POLICY?

Following the description in the previous section of the basic principles of the fiscal and monetary systems, there arise crucial questions: Did there exist any macroeconomic policy in the classical sense in Czechoslovakia and in other communist countries? Were decisions about government outlays based on either explicit or implicit estimates of the expenditure multiplier? Did the state bank have any idea about demand for money functions and were they used for managing price stability? Did the exchange rate contribute to competitiveness of the economy and to the equilibrium of the balance of payment? The general, slightly oversimplified, answer is no.

One may wonder what the reasons were in most Comecon countries, especially in Czechoslovakia, for the relatively good macroeconomic performance: zero unemployment, a rate of growth of official price indices close to zero, a rate of growth of net material product above relevant figures of OECD countries in the 1950s and 1960s and comparable to them in the 1970s.[8] Only in the 1980s was there a significant slowdown in the growth rate and rise in price levels.

The key to understanding economic policy and the performance of a communist country lies in the abandonment of the macroeconomic dimension of government interference. State activities, either from the monetary or from the fiscal side, were not neutral. Rather, they were focused on particular firms or regions, particular products, or particular social issues. Thus, the federal government never discussed any macroeconomic issue. The evidence shows that the economy was managed by microeconomic interference rather than by macroeconomic. These microeconomic interferences contained price management, the directive credit rationing system, a wide system of subsidies and centralized redistribution, or simply commands.

One may ask what enabled central authorities to provide such a policy. This can be explained using the concept of property rights. Nobody owned anything, but many could make decisions. The original normative idea of creating a socialist economy was based on the assumption that there would be no agents that maximized their own profits. Instead of creating fixed rules of behavior and leaving the values of variable parameters—above all, prices and optimal plans—to the market, the socialist state tried to directly influence parameters, prices, and outcomes, and almost completely resigned from the role of affecting the rules.

The lack of a macroeconomic dimension in government policy enabled the communist countries in the short run, above all in the 1950s, to reach some surprising results, such as in the areas of industrialization or electrification. Nevertheless, in the long run, the system was extremely ineffective. Good long-term economic performance in Comecon countries is partly myth and data falsification, partly the result of hidden and repressed inflation, and partly the creation of an inner debt against capital, nature, infrastructure, and so on.

Some effects of the declining growth capacity of economy were hidden, but they have emerged clearly in the 1980s. The decentralization of decision making during perestroika negatively affected the centralized allocation, which was ineffective but at least consistent. Decentralization and macroeconomic policy could not create positive results without solving the problem of "fuzzy" property rights. Problems connected with the insufficient legal framework, the creation of which might be even more important than policy, have been discussed in Brenner (1990).

CENTRALLY PLANNED ECONOMIES AND INFLATION

Unfortunately, there is a common belief among Western economists that centrally planned economies have had lower inflation rates, which they believed implied that a government with particularly strong power would not choose inflation as a means of raising additional resources (see, for example, Goodhart 1989: 44). In the case of Czechoslovakia, they even talk about "monetary virginity."

These authors do not consider hidden and repressed inflation, as in Klaus (1989). The core of the problem is that we must look at the cost of inflation and not at the inflation rate itself. Inflation is likely to be far more costly than simple considerations of the welfare loss on money balances suggest, as in Garfinkel (1989). Communist economies were subject to situations where individual prices and the price level did not react to excess demand because of fixed prices. Prices, in fact, did not fulfill the allocative function. Costs of hidden and repressed inflation are not very often mentioned in the literature, and it would be useful to repeat them here.

The inflation processes in the East and West had one main difference. In the West, particular markets (for food, cars, electronics, housing, etc.) were in equilibria; in the East, they were not. Microeconomic disequilibria suspended competition; in these markets, even "lemons" were tradeable. Typical reactions of suppliers have been to lower the quality, narrow the production assortment, offer bribes, and ration. This was relatively easy because there was no free entry, and most firms were monopolists. However, both consumers and producers were facing high search costs and the term "hoarding" accurately describes their behavior.[9]

But what many economists evaluate as the main dangers are indirect (behavioral) effects of hidden and repressed inflation: The behavior of agents differs from their behavior in the partial market equilibrium. Missing is the connection between the income and the purchasing power, as goods are simply not available in the appropriate quantities and/or assortments. Disequilibrium and hidden and repressed inflation increase uncertainty for a producer, who does not know the goods' prices or whether the inputs will be available.

In Czechoslovakia, as in other Comecon countries, this condition reduced all long-term activities: Firms followed short-term benefits, households preferred consumption to savings.[10] What is substantial is the fact that the behavioral defects cannot be removed very quickly.

It is not necessary to emphasize that such a broadly defined inflationary development is not solvable with macroeconomic tools, which can only slow down the conversion from hidden and repressed inflation to an open inflation during the adjustment process. Partial disequilibria cannot be removed by cutting aggregate demand without associated supply-side improvements. (Straightforward price adjustments could be in some cases socially unacceptable.) During the transition period, the increase of the price level could be driven partially (in the case of accommodative monetary policy) and almost entirely (in the case of non-accommodative policy) by the adjustment of relative prices rather than aggregate price changes.[11]

The purpose of the previous sections has been to show the current state of affairs in Czechoslovakia and their institutional background. Comments on inflation should emphasize that Czechoslovakia might face, at the beginning of its transformation, more problems than are visible from crude macroeconomic figures.[12]

CHANGES IN FINANCIAL INSTITUTIONS

The basic assumption underlying the process of sharp transformation is that in the background are the necessary institutions. The core of the transformation is unmistakably the privatization of the economy. Nevertheless, there is one crucial institutional task that has a strong connection to monetary economics: the creation of a sound banking and financial system. Accordingly, this feature could cause even more problems than privatization. A sound financial system is the precondition for future growth and its absence will cause stagnation. A period of three years to create a normal, functioning system of commercial banking does not seem long enough.

Until the end of 1989, the Czechoslovak banking sector was functioning under the monopoly of the state bank. Since 1950, this bank (a monobank) had fulfilled the role of a central bank as well as the role of commercial banks. There were some specialized banks, such as the Czechoslovak Trade Bank, a stock company (shareholders were domestic foreign trade companies and the state bank), and two very small, state-owned banks—the entrepreneurial bank, which provided foreign exchange payments for domestic households, and the investment bank, which managed securities owned by Czechoslovak households (mostly shares and bonds bought before World War II).[13] The last two banks played only a fringe role in economic life. The great monopolistic thrift institutions, Czech and Slovak saving banks, received deposits at fixed interest rates and lent them to the monobank. This system constituted the entire banking structure until the end of 1989.

Readers may find useful a short review of the basic features of that system:

1. Complete monopolization of the system, aimed at certain customers and certain sorts of banking services. (This is not the same as specialization based on economies of scale.) The banking sector was serving as a centralized redistributor of financial claims and was not providing the role of financial intermediation.
2. Low endowment of equity capital as the state budget guaranteed all credits and deposits, and the state banks could not fail.
3. Huge amount of credits with default (credit) risk, many of them being without term to maturity.
4. Insufficient volume and quality of banking services and the low density of branches.
5. A low number of employees (approximately five or six times less than in West Germany).

The first step was the transformation of the monobank into a system of a central bank and commercial banks. The idea was to establish competition in the banking sector and create a space for macroeconomic policy for the state bank.

There is nothing special about the central bank. The state bank should simply provide a very prudential, non-accommodative monetary policy. The likely intermediate targets are a zero rate of growth of real money supply[14] intervention to stabilize the exchange rate.

The assets and liabilities of the monobank that are not necessary for the future central bank have been split between two newly established, state-owned commercial banks and an enlarged investment bank. These intermediaries were created as universal banks. During 1990, some independent banks were also established. The new, state-owned banks suffer from the heritage of the previous monobank, and the independent banks suffer from a weak network and a lack of skilled employees.

The main brake on the unexpectedly slow development within the banking sector is the inconsistent legal framework for establishing and running new banks, bureaucratic barriers to entry and, above all, technical difficulties and low capital endowment. Even the current state of infrastructure does not allow for the creation of a modern bank. One possible solution, which has been widely used, is the creation of joint ventures with Western banks, especially from Germany, Austria, and France. This should shorten the way, both in terms of technology and retraining.

Can an economy be privatized without knowing the market prices of shares? How will these shares be traded after the first allocation through vouchers? Should the vouchers be neutral to the government budget? What about the inflationary impacts of this process? How will the central bank maintain its targets without open market operations? Most of these questions will be answered by practical experience in the very near future; however, we see that problems the banking system is facing create one of the bottlenecks of the transition.

ECONOMIC POLICY IN THE TRANSITION: SOME ASPECTS

There are no doubts about the definite aims of current policy: to realize the transition from a centrally planned economy to a market economy. Czechoslovakia wants to achieve the transition from a state-dominated economy to an economy based on private initiative and private property. In a short period of time, Czechoslovakia would like to be a member of the European Community.

There are few doubts about the appropriate instruments for achieving this. The instruments will be touched on later, but let us briefly mention the conditions. The reform process must build and maintain new political and social consensus within the society and, at the same time, break down the old, unproductive, and collectivistic social contract. All measures should minimize the cost of restructuring the system in terms of growth, employment, and inflation. At the same time, the government must both maintain the credibility of the reform process and not cross the tolerance limit of the population.[15]

Another important fact to be mentioned is the external environment. Most projections of the speed of the transition suppose that the economic growth rate as from the middle of 1980s will continue. Furthermore, the disintegration of Comecon and the general decline of foreign trade among these countries will require an opposite increase in trade with developed countries. What is demanded is thus both free entry to foreign markets and foreign direct investment. There are strong incentives for Western politicians to ensure this, and it seems that many of them do appreciate this challenge. If reforms in the East should fail, it will affect the West as well because it would create a new center of instability.

Until now, we have not paid attention to the foreign exchange transactions and to the balance of payments. Czechoslovakia is sharply distinguished from the other Comecon countries by its low level of international debt; the U.S. $8 billion debt at the end of 1990 is easy to support at current export levels. The reform blueprint does not expect a rapid increase of that debt. Economic programs should be supported by foreign direct investment, and convertibility should be maintained using standby credit from the International Monetary Fund (IMF).[16] The example of Polish foreign debt and hyperinflation is probably a sufficient warning to its neighbors.

Both final and intermediate targets are known, and there are no substantial doubts about appropriate policies. Authorities, at the same time, know the necessary conditions. Is there any problem?

One may say that the main issue is proper sequencing. For example, is it useful to liberalize all prices at a time when the huge majority of firms are state owned and, above all, while most of them are monopolies? Is it necessary to liberalize foreign trade? And if so, how will that influence the balance of payments? Or, should privatization of the whole economy precede price liberalization?

There are, however, no definite answers and no advanced prepared patterns. Managing these issues will demand careful, up-to-date measures in both the macroeconomic and institutional frameworks. Let us focus on some of them.

The general task is to replace the above-described microeconomic policies with real macroeconomic policy, in other words, the transition from discretionary government interferences to rules. The main and immediate task is to reduce inflationary expectations[17] using prudent and restrictive macroeconomic policy. In presenting a surplus budget for 1990 and zero-growth monetary target, the government has indicated the importance it attaches to the control of inflation.[18]

These measures, however, would not be very successful in the long run if the current institutional framework is preserved. Enterprises would continue to operate in an environment where competition is lacking and would take advantage of their strong bargaining positions, and simply do "business as usual." More sophisticated macroeconomic policies demand institutional changes, including the changing role of the state. The standard reform program falls then into two parts: (1) a package of measures that should be undertaken promptly and simultaneously, since sustaining success in some areas will be heavily influenced by progress in others; and (2) a set of longer-term policy and institutional changes that are needed to complement the initial stage.

There is a common agreement that the first package, which should be introduced as soon as the necessary preparation can be made, should include:

1. Price liberalization, covering a wide range of domestic prices of all goods that are produced under reasonably competitive conditions. It is very likely that some basic (and politically sensitive) prices will be controlled or subsidized. Total coverage of goods initially affected by the price regulations, however, will amount only to 15 percent of total output.

2. Limited convertibility within the current account for domestic residents for the Czechoslovak *koruna*. This includes the liberalization of merchandise exports and imports, free repatriation of profits, and other current account operations, as well as the establishment of a unified exchange rate responsive to supply and demand.[19]
3. An adequately financed social safety program (a "social safety net") is required to meet the needs of individuals who become unemployed or otherwise suffer as a result of the adjustment process. Approximately 50 or 60 percent of the employee's wage ought to be guaranteed. This budgetary expense would have to be constrained by both the balanced budget and the need to encourage labor force mobility.
4. State-owned enterprises should be commercialized and an incentive system for managers should be introduced. The attitude of "business as usual" must not continue. Forcing firms into a certain level of financial discipline could help reduce inflationary pressures limiting both interenterprise loans and unofficial wage bargaining.
5. Foreign direct private investment should be encouraged, particularly in joint ventures, as Western firms are afraid to do business without using "insider" information.

The above items were the basic measures that could be promptly introduced. Legal preparation had been made mainly in 1990 and the package was started on January 1, 1991. These steps must be implemented even if there is a risk of insufficient legal framework and lack of institutions.

The second package should cover privatization, the changing role of the state, and restructuralization, or even the creation of institutions and governmental authorities that are necessary for a market economy. One can see that there is a reliable pattern for these changes—the developed economies and the IMF's advice. The remaining part of this package contains long-run policies that must support the supply side of the economy. These include energy and a foreign trade strategy, as well as development programs for agriculture.

A majority of economists believe that it is impossible to leave these roles entirely to the market because ours is not a competitive market, and the risk of market failure seems to be very high. On the one hand, the economy needs competition, which could be started by dividing state-owned monopolistic firms. On the other hand, some small firms would not be able to exploit economies of scale and distribution networks. These longer-term policies with microeconomic dimensions must be extremely flexible and allow for discretionary measures.

Let us again focus on monetary and fiscal policy.

Fiscal Policy

Balanced fiscal accounts or, at least, sustainable deficits are an important precondition for successful transition. Czechoslovakia should not start with contractionary stabilization policies. In 1990, it reached a small surplus of about 1 percent of net material product. However, the radical transformation, especially the separation of enterprises from the budget and the redistribution of functions between the state and the private sector, will result in huge shifts in budgetary accounts. A part of these shifts is due to the attempt to strengthen the confidence of the public by "making the budget clear."

On the revenue side, the government is going to lose direct access to profits of privatized firms, and the private firms' taxation is likely to be initially lower. However, one can expect wage increases in the private sector, both because of its desire to attract skilled labor, and the likely lack of hitherto freely provided or subsidized collective consumption: health and education services, prices of some necessities, and so on. Generally speaking, wages are expected to rise, and profits may be low in the initial years. For these reasons, the share of taxed enterprise profits and cooperative income taxes in total revenue is likely to decrease, while the share of payroll taxes can be expected to increase.

On the expenditure side, considerable funds must be spent on infrastructure, on modernizing the obsolete facilities in the public sector, and last, but definitely not least, on reducing environmental damage. There have been large cuts in direct subsidies, which amounted to 16 percent of the net material product (NMP) in 1988, but the social safety net costs are expected to rise as unemployment increases.

On the threshold of the transition process, it is difficult to predict the net fiscal outcome of all changes. Much will depend on the speed of reforms and public economy programs, as well as on the emergence of a strong private sector and foreign direct investment. The enormous risk that the budget will come increasingly under pressure, which will result in monetized deficits and, finally, inflation, can be avoided with a prudent expenditure policy and the introduction of new tax measures. These measures should emerge in the tax reform, which will come fully into operation in the mid-1990s.

Monetary and Credit Policy

The challenge of implementing sound monetary policy—regardless of the prewar tradition—is non-trivial for several reasons. First, the banking system, in the beginning of the 1990s, is not capable of moving from a system of direct credit allocation to one of indirect allocation based on interest rates, reserve requirements, and open market operations. Second, a delicate balance must be sought between supporting positive supply reactions, demanding loans—especially by private and privatized firms—and excessive credit and liquidity expansion. Third, monetary authority will have to distinguish between changes in the aggregate price index, as a result of relative price adjustments, and real inflationary pressures, either from the "demand-pull" or domestic "cost-push" sides or resulting from exchange rate devaluations (See Hafer 1989).

For the next few years, until a modern banking system emerges, monetary policy will be executed using both indirect measures and commands. First, the authorities intend to keep domestic credit expansion in real terms within the range of -2 percent to 1 percent and, at the same time, the state bank will maintain the discount rate so as to make it positive in real terms.

Second, the directive measures consist of maximum limits on refinancing (discount) credit for each bank, prudent ratios of reserves to total assets, and of outstanding medium- and long-term loans to corresponding deposits. All banks have to raise their required reserves with the state bank and inform it when loans to one client exceed a certain level, which will be subject to change, or when its total exposure to one client exceeds 50 percent of the capital and reserves of the bank. All commercial banks will be asked to increase their equity capital/total assets ratio by an agreed date. The extensive use of "gentlemen's agreements" between commercial banks and central authorities is also expected. In fact, the authorities have little choice but to continue, initially, to intervene directly in credit allocation in order to balance concerns over inflation and supply responses. Rationing in credit markets must be phased out as the commercial banking sector develops.

The advantage of relatively large voluntary household savings will be supported by increasing the interest rates and widening savings opportunities. In the past, Czechoslovakia has not suffered from the aggregate and/or lasting imbalances in consumer markets. Partial and temporary shortages (revealing repressed inflation) did arise, but there was always a possibility of substitution.

Nevertheless, we may be concerned about the reaction of the population. Once prices have been liberalized, extensive dissaving could disorganize all markets. A combination of positive interest rates, new incentives for saving, and a prudent wage policy should prevent an extensive demand push. Because the population expects substantial structural unemployment, one may anticipate a cautious approach to consumption.

A part of monetary policy will also be exchange rate management. The establishment of limited convertibility of the *koruna* (liberalization of buying and selling foreign exchange for current account transactions and a unified exchange rate) should provide the main information for export and import activities. The government intention is to intervene on the market to limit fluctuations outside of the specified range of a real exchange rate (especially in the case of rapid depreciation of koruna) to avoid sending confusing signals to producers as well as to reduce additional inflationary pressures. These measures require, of course, substantial reserves and stand-by credit, in the short run, and the rapid improvement of the foreign trade performance in the medium term, which would help to ensure an adequate supply of foreign exchange in the interbank market.

CONCLUSION

The purpose of this chapter was to show the current state of affairs in Czechoslovakia, the background of recent developments, and the macroeconomic design of future changes. Czechoslovakia wants to realize the transition from a centrally planned economy to a market economy and, in this respect, the reform intentions and instruments are quite clear and "standard." Leading reformers do not want to repeat the mistakes from previous reform attempts by introducing some hybrid system between central planning and a market economy.

This chapter showed both internal and external preconditions of the successful transition and some reform traps and weak spots at the macroeconomic and institutional levels that might be hidden from outsiders. Special attention was paid to monetary and fiscal policy and institutional changes. In the last section, the main measures that are expected to be implemented in those areas in the short and medium term were discussed.

NOTES

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1. The price system existing for the last forty years was based on average, instead of marginal costs. The most visible example of it was the exchange rate system; the exchange rate was set according to the average cost of producing U.S. $1 of output within the Czechoslovak exporting industries. A first-year student can define the resulting misallocation.

2. Monetary measures simply played the passive, accounting role, and the economy, at least in certain parts, functioned as a barter economy.

3. We will use net material product (NMP), the most widely used measure in Comecon countries, which is close to the national income. The use of NMP was mainly the result of the communist ideology that services of almost all kinds are unproductive and do not add value. So banking services, hairdressers, computer services, cabdrivers, and so on were excluded from the economic measurement of a country.

4. In the late 1980s only, direct subsidies for food (negative turnover tax) were almost 10 percent of total expenditures. In other words, 7 percent of the net material product was redistributed for these purposes.

5. We could quote other differences between the monobank and both the central and the commercial banks of market economies that were reflected, for example, in the structure of the balance sheet. For technical details, see Garvy (1966).

6. The tradition of non-inflationary growth, at least regarding open inflation, has been already presented. Sargent (1982) gave a historical explanation for it: Czechoslovakia never experienced a period of hyperinflation or even galloping inflation, and the development in the early 1920s is an excellent example of deflationary postwar recovery. The presence of these ideas in the 1980s is an example of this prewar intellectual heritage.

7. One may prove, on empirical evidence, quite different interest rate elasticities of money (credit) demand between these sectors. In previous decades, a firm's demand showed an elasticity near zero. This led to a significant problem with macroeconometric modelling, and models with explicit money measures were rare (see Brada, King, and Schlagenhauf 1981). Usually, only particular parts of the economy were modelled, such as the foreign trade sector or household sector (see Portes and Winter 1978). In fact, only households behaved in this standard manner.

8. There was, on the other hand, significant and rapid comparative decrease in economic performance, measured in U.S. dollars, of gross domestic product per capita. There are several publications that show very wide ranges of estimates depending on the employed methodology. In all cases, the relative decrease as compared with OECD countries is obvious (see Marer 1985; Havlik 1985).

9. The final outcome is not surprising—the overvaluation of macroeconomic data. In reality, we should subtract about 2 to 3 percent of hidden inflation per annum from NMP growth rate. Also, consumer satisfaction declined. It is intuitively understandable that in particular sectors, these defects have displayed different intensities. The estimates of hidden inflation rates in the machinery

sector were completely different from that of construction (25 and 10 percent per year, respectively). Similar examples from the Soviet Union have been presented (Legget 1981).

10. Rates of savings (household savings/disposable income) fluctuated between 2.9–4.4 percent per year in the 1970s and 1980s, which is less than in the United States and OECD countries. In 1989 and 1990, this rate was close to 2 percent, excluding savings abroad and capital investment.

11. There could be an objection that when the aggregate income remains unchanged, due to prudential monetary and fiscal policy, inflation could never evolve. This is not quite true, as there is the possibility of dissaving, which depends on inflationary expectations. Also, additional income can be raised by selling property (land, houses, antiquities, etc.) to foreigners. In the transition period, there can evolve purely statistical problems. For example, new products enter the market, leading to shifts in weights in the price index that could make it non-comparable with previous calculations. Or different goods may have different price elasticities, which could result in further shifts in weights if major relative price changes occur.

12. Minister of Finance Vaclav Klaus, in his keynote address to the annual meeting of the International Monetary Fund in April 1990, said that "sometimes we are not sure whether the current economic situation is in reality an asset or a liability" (Klaus 1990).

13. The entrepreneurial bank (*Zivnostenska banka*) was the most important Czechoslovak bank before World War II. The name of the bank was preserved, in fact, only because it has had the branch and building in London. The investment bank was created in 1949, and up to the middle of the 1950s, it managed the credit rationing for investment. After the takeover of this agenda by the state bank, the investment bank was preserved without any economic reason, since its latter agenda could have easily been managed by any other bank.

14. The growth rate of nominal money supply was set at 3 percent in 1990 due to an expected increase in velocity (10%), decrease of real output by 3 percent, and expected inflation of 15 percent. The equation of exchange expressed in rates of growth ($gM + gV = gP + gQ$) had then the following figures ($3 + 10 = + 16 - 3$) in 1990, where gM = growth rate of the nominal money, gV = growth of velocity, gP = inflation rate, and gQ = growth rate of real output.

15. It is obvious that those limits are quite different from the limits facing the Polish government. According to polls, inflation of over 40 percent and unemployment over 10 to 15 percent for more than two years seem to be unacceptable in Czechoslovakia. The unemployment target for 1991 was even set at a 5 percent level.

16. To achieve this can be a difficult task. Rising oil prices, cold winters, or bad harvests could create very strong pressures on the stability of the balance of payments. The balance of payments is targeted at the U.S.$2.5 billion deficit in 1991, and the external debt is projected to be about U.S.$12 billion, or 37 percent of the GDP.

17. Similar dangers could be created via devaluation expectations; the public would not save in domestic currency and would hoard foreign exchange and/or deposit it in foreign banks (see Mejstrik 1991).

18. The risk of cost-push inflation has increased with the lifting of controls over private sector wages and prices, which is an important element in the policy to promote the expansion of the private sector. In the short run, the need to control cost-push inflation in a disequilibrium economy may justify the continuation of some form of wage control (for example, setting an indexing rule for an increase in enterprise wage bills) and price control both in the state sectors and in the markets for "necessities." Such a system must, however, be seen as temporary.

19. The old system used at least two kinds of exchange rates, one for commercial transactions and another for tourist purposes. The second one was significantly higher, partly because it served as a "tourist tax" and partly because it reflected the different price levels within the consumer and production sectors. Both exchange rates were unified by the end of 1990.